EMPLOYEES' INCENTIVE SHARES IN SINGAPORE: SOME TAX CONSIDERATIONS

I. *INTRODUCTION*

Incentive shares are shares issued or given to employees to allow them to participate in the equity of the company concerned. The rationalisation behind incentive shares is the philosophy that those who really contribute to the prosperity, growth and welfare of a concern ought to have some interest in its enhanced equity. There are, of course, considerable pecuniary and tax advantages involved as well, and some of these will be pointed out in the course of this article. It is outside the scope of this brief contribution to look in detail at the forms and administration of incentive share schemes, and it is proposed instead to consider some taxation and tax planning aspects relating thereto, with reference especially to section 10(5) of the Singapore Income Tax Act.[1]

It may be convenient at this stage to refer briefly to the relevant statutory provisions of the Income Tax Act which may apply to incentive shares.

The taxability of incentive shares may fall under two distinct charging provisions. They may come under section 10(1) *(b)* as "gains or profits from any employment": which phrase is by sub-section (2) defined to mean, *inter cilia,* any "perquisite or allowance... paid or granted in respect of the employment whether in money or otherwise". In *Comptroller-General of Inland Revenue* v. *Knight*,[2] the view was expressed that "paid or granted in respect of the employment" meant paid or granted in respect of services rendered or to be rendered. "Perquisites" are any advantages or benefits granted to employees,[3] while the word "allowance" has been said elsewhere to derive its meaning from its context rather than having its own special signification. Thus, of the word as it occurred in section 26(*e*) of the Income Tax Act of Australia Dixon J. remarked:[4]

> "Allowance" is one of the many words which take their meaning from a context rather than affecting or controlling the meaning of other words of the context in which they occur. For, considered alone and at rest rather than at work with other words, it means the allowing of a thing or a thing allowed. It is only by its application that you discover the kind of thing in mind.

Though the manner in which "allowance" is employed in section 10(2) *(a)* is as yet uncertain, a liberal view is that it is any payment, reward or benefit over and above the agreed salary. Referring to section 3 of the Australian Payroll Tax Act, 1941, which defined

[1] Cap. 141, Singapore Statutes, Rev. Ed. 1970.
[2] [1973] A.C. 428.
[3] *Per* Lord Pearce in *Pook* v. *Owen* 45 T.C. 571 at p, 592.
[4] In *Mutual Acceptance Co. Ltd.* v. *F.C.T.* (1944) 69 C.L.R. 389 at p. 402.

"wages" to mean "any wages, salary, commission, bonuses or allowances paid or payable (whether in cash or in kind) to any employee as such", Dixon J., as he then was, said:[5]

> The next word "allowance" seems to me naturally to follow as an attempt to make sure that any other kind of gains or reward allowed or conceded by the employer to the employee for his work is brought within the definition .... [It] is intended to cover any payment beyond this agreed salary of the employee for services rendered by him.

In *Inland Revenue Commissioner* v. *Parson*,[6] Haslam J., on such a liberal construction of the word, treated rights to purchase shares on advantageous terms as "allowances" within section 88(1)*(b)* of the Land and Income Tax Act, 1954 of New Zealand, which included as the assessable income of a person "all salaries, wages or allowances (whether in cash or otherwise), including all sums received or receivable by way of bonus, gratuity, extra salary, or emolument of any kind, in respect of or in relation to the employment or services of the taxpayer...."

It is unresolved in Singapore whether such a wide interpretation should be accorded to "allowance" in section 10(2)*(a),* or whether it should be more conservatively dealt with as referring only to a payment of money, more or less arbitrary in amount, whether regular or otherwise, to an employee to cover particular purposes or expenditure related to the employment. Examples would be: subsistence, travelling, conveyance or entertainment allowances, had they not been expressly excluded from the charge, if certain conditions are satisfied.

Section 10(5), which was inserted by section 3(*b*) of the Income Tax (Amendment) Act, 1973 to take effect from the year of assessment 1973, is the other material provision, and reads thus:

> Any gains or profits directly or indirectly derived by any person by the exercise, assignment or release of a right or benefit whether granted in his name or in the name of his nominee or agent to acquire shares in a company shall, where the right or benefit is obtained by that person by reason of any office or employment held by him, be deemed to be income and for the purposes of this subsection —
>
> (*a*) such gains or profits shall be the price of the shares in the open market at the time of the exercise, assignment or release of the right or benefit less the amount paid for such shares;
>
> *(b)* if it is not possible to determine the gains or profits under paragraph (a) of this subsection, the Comptroller may use the net asset value of the shares, less the amount paid for the shares, as the basis for determining the gains or profits; and
>
> (*c*) "shares" includes stocks.

Employee participation in the equity of a company may be achieved in several ways, each of which may give rise to different tax considerations, and they will be discussed in the following order:

(1) gifts of shares; and

(2) share option schemes and share incentive schemes.

[5] *Ibid*., at p. 403.
[6] 10 A.I.T.R. 557.

Incentive schemes are of various kinds. They may be, for example:

(i) partly paid share schemes;

(ii) trustee loan schemes; and

(iii) trustee purchase schemes.

II. *GIFTS OF SHARES*

The taxability of gifts made to employees depends on whether they are given by virtue of their employment or with reference to services rendered, in which case they are chargeable as profits or income of the employment, or "on personal grounds". As McTiernan J. observed in *Federal Commissioner of Taxation* v. *Dixon*[7] in relation to a very much wider charging section of the Australian Income Tax Act there applicable[8] than section 10(1)*(b)* and (2), the employment contract is not so total and extensive as to exclude social and personal relations, so that the fact that the employee, had he not been an employee, would not have received the gift is not decisive on the question of taxability. The distinction between gifts which are taxable and those which are not is very clearly brought out by Kitto J. in *Squatting Investment Co. Ltd.* v. *Federal Commissioner of Taxation*,[9] where the learned judge surveyed the English gift cases and observed:[10]

> The distinction those decisions have drawn between taxable and non-taxable gifts is the distinction between, on the one hand, gifts made in relation to some activity or occupation of the donee of an income-producing character, such gifts being variously described as accruing to the donee in virtue of his office *(Herbert* v. *McQuade* [1902] 2 K.B. 631, at p. 649), or as remuneration *(Beynon* v. *Thorpe* (1928) 14 T.C. 1, at p. 11; *Seymour* v. *Reed* [1927] A.C. 554, at p. 559), or in respect of his past services *(Beynon* v. *Thorpe, supra,* at p. 14), or substantially in respect of his services *(Blakiston* v. *Cooper* [1909] A.C. 104, at p. 107); and, on the other hand, gifts referable to the attitude of the donor personally to the donee personally, such as those which have been called mere gifts or presents made to the donee on personal grounds *(Seymour* v. *Reed, supra,* at p. 559), mere donations *(Stedeford* v. *Beloe* [1932] A.C. 388, at p. 391), gifts moved by the remembrance of past services already sufficiently remunerated as services in themselves *(Beynon* v. *Thorpe, supra,* at p. 14), payments peculiarly due to the personal qualities of the particular recipient, or personal gifts as marks of esteem and respect *(Blakiston* v. *Cooper, supra,* at pp. 107, 108).

The taxability of gifts of shares was considered by the High Court of Australia in *Hayes* v. *Federal Commissioner of Taxation*[11] and the above distinction and principle were applied. The taxpayer was originally engaged as a full-time accountant and financial adviser in the business of Mr. R. In 1942, he ceased to be a full-time employee but practised as a public accountant and secretary. Some two years later, on the advice of the taxpayer, R. sold his business to a proprietary company, three-fifths of the shares in which were taken up by the taxpayer and others. Hence R. ceased to control the business. The taxpayer became a director and the secretary of this company. As a result, business deteriorated. In 1947, R. agreed to resume

7 *Federal Commissioner of Taxation* v. *Dixon* (1952) 5 A.I.T.R. 443.
8 Section 26*(e)* of the Australian Income Tax Assessment Act.
9 (1954) 5 A.I.T.R. 496.
10 *Ibid*., at p. 524.
11 *Hayes* v. *F.C.T.* (1956) 6 A.I.T.R. 248.

more active control of the business on condition that the other shareholders should sell their shares to him, and all complied, though the proposition was initially fiercely resisted by the taxpayer. The taxpayer ceased to be a director but continued as secretary. Business prospered again, and in 1950 a public company was incorporated to acquire the whole of the share capital of the proprietary company. The taxpayer acted as secretary of the public company. Later in the same year, R. considering that he had realised this life's ambition as the founder of a large business made gifts of shares in the public company to his sons, the taxpayer, another person and trustees for the employees of the proprietary company. Evidence was led to show that the taxpayer, R. and their respective wives were personal friends who frequently exchanged social visits. On numerous occasions, R. received informal advice on various aspects of his activities from the taxpayer. It was established also that the taxpayer was adequately remunerated as an employee of R's business and the companies. At an interview in the taxation office, R. signed a statement to the effect that the shares were given to, among others, the taxpayer in recognition of past services and as an inducement for good service in the future. Notwithstanding this, Fullagar J. decided that the shares, given as they were on personal grounds, were not a product or incident of any income-producing activity of the taxpayer, hence their value could not be considered as income in ordinary parlance. Consequently, their value was also not assessable under section 26(*e*) of the Income Tax Act there considered, which charged to tax:

> the value to the taxpayer of all allowances, gratuities, compensations, benefits, bonuses and premiums allowed, given or granted to him in respect of, or in relation directly or indirectly to, any employment of or services rendered by him, whether so allowed, given or granted in money, goods, land, meals, sustenance, the use of premises or quarters or otherwise.

A similar conclusion was reached in England, where the charging provisions extended to "salaries, fees, wages, perquisites or profits whatsoever" from an office or employment of profit. In *Bridges* v. *Bearsley*,[12] a gift of shares was made by two directors and shareholders in a company to two other directors. The donors were the sons of the founder of the business, who had intimated that he would leave shares for the donees who had greatly assisted him in building up the company. However, the founder died leaving his holding of shares upon trust for his widow for life and after her death, for the donors. To rectify the omission of their father and to fulfil what the donors considered his moral obligation, they agreed to transfer blocks of shares to the donees on the death of their mother, at which time the shares would fall into their possession. In the agreement drawn up, the transfer was expressed to be made in consideration of the donee continuing his engagement with the company for a further four years, and the agreement recited that the donor desired to mark his appreciation of the past services of the donee. The Court of Appeal held that the shares were not within the charging provisions, because they were personal gifts or testimonials. Their Lordships thought it important that the employer was not a party to the deed; that the shares might, under the deed, be transferred after the directors had ceased to hold office; and, though the transfer was expressed to be conditional on their staying in office, the directors were fully re-

[12] 37 T.C. 289.

numerated by the company, apart from the gifts. On the point that the transfer was expressed to be in consideration of past services, Morris LJ. had this to say:[13]

> It seems to me that a payment which has the attributes of being a personal gift does not necessarily lose those attributes merely because the gift is in recognition of services or because the donor agrees to bind himself so as to be compellable at law to make the payment.

A case decided the other way is *Patrick* v. *Burrows.*[14] Here 2000 shares in a company were transferred by a director of the company to trustees upon trust for such of its employees from time to time as the directors for the time being might select, "the intention being that the said shares shall be available for distribution amongst any of the said employees of the company to whom the directors may from time to time deem it expedient to give an interest or an increased interest as shareholder in the company in consideration of past or future services and with a view to promote the prosperity of the company." The trustees were the other directors of the company. Two hundred and fifty shares were subsequently transferred to Mr. Burrows, and Winn-Parry J. decided that these shares were assessable, because the deed made it clear that they were received by the tax-payer by virtue of his employment. The learned judge construed the gift in this way:[15]

> As I read that clear language it comes to this: in order that a person should be qualified to receive a transfer of any shares he must first be an employee of the company and not a director, and he must be a person to whom the shares are given because it is considered that by doing so it will give him an increased interest; and the transfer is made in consideration of past or future services, the ultimate object being the prosperity of the company. It seems to me that those words essentially link the receipt of any of this block of shares with the position of employee with the company, that is, with his office or employment.

The distinction between gifts which are given in virtue of the employment and those which are conferred on personal grounds, is easy to state but difficult to apply, as evidenced by the cases in this area. Each case must be determined on its own particular facts, and generalisation from one to another is best avoided. However, the following observations may not be inappropriate:

(1) The intention of the employer in making the gift is relevant,[16] and this must be gathered from the circumstances surrounding the gift.[17] Needless to say the *expressed* intention could hardly be conclusive because it may be specious. As MacNaghten J. said with regard to gifts made by a bank in accordance with its custom to its employees who had completed twenty-five years' service:[18]

> But the employer, for the purpose of assisting an employee whom he does in fact remunerate for his services, cannot relieve his employee from his obligation to pay income tax by saying: "I do not intend it to be remuneration."

[13] *Ibid.*, at p. 320.
[14] 35 T.C. 138.
[15] *Ibid.*, at p. 142.
[16] See Lord Reid and Lord Hodson in *Laidler* v. *Perry* [1965] 2 All E.R. 121.
[17] *Brumby* v. *Milner* [1975] 2 All E.A. 773. See *infra,* pp. 47-49.
[18] *Weston* v. *Hearn* 25 T.C. 425 at p. 428.

(2) The regularity of gifts made is significant. This factor assisted both the Court of Appeal and the House of Lords in upholding the assessment on the gifts made in the case of *Laidler* v. *Perry*.[19]

(3) If an employee's contract of employment entitles him to receive the gifts, this is a very strong ground for saying that they accrue by virtue of his employment or by way of remuneration for his services.[20]

(4) The cases also show that gifts from employers to employees are more likely to be taxable than gifts made by third parties.

The question of the taxability of gifts of shares has not arisen in Singapore, but it is considered that the principles and considerations of the previously cited cases ought to be equally valid in this jurisdiction, because the issue here, as there, is the same (even if the actual charging words differ somewhat) — namely, whether or not gifts of shares made to employees are "gains or profits from any employment" within section 10(1) *(b),* the phrase being understood in its extended sense under subsection (2). Attention must, however, be drawn to the existence of additional provisions in the Singapore Income Tax Act, which have the effect of further expanding the concept of income in relation to employment where employees derive gains from shares. These provisions are contained in the new subsection (5) of section 10, which has already been reproduced. These provisions have not yet received judicial analysis, but nevertheless, their operation may be surmised, even if somewhat speculatively. It is clear from the tenor of the subsection that its purpose is to bring into charge gains or profits derived from shares obtained by employees by reason of their employment, whether this occurs through an exercise, assignment or release of a right or benefit to acquire shares. The point to bear in mind about gifts of shares is that they are intended to be held as an investment or to provide the donee with a stake in the company. Hence, unless a gift of shares can be caught by the words "exercise, assignment or release of a right to acquire shares", section 10(5) is irrelevant either when the shares are disposed of or when they have appreciated subsequent to the gift. The vexed question of taxability under section 10(5) must now be considered.

Usually a gift of shares is constituted by a transfer of the shares, and prior to this an employee would have no title or claim to them. In the normal case it will thus be difficult to imagine a gift of shares as conferring a "right to acquire shares". It may be that the words are descriptive of the sort of donation in *Bridges* v. *Bearsley,* where it will be remembered the gift was expressed to be in consideration of the donee continuing his engagement with the company for a stated period, and the court expressed the opinion that the framework of the agreement was intended to make it enforceable. It is possible that "a benefit to acquire shares" is intended to apply where no legal compulsion applies to the ability to obtain shares and if this be the correct interpretation, the phrase clearly extends to gifts of shares.

Obviously caution is warranted where employees are to be given shares, if the generosity is to be enjoyed without a corresponding

[19] 42 T.C. 351.
[20] *Per* Jenkins L.J. in *Moorhouse* v. *Dooland* 36 T.C. 1.

burden of tax liability. The gift should not be expressed to be in consideration of continued engagement or services, or conditional on the donee remaining in employment, because it may then be possible to contend that the benefit or right to acquire shares is obtained "by reason of any employment", within section 40(5). Where the objective is to retain the donee, it may be achieved by a separate service agreement, if none already exists.

Certain ancillary matters may be briefly mentioned here. A company cannot issue its shares as paid up if it does not receive the equivalent value in cash or in kind.[21] Hence a company cannot make gifts of its shares. There is, however, no prohibition against gifts being made of shares held by a company in another company. Thus shares are usually given to employees by either shareholders in the employer company or by the employer company of shares in another company. A company can, however, issue shares in return for services.[22] These courses of action can give rise to considerable problems in relation to deductibility, and will be considered in turn.

Gifts by shareholders

Where shares are given to employees by shareholders of the employer company, the usual taxation consequences would be that both the donors and the employer are not able to deduct the value of the gifts as expenses or outgoings wholly and exclusively incurred in the production of income so as to be allowable under section 14(1) of the Income Tax Act. The shares may have been given because the donors believe or are certain that the employees would then work harder now that they have an interest in the enterprise, thereby resulting in greater profitability. But the immediate beneficiary is the company, and only ultimately, if and when dividends are paid, can it be said that the shares given have produced income to the donors. For this reason the gift is insufficiently closely related to the production of the income of the donor. On this analysis the Comptroller may quite justifiably reject the donors' claim, and the company is also barred because it has incurred nothing. Such a conclusion has been reached in South Africa, where the deduction provisions are similar to those of section 14(1).[23] The fact that the recipients may be taxed on the value of the shares does not alter the position.

In exceptional circumstances, however, it is conceivable that the donors may be eligible for a deduction, as where an increase in the profits of the company results in greater income to the donors as a matter of course or right. This proposition has been established in India. In *Tata Sons Ltd.* v. C.I.T.,[24] the taxpayers were the managing agents of another company, and under the managing agency agreement the amount of the taxpayers' commission was dependent upon, and calculated by reference to, the profits of the managed company. The taxpayers voluntarily paid a sum as their contribution towards making a reasonable bonus for the employees of the managed company. It

[21] *Ooregum Gold Mining Co. of India* v. *Roper* [1892] A.C. 125.
[22] Section 54 of the Companies Act (Cap. 185, Singapore Statutes, Rev. Ed. 1970) recognises that shares may be issued for a consideration other than cash, and it stipulates certain conditions where this is the case.
[23] *N.* v. *Comptroller of Tax* 15 S.A.T.C. 270.
[24] (1950) 18 I.T.R. 460.

was held that the amount paid was deductible, its object being to increase the profits of the managed company by improving the efficiency of its employees, and thereby increasing the taxpayers own commission.

Admittedly the case was decided in relation to an amount paid, but the principle ought to be the same where assets are parted with, and for this purpose it is considered that a gift of shares (or assets) can amount to the incurring of expenditure or an outgoing. This was implicitly recognised in the South African decision of *N.* v. *Comptroller of Tax*,[23] and in *Tata Sons Co. Ltd.* v. C.I.T.,[24] it was accepted that expenses or outgoings are deductible even if voluntarily incurred. It must, however, be pointed out that the claim for a deduction by the donors should not be made in their capacity as shareholders, but as the owners of a source the production of the income from which may be increased by the shares given. The distinction is of practical importance, because the cost of the gift cannot be set against their dividend income.

Gifts by employer

A company which gives shares it holds in another company to its employees may claim a deduction in respect of the value of the gift if it can be regarded as expenses or outgoings wholly and exclusively incurred in the production of *its* income. The main difficulty here is to establish that the gift results or can result in greater efficiency of the staff, or is otherwise sufficiently closely connected with the company's own earning process.

Shares as remuneration

Difficulties have also been encountered where shares are issued as remuneration. Such shares may have been issued at par, and their market value may be considerably more. In *Lowry* v. *Consolidated African Selection Trust Ltd.*,[25] the House of Lords held that the difference was not deductible because even if the whole market value is taxable in the hands of the employees, the issue of the shares is not a trading transaction, and such a transaction does not involve the company incurring any expenses or outgoing. On the first point Viscount Maugham observed: "The issue of shares by a company, whether at par or over, does not affect the profits or gains of the company for the purposes of income tax."

However, there is another way of achieving the desired effect. An appropriate course is for the company to credit the employee with an amount equal to the market value of the shares as remuneration. This would amount to the incurring of expenditure,[26] and the debt could then be appropriated to subscribe for the shares. In this manner, the difference between the par and market values of the shares would in fact be deductible, if the remuneration is allowed.

The issue of shares to discharge a debt owing in respect of services performed would also not be an issue for a consideration otherwise than in cash, since the debt owing by the company is a

25 [1940] A.C. 648.
26 See *Elder-Smith & Co. Ltd.* v. *F.C.T.* (1932) 47 C.L.R. 478.

liquidated sum immediately payable which it has agreed should be employed to discharge the debt in respect of the shares.[27] As Sir W.M. James LJ. said:[28]

> If it came to this, that there was a debt in money payable immediately by the company to the shareholders, and an equal debt payable immediately by the shareholders to the company [for their shares], and that each was accepted in full payment of the other, the company could have pleaded payment in an action brought against them (*sic*) and the shareholders could have pleaded payment in cash in a corresponding action brought by the company against him for calls.

The significance of this is that under section 54(3) of the Companies Act, where shares are allotted as fully or partly paid up otherwise than in cash, then the company must deliver to the Registrar for registration the contract evidencing the entitlement of the allottee, or a certified copy of such where the contract is not in writing. If there is any default, every officer of the company who is in default shall be guilty of an offence, for which the maximum fine is $1000 plus a default penalty of $250.

III. *SHARE OPTION SCHEMES AND SHARE INCENTIVE SCHEMES*

The income tax legislation does not contain provisions for the approval of share incentive schemes, no doubt because these are not only rare but a relatively new experience in the Republic. It will therefore only be necessary to consider the taxation and tax planning aspects of such schemes.

1. SHARE OPTION SCHEME

An option scheme provides the framework within which a company may grant options to its employees, usually confined to its working directors and similar executives. The scheme will spell out in some detail the classes of persons who may be granted options, the total number of shares which the scheme comprises, the maximum entitlement of any single grantee, the time within which the options may be exercised and the subscription payable on such exercise. There may also be provided such other matters as it may be desirable to include.

An option confers on the grantee a right to subscribe for the shares comprised in the option at the price stated. When a consideration is stipulated for the grant, the option is irrevocable. In *Hilder* v. *Dexter*,[29] the House of Lords decided that a company may legitimately grant an option for valuable consideration to take any number of its shares of any class at any price equal to or greater than par. From the foregoing it will be obvious that share options can confer a considerable pecuniary advantage on the grantee. For instance, a grantee may acquire shares at par even if their market value may be considerably more.

There is no reported case in Singapore on the taxation of share options, but two separate provisions of the Income Tax Act must

[27] See *Spargo's Case* (1873) L.R. 8 Ch. App. 407.
[28] *Ibid*., at page 412.
[29] [1902] A.C. 474.

be looked at in this connection. In *Abbott* v. *Philbin*,[30] the House of Lords held that, where an option is immediately exercisable, the employee is assessable only in respect of the value of the right at the date of the grant. This value is the market value of the shares less their option price and the amount paid for the grant of the option. According to their Lordships, such a right is convertible into money because moneys can be raised on it, or it may be sold. For this reason, the option was held to be a taxable perquisite. This line of reasoning is appropriate to section 10(2) (a) of the Income Tax Act.

The decision leaves much to be desired from the point of view of the fiscus, because the gains from the *exercise* of the option are left out of account. Thus, where at the date of its grant an option has no assessable value in that under it the taxpayer can acquire shares at their then market value, no tax liability will arise. Yet such a right can be profitably exercised, as it was indeed in *Abbott* v. *Philbin.* Here the employee-taxpayer was granted an option to acquire shares at their then market value of 68s. 6d. per share in return for a payment of £20. At this date the option could not produce any profit even if exercised, and for this reason, it was decided that it had no assessable value, even if at a later date the taxpayer was able to exercise his option as to 250 shares when their market value at the time stood at 82s. per share, thereby deriving a profit of £166. Nonetheless, because the relevant time to ascertain if any profit accrued was, according to their Lordships, the time of the grant, the subsequent profits were not taxable.

According to the principle in *Philbin's* case, the following share options granted to employees do not attract income tax:

(1) an option to subscribe for shares at their market value at the date of the grant; and

(2) an option to subscribe for shares at a price greater than their market value at the date of grant.

A moment's reflection will show that in both situations, profits can be derived from a judicious exercise of the option. It is for this reason that section 10(5) was enacted. Two points relating to this subsection may first be considered.

The provisions of section 10(5) have apparently been drafted without sufficient regard for the rule in *Philbin's* case. More specifically, the subsection has not attempted to exclude the gains deemed to be derived from a grant of an option, taxable under the *Philbin* principle, from the computation of the gains and profits to be charged under the provisions when the option is exercised, assigned or released. This involves a very real threat of double taxation, which may be illustrated in this fashion.

Example: To show that the operation of section 10(5) may result in double taxation.

In January 1973, in return for $100 Abdul Bakar was granted an option to subscribe for 500 shares in

[30] 39 T.C. 82.

his employer company at their par value of $10 per share when their market value was $20. The *Philbin* rule would make him assessable to tax as having enjoyed a perquisite the taxable value of which would be $4900, computed as follows:

Market value of 500 shares at $20		$10,000
Less option value of 500 shares at $10	$5,000	
Amount paid for option	$ 100	$ 5,100
Assessable value under section 10(2)(a)		$ 4,900

In July 1974, Bakar exercised his option when the market value of the shares stood at $30, and by virtue of section 10(5), he would be treated as deriving an assessable income of $9,900, calculated thus:

Market value of 500 shares at $30 each		$15,000
Less amount paid for the shares	$5,000	
Amount paid for the option	$ 100	$ 5,100
Assessable income under section 10(5)		$ 9,900

Yet $4,900 of these gains would have been charged to tax when the option was granted.

There appears to be no way around the statutory language of section 10(5) to avoid this duplication of charge. Thus section 10(5) should, and could easily, be amended if this harsh and unfair consequence is to be avoided. It would be necessary only to add a new paragraph, which might read as follows: "any part of such gains or profits as ascertained in accordance with paragraphs *(a)* and *(b)* which have been charged under any other provisions of this Act shall be disregarded." Alternatively, if it is desired to exclude altogether the operation of the *Abbott* v. *Philbin* principle so as to make section 10(5) the sole provision governing the taxation of share option schemes, appropriate words could be inserted to state that no income shall be deemed to arise on the grant of an option.

However, with options which are transferable,[31] the above effect may be side-tracked by an assignment, if the grantee is prepared to allow another to exploit the option. He may be so willing if the assignee is his wife or relative. This possibility makes section 10(5) more or less ineffective, as may be illustrated by the following example.

Example: To show the ineffectiveness of section 10(5).

In June 1973, in return for $50 Abang Ahmad was granted an option to subscribe for 100 shares in his

[31] Normally employee share options are non-transferable and are personal to the grantee, the object being to prevent trafficking in options. This, however, would not preclude their chargeability under the *Abbott* v. *Philbin* principle because money can still be raised on it where the shares involved are valuable.

employer company at their then market value of $50 per share. The principle of *Abbott* v. *Philbin* would be applicable to such a grant, and hence no liability to tax would arise.

A month later, Ahmad assigned the option to his wife for $50 when the market value of the shares was the same. Though this was clearly an assignment of a right to acquire shares obtained by reason of his employment, Ahmad had not derived any gain thereby. Hence section 10(5) could not be invoked.

At the end of the year Mrs. Ahmad exercised the option when the market value of the shares had climbed to $70 per share, earning herself a profit of $1,950, computed in this way:

Market value of 100 shares at $70 per share		$7,000
Less Amount paid for the shares	$5,000	
Amount paid for the right	$ 50	$5,050
Profit		$1,950

In these circumstances it is doubtful if section 10(5) is adequately drawn to charge the gains. The right to acquire the shares was obtained by Mrs. Ahmad not, as subsection (5) requires, by reason of her employment, but by virtue of an assignment for valuable and adequate consideration. Though the subsection extends to gains or profits "indirectly" derived, it is considered an abuse of language and a travesty of good sense to speak of the gains which accrued to Mrs. Ahmad for her own benefit and for which she was not accountable to her husband, as gains derived indirectly by him.

Section 10(5) may be tightened up by additional provisions along these lines:

> A right or benefit to acquire shares obtained from a person who has been granted the right or benefit by reason of any office or employment held by him by his relative or by a company controlled by the person or his relative, whether for value or otherwise, shall be deemed to be a right or benefit acquired by the relative or the company by reason of any office or employment within the subsection.

"Relative" can then be defined in a manner considered appropriate.

The words, "gains or profits... indirectly derived by any person by the exercise, assignment or release of a right or benefit whether granted in his name or in the name of his nominee or agent to acquire shares" in section 10(5) are probably adequate to bring into account the following situations:

(1) A right or benefit granted in the name of an agent or nominee of an employee where such is exercised, assigned or released profitably by the agent or nominee. Even if the employee may not actually receive any of the gains, for

instance because they are retained by the agent or nominee or used by him to discharge the obligation of the employee, the gains would nevertheless have been indirectly derived by the employee.

(2) An employee who owes a sum of money and agrees that shares he is entitled to acquire under an option are to be transferred or held in trust for the creditor in satisfaction of the amount outstanding. It is conceivable that though the employee will not have received the shares beneficially, the gains or profits from the exercise may be treated as having been derived indirectly by him because such profits or gains are used to discharge his debt.

2. PRIVILEGE TO ACQUIRE SHARES

Options to acquire shares must be distinguished from situations where employees are merely allowed to subscribe for shares on advantageous terms, as where an employee is given a privilege to apply for shares at their par value. In this type of situation no right to acquire shares is conferred, hence any gains or profits can only be ascertained when the employee applies for the shares and his application is accepted. Consistently with this, tax liability should be imposed only then if gains result. The English courts have adopted this approach. Two cases may be looked at here.

In *Weight* v. *Salmon*,[32] the taxpayer was entitled to a fixed salary under his service agreement by which he was employed as a managing director. By resolution each year the directors gave him the privilege of subscribing for unissued shares in the employer company at par. The market value of these shares was considerably higher. The House of Lords held that the difference between the market value and the subscription price of the shares represented an emolument under Schedule E, and this gain accrued when the employee subscribed for and was allotted his shares.

The principle that profit cannot arise until such time as the offer to subscribe for shares is accepted by the employee is even more clearly illustrated by *Bentley* v. *Evans*.[33] The taxpayer's employers, X. Co. Ltd., operated an "Employee Share Purchase Plan" under which the taxpayer was offered the opportunity to acquire fifteen shares in the parent company at Can.$37 per share (which was 15% below their market value). In 1953, the taxpayer elected to buy these shares and the agreement was that they were to be paid for by monthly instalments deducted from his pay, commencing with December of that year and ending in June 1955. Under the agreement, the taxpayer had no rights or responsibilities with regard to the shares, nor was he entitled to any dividends until the shares were fully paid up and issued, but he was at liberty to cancel his election to purchase. In 1954, the taxpayer received nine shares, and in November of that year he paid cash for the remaining six shares. In an appeal against an assessment, it was held that the assessable profit was the difference between the market value of the shares when the taxpayer offered

[32] 19 T.C. 174.
[33] 39 T.C. 132.

to buy them and the amount paid or payable for the shares, and not, as the Crown contended, the difference between the latter amount and the market value of the shares when issued.

Section 10(5) apart, there is no reason for believing that the position would be any different in Singapore. Under the subsection, a privilege or benefit to acquire shares, exercised profitably, is charged to tax, and it is reasonable to assume that such an exercise normally occurs when the offer is accepted. But the amount of the gains is taken as the difference between the market value of the shares (or where this is not available, their net asset value) and the "amount paid for the shares". Where shares are to be paid for over a period of time, as in *Bentley* v. *Evans,* where it will be recalled, the subscription price was to be paid in instalments to be deducted from the pay of the employee over some one and a half years, difficulties of computation may arise, depending on the construction to be placed on "paid" in section 10(5). Assuming profits from a privilege to acquire shares accrue when an employee elects to buy the shares, the amount paid, at this moment at any rate, will be only a fraction of the subscription price. In this way, if "paid" is construed literally, the charge would be inordinately larger. It is this consideration which suggests that section 10(5) may have altered the position so that it is only when the shares are issued that the gains must be computed. This, however, strains the ordinary meaning of the "exercise" of a benefit to acquire shares, so that an alternative interpretation which avoids this may be preferable. It is submitted that the solution to the problem lies in construing "paid" as meaning "paid or payable".[34] If this is the correct view, privileges or benefits to acquire shares fit nicely into section 10(5).

3. Partly Paid Share Scheme and Trustee Scheme

The essentials of a partly paid scheme are that the employee would be allowed to subscribe for shares in the company but would be called upon to pay up only a small proportion of the issue price. The balance would be called up some considerable time later, and this constitutes the advantage to the employee. In return for this, a premium is usually payable on a call being made. Additionally, the shares would, so long as the loan is outstanding, carry no dividend or voting rights.

Employees may not possess sufficient cash to pay for their incentive shares, and so some financial assistance from the company may be necessary. Section 67(1) of the Companies Act, however, prohibits a company from providing any financial assistance in connection with any purchase or subscription of its shares or shares in its holding company by any means, directly or indirectly. This prevents the company from lending money or providing funds to or for its employees to acquire incentive shares. Section 67(2) however contains three exceptions, of which two only need be mentioned in the present discussion, and both of them apply only to fully paid shares. Where it is intended that employees — and this includes employees of a subsidiary company — should be able to subscribe for

[34] In the following Indian cases, such a construction was adopted: *Pethaperumal Chitiar* v. *C.I.T.* 31 I.T.C. 278; *Pereira & Roche* v. *C.I.T.* (1966) 61 I.T.R. 371.

shares to be held by themselves by way of beneficial ownership, section 67(2)(c) allows the provision of financial assistance by the company, but only if no director is included in the scheme. Hence where directors (the term is defined extensively to include any person occupying the position of a director by whatever name called, a person in accordance with whose instructions or directions the directors of a company are accustomed to act and an alternate or substitute director[35]) are to participate, financial assistance can only be provided if the company takes advantage of section 67(2)(*b*). The trustee loan scheme and the trustee purchase scheme are expressly catered for by this paragraph.

Under a loan scheme, the company would make funds available to trustees who are authorised to make loans to selected employees to enable them to subscribe for shares. The loan would carry either no interest or a very low rate of interest and the subscription price for the shares would usually be fixed at some point below their market value. In return for this benefit the shares would, so long as the loan remains outstanding, carry no dividend or voting rights. In practice, share certificates and blank transfers would be held by the trustees during the currency of the loans.

With a trustee purchase scheme, the company would make funds available to trustees to be used to buy incentive shares for selected employees. The trustees would be authorised to transfer to employees shares so acquired on payment by them of their fair value.

The above account represents merely an outline of what the various schemes involve, and should be taken as such. There are in practice so many variations dictated by the circumstances of particular companies that it is impossible to deal with, nor is it the intention of the writer to dwell on, all the permutations in a brief article. Instead, only some taxation and tax-planning points will be discussed.

(i) **Partly paid scheme**

Under a partly paid scheme employees who are allotted shares would be required to pay up only a fraction of the subscription price. This on its own would not give rise to liability, and liability, if any, would depend on whether the shares are issued at their full value or not. Where they are not the rules outlined earlier on would be material for determining their taxability.

Section 10(5) must, however, not be overlooked. Should shares be acquired for less than their market value, then the difference between this value and the amount paid for the shares must be treated as assessable income, because there may in this case be an exercise of a right or benefit to acquire shares. Thus an employee is within the subsection if by virtue of his employment he is allowed to subscribe for shares even if on allotment he would be required to pay up only a proportion of the subscription. Similarly, an option to acquire shares may also be caught whether the grantee is required to pay up the whole value of the subscription price or only a fraction of it upon the exercise of the right.

[35] Section 4(1), Companies Act.

Usually the only time when the incidence of tax has to be considered for the purposes of section 10(5) is the time of the exercise of the employee's right to acquire shares or the time when he takes up the offer to purchase them. This may not be the only relevant time in relation to partly paid schemes, however. It will be recalled that with this type of scheme the shares do not carry full dividend and voting rights until the full price is paid. It is an unsettled point whether this act of payment on the part of the employee may be considered an exercise of a right or benefit to acquire shares, especially when it is only then that his shares become fully transferable and free from restrictions. The point is not without practical significance because the market value of shares may have risen between allotment and the payment of the balance of the subscription price. Be this as it may, the problem is not without a remedy. This application of section 10(5) may be prevented by providing that the company alone can make calls on the shares. In this way, the employee cannot be regarded as having exercised any right, because the making of the call is within the exclusive control of the company.

(ii) **Trustee loan scheme**

The taxability of shares acquired with loans or funds made available to employees by an employer *via* trustees is governed by the principles outlined earlier on. Thus, no tax liability would usually arise where shares are purchased at their market price, and, where employees are granted options or merely privileges to acquire shares at prices below their market value, the tax rules applicable to share option schemes and privileges to acquire shares would then be applicable.

It is intended, however, in this section to discuss three aspects relating to trustee loan schemes, namely, the taxation implications of loans made on advantageous terms to employees, the tax considerations arising when those loans have to be written off or released, and the deductibility of interest, if any, payable on the loans.

Interest free loans

Where a company provides loans to employees to enable them to subscribe for incentive shares, and exacts either no, or a lower rate of, interest, there is some controversy as to whether the benefit in the form of having to pay little or no interest constitutes a perquisite, or is otherwise taxable as benefits or advantages where provisions exist for taxing such generally. In the case of Singapore, it is thought that benefits or advantages are taxable only if convertible into money or money's worth.

In a Canadian case,[36] it was decided that an interest free loan did not give rise to a "benefit received or enjoyed [by an employee] in respect of, or in the course of, or by virtue of, [his] office or employment" within section 5(a) of the Canadian Income Tax Act there applicable. The Chairman of the Board of Review, W.S. Fisher Q.C., made some interesting observations with regard to interest free loans:[37]

> Apart from specific legislation in a taxing statute I know of no law which imposes an obligation upon a lender to demand the payment of

[36] *No. 359* v. *M.N.R.* [1956] 16 Can. Tax ABC 24.
[37] *Ibid*., pp. 27-28.

> interest in connection with a loan granted by the lender to a borrower, and if the lender does not require the payment of interest, the borrower is under no obligation to pay interest.

A contrary and competing view has been put forward by the Court of Appeal of Guyana in *McDavid* v. *Commissioner of Inland Revenue*.[38] The taxpayer was employed as a managing director at a fixed salary by a life insurance company. By an agreement entered into on the same day as his contract of employment, the company agreed to lend him free of interest money for the duration of his employment for the purchase and equipment of a residence. In these circumstances, their Lordships, Stoby C.J., Persaud and Cummings JJ.A., held that the interest foregone was a "gain from any office or employment" or an "allowance granted in respect of the employment whether in money or otherwise" within section 5(*b*) of the Income Tax Ordinance of Guyana. It should perhaps be pointed out that the court considered it significant not only that the two agreements were entered into on the same day but also that the loan was expressed to be for the duration of the employment contract, and it was prompted to remark that the loan agreement "might as well as have been one" with the service agreement.

In time these conflicting views will have to be evaluated locally, and it is proposed here to consider some of their respective merits. There is a rational attraction in the Canadian approach which fits in well with the established canon of construing taxing statutes, that unless a taxpayer falls clearly and squarely within a charging provision, he should not be taxed on some imputed basis. Where interest is not stipulated for, there is simply no interest payable, so that an employee may be said to be just fortunate. It is imputation and conjecture to assume that anything is foregone by the employer for the benefit of the employee. It may even be suggested that whatever commercial prudence and economic considerations may otherwise dictate, there are some cultures or religions which are uncompromisingly opposed to usury. The opposing view presupposes that interest is an essential and indispensable feature of a loan, and denies the existence of kindly employers, insisting on the principle that an outlay is worth making only if it yields a pecuniary return. Accordingly, it assumes that a loan would not be made except on interest, and hence where this is not exacted, the amount is foregone. This approach runs counter to another cardinal principle of taxation law that a man is not obliged to make a profit if he does not so desire, and unless the tax legislation deems otherwise, profit should not be imputed to him.

Different considerations apply, it seems, where an employer borrows at interest to lend to an employee free, or at a lower rate, of interest. Here it is not difficult to see that the employer has incurred expenses for the benefit of the employee, and it could not seriously be challenged that a benefit of this sort should not be assessed as a perquisite under section 10(2)(a).

In practice, however, most tax jurisdictions do not assess employees who receive interest free loans or loans at a very law rate of interest. This is the position in the United Kingdom and South Africa, and it is understood that the Comptroller in Singapore also takes the same stand.

[38] [1966] W.I.R. 504.

Loans written off or released

Loans made to employees may for some reason have to be released or written off, and interesting problems of taxability and deductibility may emerge. Again, views differ as to the tax consequences which should attach. It is possible to argue that an employee whose debt is released or written off derives a benefit in the shape of not having to repay a sum of money he had the use of. Accordingly, if this benefit can be said to accrue in respect of his employment, he should be taxable thereon. The English case of *Clayton* v. *Gothorp*[39] may be taken as exemplifying this analysis. In that case, the taxpayer's wife was employed by a local authority as an assistant health visitor. She applied for and was accepted for a course which would entitle her, at its conclusion, to a certificate as a health visitor, and she gave up her employment to commence the course. Before doing so, she had entered into an agreement with the local authority that in return for the loan of a sum equal to the salary that she would have drawn if her salary had not ceased, she would return to the service of the authority for a period of not less than 18 months, after which the loan would cease to be repayable. She duly passed the course and satisfied the terms of her agreement. She was assessed successfully on the loan forgiven on the ground that at the date the loan ceased to be repayable, there was a notional payment to her.

The alternative solution is not to charge the employee at all. The underlying reason may be said to be this. When a loan is released or written off, an employee receives nothing, and all that happens is that an obligation to repay a sum of money is forgiven. On the employer's side, there is no actual further outlay of money. Instead, a loss is incurred, but it is in respect of a sum of money put out when the loan was made. In other words, the contention here is that an employee should not in the absence of specific statutory authorisation in the tax legislation be taxed on a notional basis, viz. the "receipt" of a sum of money when his debt is discharged.

In any case, assuming that an employee can be legitimately considered as having enjoyed an income benefit when his loan is forgiven, it does not necessarily follow that such a benefit is taxable. Thus, unless the benefit could be said to arise from or accrue in respect of the employment, then there should be no charge to tax thereon. Consequently, it is advisable, where a loan proves uncollectible or the employer wishes to allay the financial hardship of an employee, to ensure that the release of the loan is not made referable to services rendered or to be rendered, or conditional on a period of employment with the employer.

Specifically in the context of a trustee loan scheme there appears to be another way in which an assessment to tax can be resisted. In *Hochstrasser* v. *Mayes*,[40] an employee who was reimbursed under a scheme established by his employer to compensate employees for losses incurred in the disposal of their homes which resulted from their employment was held not assessable on the compensation he received. Among other reasons for the decision, which are not relevant to the present discussion, one was that the amount or benefit did not

[39] 47 T.C. 168.
[40] [1960] A.C. 376.

arise from his contract of employment but from the contract to reimburse entered into pursuant to the scheme. It may be possible to argue, assuming that a benefit can be said to arise from the release or writing off of a loan, that the benefit was received by virtue of the employee being a participant in a share incentive scheme.[41] Once again, it is essential that the release should not be connected with or referable to services rendered or to be rendered.

The deductibility of loans which are written off is not without its attendant difficulties. A loan is normally a capital transaction so that any loss that results would not be deductible. Thus, in a South African decision,[42] it was held that advances to employees which proved uncollectible were not deductible because the losses were of a capital nature. Again, unless loans are made wholly and exclusively with a view to maintaining or increasing the profit of a business, the consequent losses would not qualify as "outgoings or expenses wholly and exclusively incurred … in the production of the income" within section 14(1). The Guyanese Court of Appeal decision in *Bookers Central Services Ltd.* v. *Inland Revenue Commissioners*[43] may be cited for this proposition. Here, Bookers Central Services sought to deduct a sum of $134.50 in respect of uncollectible loans made to certain of its employees as expenses wholly and exclusively incurred by it in the production of its income within section 12(1) of the Income Tax Ordinance of British Guiana (now Guyana).[44] This claim was rejected by Phillips J., who took the view that losses in respect of the loans made for the purpose of promoting the interests of the company in encouraging good staff relationships did not come within the provision. After reviewing the various English authorities cited by counsel, his Lordship said:[45]

> In the instant case the loan to an employee was to some real extent made for the purpose of promoting the interests of the company in encouraging good staff relationships but not wholly and exclusively for the purposes of producing, acquiring or earning the profits of the trade. In our view the payments to qualify as proper deductions must in truth have been laid out exclusively for the purposes of the trade and not merely with the incidental intention of assisting the trade.

Where, however, the making of loans is sufficiently related to the production of income, then the resultant losses would be deductible. This nexus may be established if it can be shown that the loans were made to reduce the rate of employee turnover which is detrimental to the earning of profits. In an Australian case,[46] the taxpayer company carried on business as retail butchers. For some time prior to incorporation, it had been the practice of the founder of the company to make interest free loans to his employees to tide them over minor financial difficulties. After incorporation, the practice was continued because it achieved a better employer-employee relationship, and prevented high labour turnover. There was evidence that the loss of an employee from a shop resulted in a measurable decline in sales because, in the suburban trade, friendly relations were built up between

[41] The learned editors of Potter and Monroe's *Tax Planning,* 7th edition, take such a view: see p. 439.
[42] I.T.C. No. 249, 75 S.A.T.C. 44.
[43] [1959] 1 W.I.R. 323.
[44] Cap. 299.
[45] *Ibid*., at p. 329. Regrettably, the report of the case did not state for what purposes the loans were made.
[46] 14 C.T.B.R. *Case* 80.

customers and employees. Certain loans were found to be irrecoverable because some employees "completely disappeared", and consequently these loans were written off. Such losses were held to be deductible because they were incurred in respect of loans made to employees in the course of carrying on the business for the purpose of earning or producing income under section 51 of the Income Tax Assessment Act. That section is in substantially the same terms as section 14(1) of the Income Tax Act of Singapore.

The inference from the above decisions is that losses in respect of loans made to employees to enable them to subscribe for shares which turn out to be irrecoverable would normally not be deductible because, though the loans may be made in the course of, or arise out of, or are connected with, the business, their real object is to enable the employees to acquire a stake in the company and even if this creates congeniality and improves the staff relationship, this is probably only an incidental purpose. If the business of the company is dependent on the services of its skilled employees, and the only way to retain their services is to allow them to run the business unhampered and free from outside interference — to achieve which it is necessary for them to acquire a controlling interest in the company — it is conceivable, though it has not been specifically decided in Singapore, that losses in respect of loans made to them for this purpose may qualify for deduction as being incurred wholly and exclusively in earning income. Some support for this proposition may be weaned from the English case of *Heather* v. *P.E. Consulting Group Ltd*.[47] But it must be stressed that this possibility is likely to be rather exceptional and confined to special circumstances.

Deducibility of interest on loans

The difficulties do not end here, because questions of deductibility may also have to be resolved where employees have to pay interest in respect of loans made to them to acquire shares. There are basically two issues here. Can the employee deduct the interest as being expenses incurred wholly and exclusively in producing (i) his remuneration and salary in respect of his employment, and (ii) his dividend income from his shares?

The first question has received a negative answer in South Africa. In *Commissioner of Inland Revenue* v. *Shapiro*,[48] the taxpayer in order to acquire shares in the company in which he was employed borrowed some money and paid interest thereon. His claim to deduct the interest from his salary and commission was rejected because there was no real nexus between the interest expended and the production of his salary or remuneration. These were regarded as produced by his services.

Interest paid may not be deductible against income from the shares acquired for two reasons. Firstly, incentive shares would in the usual case be purchased as an investment rather than as an income-producing asset. On this ground, the claim may be disallowed as the interest would not be payable on capital employed in acquiring the income within section 14(1) (a) of the Income Tax Act. Secondly,

[47] [1973] 1 All E.R. 8. For discussion, see *infra,* p. 49.
[48] 4 S.A.T.C. 29

dividends are payable only if the directors or company decide to pay, and generally only if there are profits. The ownership of shares would not on its own produce a dividend. Accordingly, the claim may be rejected because the payment of interest is neither sufficiently closely related to the production of the profits of the company nor to the payment of dividends.

(iii) **Trustee purchase scheme**

In this type of scheme, the employer company would pay to trustees moneys to enable them to purchase shares in itself or in a related company. These shares would subsequently be transferred to selected employees at their fair value. Normally no income tax liability attaches, so far as employees are concerned, to the moneys paid to trustees. These moneys would not normally be income to the trustees, and are really in the nature of gifts, albeit ear-marked for specified purposes. The employees are not chargeable thereon because (quite apart from the fact that it is probably not income) no part of the moneys accrues to them.

Shares may be acquired by the trustees at their market price, in which case no question of benefit arises. It is submitted that shares acquired below their market price do not attract any tax liability either, because the acquisition of shares is, without more, a capital transaction, even if a pecuniary gain may have been conferred. No part of this gain can be attributed to the employees normally either.

Shares may ultimately be purchased from the trustees at their fair value and this again would not result in any profit to the employee concerned. In any event, even if gains may be derived (because the shares were transferred below their market value) the employees may not be taxable, because such gains could not be said to arise from the employment but, on the principle propounded in *Hochstrasser* v. *Mayes,* they accrue to the employee as a participant in a share incentive scheme. The gains could not be regarded as paid or granted in respect of the employment if under the scheme the employee's right to acquire shares is not conditional on, or stated to be with reference to, services rendered or to be rendered. For these reasons, both section 10(2) (*a*) and section 10(5) are usually inapplicable.

Sometimes a share incentive scheme may, for various reasons, have to be wound up. It may be that the company running it has merged with or been taken over by another company, and it is found impractical to continue the scheme. The rules of the scheme would usually prescribe the mode of distribution of its funds and assets in such an event. It is suggested that the provision for distribution should not be expressed to be in consideration of services or be related to the employment. The reason is that, where this is done, it may be possible to argue that the distribution is received by virtue of the employee being a participant in the scheme when such scheme is wound up, and it follows that the *causa causans* of the payment is the termination of the scheme. It has been said that merely because a payment would not have been received by an employee had he not been an employee, this would not make the payment an emolument or perquisite of his employment,[49] as there may be other reasons for

[49] *Per* Lord Raddiffe in *Hochstrasser* v. *Mayes* 38 T.C. 673 at p. 709.

the payment. A problem in this connection recently came up before Walton J. in England.[50]

In *Brumby* v. *Milner*[51] W. Ltd. set up a profit sharing and share incentive scheme. Under the scheme, trustees were to be granted loans to purchase shares in the company to be held on trust for the benefit of the employees of the company. The scheme, approved by the directors of the company, was embodied in a trust deed entered into between the trustees and W. Ltd. The deed recited the fact that the company desired to institute a scheme for the benefit of its employees and that the primary object of the scheme was that the shares acquired for the purposes of the scheme should provide income for division between them. Clause 8 directed that on the determination of the scheme, the trust fund should be realised, and after paying the debt and any other amounts owing to the company, the balance was to be distributed "among the employees and former employees in receipt of pensions from any Funds or Schemes under which they shall be entitled by virtue of having been an employee respectively as at the date of the determination of the scheme" in such proportions as the trustees should determine, and in default of such determination, equally. The taxpayer received an interim award of £100 when, unexpectedly, the scheme was wound up because the company merged with another. Walton J. decided that the payment, though capital in the hands of the trustees, was income in the hands of the taxpayer, and an emolument being "salaries, fees, wages, perquisites and profits whatsoever" from the employment under Schedule E. In his judgment, a payment made for acting as or being an employee was an emolument arising from the employment, as was there the case, whether looking at the trust deed alone or at all the circumstances of the case. According to his reasoning, clause 8 and the explanatory booklet for the scheme (wherein it was stated that the scheme was to give employees an interest in the shares of the company and a means of sharing in its profits) provided clear evidence of this, and it followed that the *causa causans* of the payment was the termination of the scheme as well as the fact that the taxpayer was or acted as an employee. Thus he said:[52]

> If I return to the reasons given by the Special Commissioners for allowing the taxpayer's appeals, and for one moment following their use of the contrasting expressions *"causa causans"* and *"causa sine qua non",* it appears to me most clear that their conclusion that the *causa causans* of the payments was the decision to wind up the scheme is at best a partial truth. It is true in the sense that the decision to wind up the scheme was the *causa causans* of the payments being made at the time they were made; but that is not the subject matter of the present enquiry at all. The subject-matter... is why the payments were made to the persons to whom they were made; and the *causa causans* of that was, and it could only be, the provisions of clause 8(c) of the trust deed.

The above decision should be contrasted with an Australian case where a somewhat similar situation was considered, but an opposite conclusion was reached. In *Constable* v. *Federal Commissioner of Taxation*,[53] the declared object of a combined provident fund was "to accumulate for the benefit of the companies' employees who have

[50] In *Brumby* v. *Milner* [1975] 2 All E.R. 773. See also fn. 54A.
[51] *Loc. cit.*
[52] *Ibid.,* at p. 790.
[53] 5 A.I.T.R. 371.

joined the fund certain sums as provision for themselves and their families". Under the regulations of the fund, the employee was obliged to pay 10% of his salary, and the employer an equal amount. Any interest and other revenues earned from investment of the moneys of the fund were declared to be "the assets of the fund". A separate account was kept in the books of the fund for each member, and his own contributions were credited therein (subject to a discretionary power of the administrators of the fund) along with his employer's contributions in respect of him, plus a share of any annual net profits from investment of the moneys of the fund. The regulations stipulated that a member was to be paid the amount standing to his credit on his retirement or death, and it was specifically declared that no member should have any rights or claim to the amount standing to his credit except as provided in the regulations. However, under rule 23, in the event of any alteration to the regulations effecting a curtailment of the rights, or an increase in the obligations of a member, he was entitled, upon giving written notice to the administrators, "to withdraw the amount as shown by his account". Pursuant to this rule, the taxpayer gave notice and received a sum of £403 from the administrators. It was held here that the payment was firstly, of a capital nature, and secondly, not an allowance, gratuity, compensation, benefit, bonus or premium "allowed, given or granted to [the taxpayer] in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by him" within section 26*(e)* of the relevant Commonwealth Income Tax Assessment Act. The taxpayer became entitled to the sum by reason of a contingency occurring, namely the alteration of the regulations curtailing the rights of members, and this was in no way an allowing, giving or granting of anything to him. The Court declared:[54]

> It appears to us that the taxpayer became entitled to a payment out of the fund by reason of a contingency (viz. an alteration of the regulations curtailing the rights of members) which occurred in that year enabling him to call for the amount shown by his account. It was a contingent right that became absolute. The happening of the event which made it absolute did not, and could not, amount to an allowing, giving or granting to him of any allowance, gratuity, compensation, benefit, bonus or premium. The Fund existed as one to a share in which he had a contractual, if not a proprietary, title. His title was future, and indeed contingent or, at all events, conditional. All that occurred in the year of income with respect to the sum in question was that the future and contingent or conditional right became a right to present payment, which was made accordingly. This, in our opinion, cannot bring the amount or any part of it within s.26(e). The amount received from the Fund is a capital sum and unless it or some part of it falls under s.26(e) (there being no other applicable imposition of liability) it is not part of the assessable income.

It is submitted that the reasoning of Walton J. in *Brumby* v. *Milner* is suspect, and the decision in *Constable* v. *Federal Commissioner of Taxation* is to be preferred. Though the learned judge conceded that a payment received by an employee is not taxable as an emolument of his employment simply because he would not have received it had he not been an employee, and rightly accepted Lord Radaliff's construction of "perquisite or profits... therefrom" (i.e. the office or employment) as requiring that a payment must be made "in return for acting as or being an employee", it is respectfully suggested that his conception of the *causa causans* of the payment which he had to

[54] *Ibid.,* at pp. 374, 375.

deal with was spurious.[54A] The provisions of the trust deed merely identified the beneficiaries, so that the payment could not be said to arise from their contract of employment simply because it was made under the deed. It is also quite clear from the concluding part of Lord Radcliff's judgment which was relied upon by the learned judge that to his Lordship a payment would be made "in return for acting as or being an employee" if "the entitlement to the money was... any services given by [the employee],"[55] and this was perhaps not fully appreciated by the judge. The rationale of *Constable* v. *Federal Commissioner of Taxation* is more in accord with the line of approach of the House of Lords in *Hochstrasser* v. *Mayes,* and is on this ground more acceptable.

The deductibility of moneys paid to trustees under a trustee purchase scheme was considered by the Court of Appeal in England in *Heather* v. *P.E. Consulting Group Limited.*[47] The taxpayer company carried on business providing services in managerial and industrial consultancy, and its professional staff numbered 310, all of whom held university degrees and professional qualifications. Almost all its issued shares were held by P.E. Holding Ltd., its holding company. 41% of the equity of the holding company was held by the group's pension fund and the remaining 59% was owned by outsiders. Drastic changes in management were made by the outside shareholders on two occasions, and these upset the senior professional staff. As a result, a scheme to acquire control of the group was initiated. In accordance with the United Kingdom equivalent of section 67(2) (b) of the Companies Act, a trust was set up under which trustees were to use the trust funds to acquire shares in the taxpayer company and P.E. Holding Ltd. to be held by or for the benefit of employees of the taxpayer company. They were to hold the shares for the benefit of the employees, to whom they would offer them for sale at their fair value. There were provisions for these shares to be repurchased by the trustees or other employees on the death or retirement of an employee. The taxpayer company covenanted to make annual payments to trustees amounting to 10% of the consolidated profits of the group with a minimum of £5,000 a year. There were provisions under which the company could discontinue, suspend, reduce or increase these payments. On appeal against the disallowance of these payments by the Revenue, the Court of Appeal unanimously upheld their deductibility. The payments were not capital but revenue in nature, because the purpose of the scheme was to enable the taxpayer's business to be carried on more efficiently, and this depended on the qualifications and skill of its professional staff and their unhampered conduct of the business, and the expenditure consisted, not of a single payment on which the scheme depended, but of a series of annual sums, the aggregate of which was unpredictable and one of which on its own was insufficient to achieve the purpose of the scheme. Hence the sums paid did not come within the principle of *British Insulated and Helsby*

[54A] Subsequent to the writing of this article, the Court of Appeal in [1975] 3 All E.R. 1004 affirmed the decision of Walton J. However, it did so on the ground that, as the scheme was, on the facts found by that court, one based fundamentally on reward for services by employees, the terminal payments were referable to services rendered, and were therefore profits arising from their employment. My criticisms of Walton J.'s reasoning are therefore, it is felt, still valid. Leave to appeal to the House of Lords has been granted.

[55] *Per* Lord Raddiffe in *Hochstrasser* v. *Mayes, supra* at p. 709.

Cables Ltd. v. *Atherton.*[56] This part of the judgment was expressed by Buckley LJ. as follows:[57]

> In the present case it seems to me that the payments with which we are concerned are different in their character in several respects, which may be material, from the sort of payment which was under consideration in *Atherton's* case. In the first place, whereas the payment in question in *Atherton's* case was a single payment, we are here concerned with a series of payments being made annually under the covenant contained in the trust deed. No one of those payments was in itself sufficient to achieve the object of the scheme incorporated in the trust deed. The aggregate of those payments was unpredictable. The payments year by year were to be calculated by reference to their fair value for the time being of the shares in the taxpayer company, which might vary year by year, and so it would be impossible at any stage to say what moneys would have to be contributed by the taxpayer company in the future in order to achieve the objective of buying 40% of the shares of the company at their par value. Moreover, the taxpayer company could under the trust deed at any time have discontinued these contributions or brought the whole scheme to an end.

The payments were also "intimately connected with the day to day operation of the taxpayer's business",[58] and "directly related to the conduct of [its] trade" because their objects were to enable the staff to purchase a stake in the taxpayer company, thereby providing an incentive to greater efforts on their part and removing the possibility of outside interference with the conduct of the business.

The deduction provisions considered in *Heather* v. *P.E. Consulting Group Ltd.* speak of expenses wholly and exclusively incurred for the purposes of the trade, but it is considered that the principles embodied therein are of equal force and validity when applied to section 14(1), even if this subsection refers to "expenses wholly and exclusively incurred in the production of... income". Though the English provisions are clearly wider, their scope and effect are broadly the same, and this is borne out by a perusal of cases decided in Australia, New Zealand and South Africa under their respective provisions, where English cases are often referred to and their reasoning applied. It is submitted that the P.E. Consulting Group Ltd.'s type of expense ought to qualify here as wholly and exclusively incurred in the production of income. Firstly, it is a payment made voluntarily on grounds of commercial expediency and in order to facilitate the conduct of the business. Such a payment has been allowed under provisions analogous to those of section 14(1). In *Sun Newspapers Ltd.* v. *Federal Commissioner of Taxation*,[59] Latham C.J., allowing a payment made under a restrictive agreement to prevent the publication of a competing newspaper, said:[60]

> It is true that the agreement under which the payment was made was an agreement which bound Associated Newspapers Ltd. [the party restricted] and which did not bind Sun Newspapers Ltd. But the payment was plainly made by Sun Newspapers Ltd. as a payment which was expedient for business purposes, and the fact it was made voluntarily does not exclude the possibility of it being an allowable deduction.

[56] The Court in *British Insulated and Helsby Cables Ltd.* v. *Atherton* [1926] A.C. 205 decided that a payment is more likely to be capital if made not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of the trade

[57] [1973] 1 All E.R. 8, at p. 16.

[58] *Per* Buckley L.J., *loc. cit.*

[59] (1938) 61 C.L.R. 337.

[60] *Ibid.*, at p. 405.

Secondly, it is a payment made to increase the efficiency of its employees, and thereby the profits of the company.

It should not for a moment be assumed that the decision in *Heather* v. *P.E. Consulting Group Ltd.* opens up a new field of deductions in respect of contributions to trustees for the purchase of employee incentive shares. It is only where such contributions or payments can be considered essential for the conduct of the business of the company that they are allowable.

IV. *VALUATION OF SHARES*

Valuation is not an exact science, and where it is shares that have to be assessed — especially shares in private family companies — the problem can be as taxing as the determination of the liability to tax. The need for precise principles of valuing shares becomes particularly pressing with the imposition of various duties (e.g. stamp duty, estate duty and, in other jurisdictions, capital gains tax) on possession and transfer of property, since one of the commonest forms of wealth must surely be shares and securities of companies. It was not too long ago that the courts were first faced with the problems of share valuation, and consequently, guiding principles are still in the process of evolution. However, only some of these will be mentioned here, and this section is instead devoted to a discussion of the mode of valuation prescribed by section 10(5), and how restrictions imposed on dealings with and transfers of incentive shares may affect their value for income taxation purposes.

The actual value of incentive shares must be ascertained because:

(1) where they are taxable as profits or gains from an employment, the taxable quantum is the difference between this value and the amount actually paid for the shares plus any consideration which may have been given for the grant of the right or benefit to acquire the shares; and

(2) if section 10(5) applies, the gains or profits chargeable to tax are the difference between their market value, or their net asset value, and the amount paid for the shares.

One is inclined to assume that the selling price of shares publicly quoted on the stock exchange is their market value, but in practice this may not be the case. The valuation of shares, in private and public companies, calls for an examination of all matters, favourable or unfavourable, affecting the companies and their shares. Among others, these have been considered material by judges:[61]

(1) the state of the industry, trade or business in which the company is engaged;

(2) the capital cover of the company, i.e. whether or not its net assets are adequate to repay its paid up capital;

[61] See *Attorney General of Ceylon* v. *Mackie* [1952] 2 All E.R. 775; *Smyth* v. *Revenue Commissioners* [1931] Ir.R. 643; *Re Hogg deceased* [1939] M.L.J. 139; *In re J.B. Young deceased* [1955] M.L.J. 108; *Holt* v. *Inland Revenue Commissioners* [1953] 2 All E.R. 1499; *Gregory* v. *F.C.T.* (1971) 2 A.T.R. 225; *Abrahams* v. *F.C.T.* (1944) 70 C.L.R. 23; *Myer* v. *Commissioner of Taxation* [1937] V.L.R. 106; *Perpetual Trustees Co. Ltd.* v. *F.C.T.* (1942) 65 C L.R. 572; *I.R.C.* v. *Crossman* [1936] 1 All E.R. 762.

(3) the dividend yield of the shares;

(4) the estimated maintainable profits of the company based on its past results;

(5) stock market trends and conditions;

(6) the state of the operation and management of the company and its competitive strength compared with others engaged in a similar line of trade or business;

(7) employee relations in the company;

(8) changes, if any, in the supplies and prices of raw materials used by the company;

(9) whether its shares are marketable. In general it may be said that shares of a lower nominal value or those carrying voting control are easier to dispose of, and hence would fetch a better price; and

(10) generally, the political climate of the time.

Some of the factors may weigh particularly heavily with shares of private family companies, while others may be more significant in relation to public companies. Again, the adverse effects of one may be offset by the advantages of another. But unless some very good reason exists, one should not be taken to the exclusion of others. The judgment of Hanna J. in the Irish estate duty case of *Smyth* v. *Revenue Commissioners*,[62] where what had to be determined was the price which a holding of shares would fetch if sold in the open market at the time of the death of the deceased, may be taken to be indicative of the correct line of approach in this matter. The learned judge proceeded in this way:[63]

> In my opinion, in estimating the price [of the shares], every advantage and disadvantage to the company and every benefit and clog attaching to the shares, as well as the nature of the particular company, must be considered. According as the facts differ, more weight will be given to one element than another. You must consider the profit-earning capacity, the return for the purchaser's investment, the general solvency of the company, the extent of the security in the shape of assets, the nature of the management, the objects of the company, its method of business, the capital value of the assets of the company, the restrictions upon the transfer of the shares and the amount of liabilities. On some of these elements persons accustomed to value can place a relevant figure, but the test for some of the others is merely general business experience. In my judgment, the profit-earning capacity of the share is the most important item, and would be most prominent in the mind of the purchaser in this case. When I say "profit-earning capacity" I mean profit-earning on a reasonable commercial basis for a company such as may be under consideration, not necessarily as appearing in the balance sheets, which may, for reasons of the proprietors, be prepared on a particular basis. But while that is in the foreground you must consider as a definite and well-marked background the capital value of the share. It may operate either to increase or decrease the price as the case may be.

The necessity to evaluate all relevant factors is also clearly demonstrated in *In re J.B. Young, deceased*,[64] a Malayan case. Here a business formerly carried on in partnership in the United Kingdom was bought over by a company incorporated and registered in Malaya.

[62] [1931] Ir.R. 643.
[63] *Ibid.*, at p. 656.
[64] [1955] M.L.I. 108.

There was in fact no alteration in the conduct of the business, except that the partners became directors. Thus the divisible profits were shared by special remuneration, and the dividend on ordinary shares was calculated as a fixed interest on capital as in a partnership — approximately a 5% yield, though in some years there was a slight variation. The Estate Duty Office valued the shares of a deceased shareholder at $150 per share based solely on their yield, while the estate contended that the proper value should be $100 per share, in view of the very special articles of the company relating to transfer, reserves, and dividend. This contention was upheld by Mathew C.J. who summed up as follows the relevant factors which he took into account:[65]

> Bearing in mind the following factors —
>
> (i) the special position of the shareholders; (ii) the special provisions dealing with the transmission of shares; (iii) the special provision of article 81 which, if fully implemented, would preclude transfers to reserve; (iv) the unlikelihood of earning a dividend of more than five per cent; and (v) the fact that assets and liabilities approximately balance, I have come to the conclusion that no normal investor would be prepared to pay more than $100 for a share.

In *Holt* v. *Inland Revenue Commissioners*,[66] the deceased held 43,698 ordinary shares of £1 each out of a total issued of 697,680 in a private limited company, while the rest were held by members of a family or family trusts. There was a strong desire to retain control in the family. The articles prohibited the unfettered transfer of shares to non-members so long as a member or a person approved by the directors was willing to purchase them at a fair value, to be fixed by the auditors of the company should there be any disagreement; and the directors could refuse to register a transfer. The company traded in West Africa where its trade had been affected by riots and a boycott of European traders, and was made hazardous by variations in prices. During the First World War, the company made large profits, and accumulated reserves which tided it over its heavy losses in the immediately following years. In 1937, only modest profits were made, but in 1938, and during the Second World War and the two years following, it made large profits again. In these years, only small sums were available for reserves or dividends because of the imposition of excess profits tax. The large profits of 1946 and 1947 reflected the rates of inflation at the time. The practice of the company was to limit dividends to 5%. The company was also overtrading, and incurred a large bank overdraft. Two of its five ships required replacement, and under the then tax legislation, allowance was given for historic cost only, and not on a replacement basis. In determining the price the shares would fetch if sold in the open market as required by the Finance Act, 1894, section 7(5), Danckwerts J. took all the factors into consideration, even the possibility of an increase in dividends, which he thought the members of the family might call for in view of the drop in the value of money. His Lordship stated:[67]

> Now, it is plain that the shares did not give a purchaser the opportunity to control the company, or to influence the policy of the directors to any great extent, as the shares available only represent 43,698 shares out of 697,680 ordinary shares which had been issued. Any purchaser, there-

[65] *Ibid.*, at p. 111.
[66] [1953] 2 All E.R. 1499.
[67] *Ibid.*, at pp. 1058, 1059.

> fore, would be dependent on the policy of the directors, so long as they should have the support of the general body of the shareholders. I think the kind of investor who would purchase shares in a private company of this kind, in circumstances which must preclude his disposing of his shares freely whenever he should wish (because, when registered as a shareholder, he will be subject to the provisions of the articles restricting transfer), would be different from any common kind of purchaser of shares on the Stock Exchange, and would be rather the exceptional kind of investor who had some special reason for putting his money into shares of this kind. He would, in my view, be the kind of investor who would not rush hurriedly into the transaction, but would consider carefully the prudence of the course, and would seek to get the fullest possible information about the past history of the company, the particular trade in which it was engaged and the future prospects of the company. I think that such a purchaser would consider the inter-war results of the company, the effect of the 1914 war on the company's trading and the heavy losses sustained in the years which followed that war. In my view, therefore, the evidence of the witnesses for the Crown is open to criticism in so far as it ignores or minimises unduly (as it seems to me) the history of that period in the company's trading. The possibility of losses due to some severe fall in prices emphasises the importance of reserves, and I do not see how anyone considering the financial situation of the company could properly ignore the effects of inflation on the value of money, the way in which the building up of adequate reserves to meet the difficulties likely to be caused by a slump in prices has been handicapped by the enormous sums required to be taken from profits for taxation in the years of the Second World War, and the way in which the provision for the replacement of capital assets, such as ships, has been made more difficult by allowances for depreciation being made on the basis of original costs and not the expense of replacement. In my view, these matters, as well as the fluctuating nature of West African trading, would be likely to have greater effect on the mind of the hypothetical purchaser than was admitted by witnesses for the Crown. I rule out of consideration the knowledge provided by the passage of time since March 11, 1948 [the date of the deceased's death] that the company's dividend on ordinary shares has not been increased from 5% and that the company has been able to avoid a public issue of ordinary shares by launching an exceedingly successful issue of new preference shares in September 1950. But I think that the witnesses for the Crown have over-valued the prospects on March 11, 1948 of an increase of dividend and the issue of ordinary shares in the future.
>
> On the other hand, owing to the fall in the value of money, 5% on the ordinary shares did represent a much smaller return in fact to the members of the family than that dividend represented in the pre-war years and there might have been pressure by the family in 1948 or later to increase the dividend (having regard to the ample earnings of the company). Moreover, some possible hypothetical purchaser might well have thought that the company would be forced to raise further capital by an issue of ordinary shares to the public instead of adopting the method of an issue of preference shares or debentures or unsecured notes. Any such anticipation could have no more certainty than a guess. But I think that the petitioner's witnesses have under-valued this element in the price which the hypothetical purchaser might pay in the hypothetical open-market.

Private companies present special problems of valuation because of peculiar articles often applicable to them. Articles of private companies often prohibit the unfettered transfer of shares to persons who are not members of the company, and confer on directors an absolute or qualified power to refuse to register any transfer. In addition, a shareholder desirous of selling his shares may be obliged to offer them to existing members at a fair value, or, failing an agreement as to this, at a price to be fixed by the auditor of the company. Not infrequently, companies have to go public for various commercial reasons. All these considerations may have effect on the value of their shares.

Where directors are given absolute power to refuse to register transfers of shares without assigning any reason, this would suggest

that since such shares may not be freely disposable they would have no market value in the true sense of the concept. And where the shares would be acquired under a pre-emption right at a fair value or at their par value, it is not unreasonable to believe that this should be treated as their market value. For these reasons, it may be wondered whether section 10(5) is accordingly limited. This, however, is not the only approach to the matter, and it has been decided in an estate duty context that the question of the price which shares would fetch, if sold in the open market, must be determined by ignoring the prohibition or fixation imposed by such articles. But the value of the shares should reflect these restrictions. As Lord Fleming said with regard to such articles in *Salvesen's Trustees* v. *I.R.C.*:[68]

> ... if the articles of association be complied with, a sale in the open market in a reasonable sense seems to be impossible. The petitioners argued that the maximum price the shareholder can obtain for his shares in the open market is determined by the best price he can obtain in the closed market, viz. £1 [their par value]. But it appears to me that if this argument is well founded, it merely demonstrates that there cannot be a real sale in the open market under the articles. The Act of Parliament requires, however, that the assumed sale, which is to guide the Commissioners in estimating the value, is to take place in the open market. Under these circumstances, I think that there is no escape from the conclusion that any restriction which prevents the shares being sold in an open market must be disregarded so far as the assumed sale under section 7(5) of the Act of 1894 is concerned. But, on the other hand, the terms of that subsection do not require or authorise the Commissioners to disregard such restrictions in considering the nature and value of the subject which the hypothetical buyer acquires at the assumed sale. Though he is deemed to buy in an open and unrestricted market, he buys a share, which, after it is transferred to him, is subject to all the conditions in the articles of association, including the restrictions on the right of transfer, and this circumstance may affect the price which he would be willing to offer.

In determining the market worth of shares, the court thus conceives a hypothetical purchaser, albeit a prudent, willing one, making an offer in an equally hypothetical market. Accordingly, such a purchaser would make full enquiries, and investigate all matters which affect the company. But to what extent is he to be treated as in possession of material facts? The question can assume vital significance with shares in a private company which seeks a quotation on the Stock Exchange, since this usually results in an enhancement in the price of the shares. However, at the relevant date when their market value has to be quantified, this information is still confidential, or there is only a possibility of the quotation materialising. In *Lynall* v. *Inland Revenue Commissioners*,[69] a private family company with a successful profit record, a strong liquid position, a high dividend cover and a very satisfactory cash flow sought professional opinion as to the advisability of a public floatation. At the time of the death of a deceased shareholder who held 28% of the issued share capital, the directors were in possession of documents which advised in favour of a public floatation, but this was strictly confidential information. The Crown contended that where substantial blocks of shares in private companies were in the market, it was the invariable practice among boards of directors to answer reasonable questions put by purchasers or their advisers, and because of this the possibility of a public floatation would

[68] [1930] S.L.T. 387, at p. 391. See also *I.R.C.* v. *Crossman* [1936] 1 All E.R. 762 and *Lynall* v. *I.R.C.* [1972] A.C. 680.
[69] [1972] A.C. 680.

have been disclosed. Accordingly, the market value of the shares of the deceased for the purposes of section 7(5) of the Finance Act, 1894 must be determined on the basis that a prudent willing purchaser would be aware of this. Their Lordships in the House of Lords rejected this argument, because the directors had taken great care to ensure that disclosure would be made only to those of the highest repute so that it could not be presumed that all genuine potential bidders or nominees would get the confidential information. As Lord Morris said:[70]

> If, however, the [relevant] documents and information contained in them were confidential to the Board, as they were, the information could not be made generally available so that it became open market knowledge ....

Though some boards of directors may be willing, and quite properly, to divulge certain secret information, it is impossible to define, as a universal guide, the extent or limits of confidential information which may be presumed to be in the possession of a willing, prudent purchaser. This problem was also alluded to by Lord Morris:[71]

> On the wider issues I doubt whether it is possible to define with precision the extent or the limits of the information on the basis of which a hypothetical purchaser of shares on a sale in the open market might purchase. There may be cases where prudent and careful potential purchasers of a large block of shares will be unwilling to purchase shares unless they have the inducement of being given confidential information which is not generally known. If in practice some large deals take place on the basis that some information is given which must be kept secret, then any such practice is the practice not of an open market but of a market operating in a special way. I would see great difficulties if the Commissioners or a court had to assess the extent to which a particular board of directors would or would not have been likely or willing to answer some particular enquiries — there may be some enquiries of which it can with certainty be said that they would readily and properly and openly have been answered. A purchaser in the open market would probably not be content merely with what would be published information in the sense of information which had been in print in some documents sent out by a company to its shareholders. He would form his own idea as to the company's prospects having regard to trends and developments which are matters of public knowledge. Furthermore, on known facts in regard to a private company and its directors and its management, he would form his own reasonable deductions.

If the real value of shares can exceed their nominal or par value, it may also fall below it. This latter situation may arise where a company has been incurring heavy losses, and in such an instance the shares would probably not be realised for more than the value of the net tangible assets of the company. This value would thus be the true worth of the shares. In *Attorney General of Ceylon* v. *Mackie*,[72] M. was a director of a company incorporated in Ceylon in 1922. Up to 1940, the company's profits and losses fluctuated, and there were considerable profits in 1939 and 1940. In 1940, the future of the rubber trade in which the company was engaged was unpredictable, and it would have been difficult to find anyone willing to invest large sums of money on speculation. M. died holding 9,201 preference shares (nearly half of all the preference shares) and all the management shares. The Privy Council decided that, though generally the value of an established business as a going concern would exceed the total value of its tangible assets, this was not universally true. In the

[70] *Ibid*., at p. 699.
[71] *Ibid*., at pp. 699, 700.
[72] [1952] 2 All E.R. 775.

present case, the shares could not be sold for more than a price based on the value of its tangible assets, and this should be taken as their market value for the purposes of section 20(1) of the Ceylon Estate Duty Ordinance, 1938. Lord Reid stated:[73]

> No doubt, the value of an established business as a going concern generally exceeds, and often greatly exceeds, the total value of its tangible assets. But that cannot be assumed to be universally true. If it is proved in a particular case that at the relevant date, the business could not have been sold for more than the value of its tangible assets, then that must be taken to be its value as a going concern... and [hence the price which the shares would fetch if sold in the open market].

Section 10(5) *(b)* of the Singapore Income Tax Act adopts the above basis for ascertaining the gains or profits from the exercise, release or assignment of any rights or benefit to acquire shares where either the price of the shares cannot be determined, or cannot be realistically determined, by reference to a market.

Another aspect of section 10(5) may be referred to here. The amount of gains or profits according to the subsection is the difference between the market value or the net asset value of the shares and "the amount paid for the shares". Taken literally, this would preclude the deduction of any consideration given for the right or benefit to acquire the shares.

Hitherto, restrictions which have been referred to as affecting the market value of shares are those that may be said to attach to or be inherent in the shares. The point which must be considered here is whether restrictions which are external incidents, in the sense that their imposition is not the consequence of the manner in which the share structure and articles are organised or set out, have the same effect. Locally, this is again undetermined, but in Australia and England, restrictions on trafficking in incentive shares, legally binding or otherwise, which are stipulated by the trust deed under which the shares are acquired, or conveyed verbally to employees have been held to operate to reduce the value of the shares for the purposes of taxation. Thus, a written undertaking by an employee not to sell his incentive shares should be taken into account in ascertaining the market value of the shares as well as a verbal undertaking to that effect.[74] Again, a legally unenforceable restraint has been held to have the same effect. In an Australian case,[75] the taxpayer was allotted 100 shares at par in the company which employed him. The current market value then was considerably greater. In allotting the shares, the directors of the company had advised the employees that the shares should be held as a long term investment and indicated that the company would take a serious view of any trafficking in the shares. The Commissioners assessed the difference as "the value to the taxpayer of [an] allowance [or] benefits ... allowed, given or granted to him in respect of, or for or in relation directly or indirectly to, any employment..." but without considering the restraint on their disposal. The Board of Review, however, decided that the restraint affected the value of the shares, even if it was not legally enforceable:[76]

> Whilst it is true that at law the shares were freely negotiable, in point of fact their negotiability was far from free, for to have sold them in

[73] *Ibid*., at p. 779.
[74] *Ede* v. *Wilson 26* T.C. 381.
[75] 11 C.T.B.R. (N.S.) *Case* 65.
[76] *Ibid*., p. 398.

the face of their employer's wishes to the contrary would have obviously courted displeasure with the attendant probability of prejudiced chances of promotion, etc. In other words, although an employee could have sold the shares for their market value at any time after allotment, he would have had to measure against any profit the cost in the shape of strained relations with his employer.

V. *CONCLUSION*

Employee incentive shares are a product of modern economic life, and they reflect perhaps a trend towards the linking of ownership of shares with the generation of income, which have since the advent of industrialisation become somewhat divorced from each other. They are better understood when viewed against the perspective of increasing collective labour power and the emergence of a highly trained and skilled work force in some sectors of commercial life. Thus incentive shares are essentially commercial expedients or devices aimed at the recruitment, retention and goodwill of employees in a business world which has become increasingly competitive. The pecuniary and tax considerations are perhaps of secondary importance.

The choice of a suitable arrangement is one which must be made in the light of the particular circumstances of particular companies and particular businesses, not forgetting particular employees, and no general advice is of any great value, if it is possible to give such advice at all. Only certain general observations should be made. Share options are generally less expensive and complicated to implement and operate, and are especially attractive to employees, because there is usually no initial outlay of capital and hardly any possibility of loss, the emphasis being on profit. By virtue of section 68 of the Companies Act, however, options over unissued shares cannot be validly granted after the commencement of the Act if they are to be exercisable beyond five years from the date of the grant. Shares acquired through option schemes would be beneficially held by employees, and this may not be completely satisfactory where it is intended that they should be held as a long term investment. Partly paid schemes and trustee schemes may be preferable for this reason. On the other hand, trustee schemes enable the employer company to provide financial assistance, without which the object of incentive shares may be very difficult to realise.

Specially enacted to bring into account pecuniary and tax advantages connected with incentive shares, section 10(5) has been shown to be ineffective, at least in several situations, and unsatisfactory in others. Thus, until these deficiencies are corrected, the section holds no threat to skilful tax avoiders, but may be unfair to unwary taxpayers. Such a situation should not remain unremedied.

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