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In this Issue:

- (i) Topical tax issues- Share Options to Employees- can the Employee avoid tax on exercise of the option ?
- (ii) Securities Law- latest case in the UK- the dangers for Investment Advisers failing to properly disclose investment risk to clients;
- (iii) Employment Law- the dangers of the Disability Ordinance;
- (iv) Insider Trading Ordinance- Trustees of Trusts buying publicly listed shares should exercise care;
- (v) Company financing purchase of its own shares- is it possible ?

1. Topical Tax Issues

Most Employers who wish to grant senior Employees and Executives options to buy shares in a Hong Kong Company (or Company based elsewhere) will know that section 9 of the Inland Revenue Ordinance taxes gains calculated on the open market value of the shares at the time of exercise of the option less any consideration paid for the shares.

Can this tax be avoided ?

Legal avoidance (as opposed to evasion) of the tax is not easy, and while it is possible to establish a structure that might, at first sight, avoid the application of the legislation, it is wise to bear in mind certain warnings set out in the IRD circular on share options (No 38- updated March 2005). These are:

- (a) there is an obligation on the Employee to inform the IRD where there has been a gain made under section 9;

- (b) the obligation to advise the IRD does not arise simply because a tax return is sent; section 21(2) requires notification even if there is no obligation to file a return;
- (c) The Employer will also have an obligation under section 54 (4) to advise the IRD of the terms of a share option granted to an Employee and of a gain on its exercise. Employers are also issued forms each year under section 52 (2) requiring returns detailing all remuneration to Employees.
- (d) Quite apart from the statutory obligations, the IRD clearly believes that arrangements to avoid tax under section 9 may constitute evasion and be caught under the anti- avoidance provisions in sections 61 and section 62 of the IRO. These sections are designed to catch any arrangements whose purpose is primarily tax avoidance, or where the arrangements are obviously artificial with no realistic commercial objective.

Notwithstanding the risks outlined, planning to avoid the application of section 9 may be possible if based on strictly commercial considerations and if the arrangement is not caught by the wording in section 9.

We do not wish to suggest that any of the suggestions below might be foolproof, and much depends on the circumstances, but in the following situations the liability to tax might not arise:

- (a) where the agreement signed between the Employer and the Employee is discretionary, and no legal right is granted.
- (b) the same as in (a), but the right is granted subject to the consent of the Board of Directors approving the actual grant when the option is exercised;
- (c) the right being granted for full commercial value of the shares, with interest free finance from the Company or its Directors. However, the later release of the loan may be a taxable perquisite;
- (d) the right is granted not to the Employee, but to a family trust where the Employee is not a beneficiary, but may be appointed one later by the trustee's discretionary power. It is not clear if the IRD would accept this as an avoidance device, but given the Employee derives no direct benefit and the Trustee may not be obliged to file a tax return this method may offer opportunities for planning;
- (e) the right is granted not to the Employee as an Employee, but as an independent consultant;
- (f) the right is granted to a company that owns the shares in the Employer company where it may be difficult to place an open market value on the shares;

(g) the Employer may grant no options in writing, but elect to fund one off share purchases in a private capacity, bearing in mind however that the transfer of shares to an employee even at market value or the gift of funds might still be caught; the shares because they are income to the Employee and the funds on the basis that they are a cash perquisite. However, one off private arrangements with no legal options involved may well offer a method of planning, although an Employee is not likely to find such informal arrangements attractive given he has no written option to compel a share sale even if reaching performance targets.

Summary:

While planning to avoid tax on the exercise of share options may be possible, some planning may well be open to attack under the anti- avoidance provisions and Employers may well find that increasing the attractiveness of the option and granting other non -taxable perquisites in a combined package may be a safer option.

2. Securities Law- UK Case a Warning to Investment Advisers in Hong Kong

The recent UK case of Peekay Intermark Ltd V ANZ Banking Group is a timely reminder to Investment Advisers and Securities Dealers about the dangers of not properly disclosing the investment risk on an investment product and then trying to rely on the exemption clause in a client risk disclosure form to protect against liability.

Briefly, the facts were that the Claimant, Peekay Intermark Ltd. ("Peekay"), claimed damages under section 2(1) of the Misrepresentation Act 1967 for alleged misrepresentations as to the nature of an investment product being marketed by the Defendant, Australia and New Zealand Banking Group Ltd. ("ANZ") in early 1998. Peekay invested US\$250,000 in the product in question, in February 1998. The investment decision was taken by the Second Claimant, Mr. Harish Pawani, a director and controlling shareholder of Peekay. The Claimants contend that the alleged misrepresentations were made by a representative of ANZ who introduced the product to Mr. Pawani, that the misrepresentations induced Mr. Pawani to make this investment on behalf of Peekay, and that he would not have made it had he been aware of the true nature of the product. Peekay claims damages in the sum of US\$244,081.94, being the difference between the sum invested and the amount ultimately realised by the investment.

The Court found that there had been a misrepresentation of the investment product by the ANZ staff, but the ANZ Bank relied on an admission in the Risk Disclosure Statement that the Claimant understood the investment product and accepted the risks of trading. The Second Claimant relied on a letter he had written to the ANZ about the kind of investment he was looking for.

The Court found that Mr. Pawani was in fact induced to invest US\$250,000 in the name of Peekay by ANZ's misrepresentation as to the nature of the product. It was based on a derivative product and the Court accepted his evidence that he would not have made the investment if he had known the true position, namely that Peekay would have no interest whatsoever in the investment and no control over what was to happen in the event of a default.

The Court held that the advice to investors in the Risk Disclosure Statement was no answer to the misrepresentation claim. In any event, Mr. Pawani's instruction letter should have made clear to anyone at ANZ who understood the true nature of the product that, notwithstanding the disclosure statement, Mr. Pawani was still under a misapprehension as to its nature.

The Court also held that an accurate description by ANZ of the nature of the product, before Mr. Pawani had committed his/Peekay's funds, would doubtless have sufficed as sufficient disclosure and ANZ would have been able to rely on the protection in the risk disclosure statement.

Summary:

[It seems obvious, but the lesson from the above case for Investment Advisers is that even a slight misrepresentation of the nature of an investment product may mean that either the exemption clause does not on its terms apply to the misrepresentation to give protection, or the provisions of the Control of Exemption Clauses Ordinance in Hong Kong apply so as to prevent protection where an Investment Adviser seeks to avoid liability with an exemption clause that is too wide in its application.](#)

3. Disability Ordinance- the Dangers of Dismissing a Staff Member with a Disability

The objectives of the Disability Ordinance ('DO') are to prohibit employers and other members of the public from discriminating against an employee or member of the public on the basis of a disability.

The dangers of breaching the DO are not well appreciated by Employers, nor is there a clear appreciation that the DO may apply to a wide range of disabilities in every day situations.

Take one example. A paid chauffeur or driver who has been employed for say 14 years with the same Employer. He suffers a heart attack and is hospitalised on paid sick leave which he has accumulated. He is still hospitalised after one month and the medical report from the Hospital reveal a stroke and suggests a period of recuperation.

The Employer wishes to dismiss the Employee as he may be a danger in the future if he suffers another heart attack by driving. He also has to lift heavy boxes as part his employment.

If the Employer dismisses the Employee now, he will be in breach not only of the Employment Ordinance (you cannot dismiss an Employee while on sick leave) but also possibly the DO. The penalties include a fine of up to HK\$100,000.00.

The situation of the Employee creates a complex situation, and one can envisage circumstances where other personal afflictions, some slight, might be a disability. It comes down to an issue of whether the Employee, having suffered a heart attack, has a disability as that term is defined in the DO and if he has, whether the Employer would be guilty of an offence by dismissing him on the basis that he could no longer fulfil his functions as a chauffer and office assistant.

The definition of disability refers to “total or partial loss of a person’s bodily or mental functions” so in an abundance of caution one may have to assume there is a disability.

Assuming there is a disability, the next issue is whether the Employer can dismiss the Employee on the basis that he might not be able to carry on his driving duties safely, or may not be able to indulge in the physical activity of lifting boxes.

This may depend on:

- (a) the total number of employees the Employer has may be a relevant factor; an employer employing under a certain number (previously 5) may not be affected by the DO, but for the purposes of these comments, we will assume that the DO does apply to you. The Government by Gazette notice may change the numbers;
- (b) unless exempted for the reasons referred to in (c) below, it would be unlawful for the Employer to dismiss the Employee on the grounds of the disability or subject him to any other detriment if he suffers a disability;
- (c) whether the Employer may dismiss the Employee pursuant to section 12 (2) of the DO if after taking into account past training qualifications and experience, his previous performance, and other reasonable factors, the Employee would not be able to carry out the “ inherent requirements of the particular employment”. This means that if the Employer had proof that the stroke had so affected the Employee that he could not drive properly, risked other persons lives while driving, or was unable to carry out the physical requirements required of him, the Employer might be able to dispense with his services. There is also an exemption if the Employer as employer were asked to provide additional services or facilities not usually provided to those without a disability and provision of these services would cause the Employer undue hardship;

Summary:

[The DO must be taken seriously. Even a minor disability affecting an Employee may be covered under the DO. Potential fines are very large. Unjustified dismissal may](#)

[not only incur a fine but also trigger a civil claim for damages on the basis that it was the disability that was the reason for the dismissal, and not other grounds, such as failure to perform duties properly.](#)

Insider Trading- Can Trustees be Caught ?

The new Market Misconduct Tribunal was set up under the provisions of the new Securities and Futures Ordinance to cover illegal insider trading in securities. We raise the issue of the liability of a Trustee who is perhaps instructed by the Settlor of a trust to buy securities on the open market where the Settlor is connected with the corporation in which the dealing takes place. Assuming that the Settlor had illegal information under the SFO, a Trustee personally seems to be liable for the offence of insider trading unless the Trustee can come within the exemption of section 292 (4) and prove that he did not advise on the security, was an agent only, and did not know the Settlor was connected to the corporation or that he did not know that the Settlor had the prohibited information.

While in most cases a Trustee may be able to come within the exemption mentioned, one can envisage circumstances where a Trustee may act as principal and know something of the connection of the Settlor with the corporation. The defense that the Trustee was an agent might not always be available.

Summary:

[The new Market Misconduct Tribunal is new and there have been no decided cases as yet. Its scope is uncertain. However we would council caution on the part of Trustees asked to purchase securities, say through a BVI company, where there is a suspicion that the instructing party is connected to the corporation and perhaps has knowledge not generally known to the public.](#)

4. Can a Company Finance a Shareholder to Buy its Own Shares ?:

The answer to this question was traditionally in the negative as it was regarded as a reduction in capital of a Company thus prejudicing creditors.

Amendments to the Companies Ordinance in Hong Kong have made it possible for a Company to provide finance to Directors in certain circumstances, but planning may be able to go further, so that Directors can be financed by the Company to buy shares.

For more information on this topic, see Newsletter 2 on our Web site- www.Transnational.co.nz

We advise persons interested in using the planning to run it past their auditors first; there may not be unanimous agreement that what we suggest is possible or in line with the Companies Ordinance.

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