Case No. D46/98

Penalty tax – incorrect salaries tax return – failure to disclose director's fees and bonus received on 2 July 1996 in the tax return for the year of assessment 1995/96 – whether monies taxable when received or when entitlement to them established – whether a reasonable excuse existed under section 82A Inland Revenue Ordinance – demeanour of the taxpayer – 10% penalty under section 82A Inland Revenue Ordinance.

Panel: Andrew Halkyard (chairman), Robin M Bridge and Alfred Chow Cheuk Yu.

Date of hearing: 15 April 1998.
Date of decision: 22 June 1998.

The taxpayer was a practising dentist. He also served as a director of Company X, a land investment company ("the Company"). After his first year as a director, he became entitled to a bonus as well as a director's fee from the Company ("the monies").

The monies were noted in the employer's return for the year of assessment 1995/96 filed by the Company in respect of the taxpayer. In addition, the monies were included as expenses in the Company's accounts for the year ended 31 March 1996. Nevertheless, the monies were only paid to the taxpayer on 2 July 1996 after the annual general meeting ("AGM") of the Company held on 25 June 1996.

The taxpayer argued:-

(i) That the monies were only approved at the AGM of the Company and the monies only accrued, for tax purposes, at that time;

(ii) That there was a reasonable excuse established under section 82A of the Inland Revenue Ordinance ("IRO") as per sections 11B and 11 D of the IRO (D78/88, IRBRD, vol 4, 155, BR13/74, IRBRD, vol 1, 159 and D35/85, IRBRD, vol 2, 217 were cited);

(iii) Since this was the first year that the taxpayer was receiving the monies, he honestly believed that the fee and bonus received after 31 March 1996 were taxable in the following year. Besides, he had already paid salaries tax on the subject monies;

The Board was shown the Articles of Association of the Company by the Commissioner.

Held:

1. Although the exact amount of bonus was not known at 31 March 1996, all the facts giving rise to the entitlement were established as at that that date. The date of payment of the monies was, therefore, irrelevant;

2. Although the taxpayer did have a genuine belief that he was not chargeable to tax on the monies, it was not considered a reasonable excuse in terms of section 82A of the IRO for failure to include that income in his tax return. He had not checked that belief with his representative nor had he challenged the Company's accounts or the employer's return;

3. There were, however, various mitigating factors in this case. The taxpayer's reasons for not including the omitted income were not without foundation – the question of accrual of income was not straightforward (D35/85, IRBRD, vol 2, 217);

4. The Board had the benefit of hearing the taxpayer's evidence and considering his demeanour. He gave his evidence without artifice. In the circumstances, a penalty that equated to 17.7% of the undercharged tax was excessive. The Board followed the tariff in recent cases and decided that the penalty tax under section 82A of the IRO be reduced to 10%.

Per Curiam

Although the principle established in D36/88, IRBRD, vol 3, 354 (a taxpayer who has omitted income, which he genuinely believed to be non-taxable, could not argue in an appeal against penalty tax under section 82B that the assessment, included that income and which had become final and conclusive, was incorrect) operated harshly in certain cases, it represents the tenor of Board of Review decisions considering this matter.

Appeal allowed.

Cases referred to:

D78/88, IRBRD, vol 4, 155
BR 13/74, IRBRD, vol 1, 159
D35/85, IRBRD, vol 2, 217
D36/88, IRBRD, vol 3, 354

Tong Watt Po Kuen for the Commissioner of Inland Revenue.
Li Kong Shing of Messrs K S Li & Co for the taxpayer.

Decision:

This is an appeal against an assessment for the amount of additional or penalty tax imposed by the Commissioner under section 82A(1) of the Inland Revenue Ordinance ('IRO').

The facts

We find the basic facts, which have been agreed by both parties, set out in a document entitled 'Agreed Statement of Facts'.

Evidence of the Taxpayer

The Taxpayer elected to give sworn evidence before the Board. We found him to be a competent witness. On the basis of that evidence and the various documents placed before us we make the following findings of fact.

1. In his tax return – individuals for the year of assessment 1995/96 the Taxpayer omitted to include any details of the following amounts he received from his office of director of Company X, a land investment company ('the Company'):

Bonus	:	$1,659,697
Director's fee	:	$4,000

The Taxpayer did, however, include such details relating to an amount of $130,000 received from his office of director of a related company, Bank Y.

2. The director's fee and bonus described at fact 1 were contained in the employer's return for the year of assessment 1995/96 filed by the Company in respect of the Taxpayer. The period of office to which these amounts related was stated as 30 May 1995 to 31 March 1996. The employer's return was dated 6 May 1996.

3. The director's fee and bonus described at fact 1 were paid to the Taxpayer by the Company on 2 July 1996. On this date the Company sent to the Taxpayer his copy of the employer's return.

4. The director's fee and bonus described at fact 1 were included as expenses in the profit and loss account of the Company for the year ended 31 March 1996.

5. The following provisions of the Company's articles of association deal with payments of remuneration to the directors as well as payments of dividends and bonus.

> '70. The remuneration of directors and of the managing director shall be such sums as may from time to time be decided in general meeting.'
>
> '93. The capital subscribed by the shareholders shall bear interest at the rate of ten per cent per annum … and shall be payable to the shareholders … at such

time in every year as may be fixed by the directors provided that payment of such interest shall be made only out of the profits of the Company. [The directors are then given the power to postpone payment of such interest.]

94. The balance remaining of the profits of the Company, after deduction of interest on capital, shall be applicable as follows:

(a) Payment and distribution amongst the promotors of the Company and directors of the Company of a bonus equal to fifteen per cent of such balance in such proportion and manner as the directors shall decide.

(b) [Deleted]

(c) [Payment to general manager and other employees of a bonus equal to fifteen per cent of such balance.]

(d) The surplus of the profits … shall be divisible among the members in proportion to the amount of capital paid up on the shares held by them respectively.

95. The Company in general meeting may declare a dividend to be paid to the members …'

97. 'The declaration of the directors as to the amount of the net profits of the Company shall be conclusive.'

6. On 25 June 1996 the annual general meeting of the Company for the year ended 31 March 1996 was held. The minutes of that meeting stated that the Company's accounts were 'submitted to all shareholders for perusal'. During the meeting the shareholders unanimously passed resolutions submitted by the board of directors to declare a dividend of $5,000 per share (item 3) and to pay a director's fee of $4,000 (described as an 'honorarium') to each director (item 4; compare fact 1). Apart from the matter referred to at item 4, no other resolution related to the payment of any fee or bonus to the Company's directors.

7. The director's bonus derived by the Taxpayer from the Company for the following year ended 31 March 1997 was included in the Taxpayer's tax return for the year of assessment 1996/97. In December 1996, when he knew that his bonus for that year would not be as large as in the year of assessment 1995/96, the Taxpayer lodged a claim with the assessor for holdover of provisional salaries tax charged for the year of assessment 1996/97.

8. At all relevant times the Taxpayer was a practising dentist.

9. The Taxpayer explained his omission in a clear and simple way. He stated that he thought that the income omitted would be subject to salaries tax in the subsequent year of

assessment 1996/97 because he was only entitled to (and only received) the income after 31 March 1996. In the event, the amount received on 2 July 1996 was not reported in the Taxpayer's tax return for the year of assessment 1995/96, which was signed by him on 20 September 1996. The Taxpayer did not consult his tax representative (see below) before signing his tax return for the year of assessment 1995/96. Although the omitted income was assessed by the assessor in the Taxpayer's salaries tax assessment for the year of assessment 1995/96, he did not object to this assessment because he thought he would be obliged to pay salaries tax, in any event, in the following year. He did not challenge the correctness of the Company's accounts which included the amount of the bonus as an expense for the year ended 31 March 1996 (see fact 4); nor did he seek to have the employer's return (see fact 2) withdrawn or amended.

Contentions of the Taxpayer

10. During the hearing, the Taxpayer was represented by Messrs K S Li & Company, Certified Public Accountants ('the Representative').

11. The Representative's argument was also clear and simple: the Taxpayer did not lodge an incorrect return because the director's fee and bonus were not accrued until approved by the Company in general meeting (see article 70 set out at fact 5). Although the director's fee and bonus were included in the Company's accounts (see fact 4) the annual general meeting of the Company held on 25 June 1996 adopted and approved those accounts (see fact 6). On this basis, the Representative argued that the Taxpayer had a reasonable excuse for lodging his return as per fact 1. In support of this argument, the Representative drew our attention to sections 11D and 11B of the IRO as well as the following cases:

> *D78/88, IRBRD, vol 4, 155: 'The March earnings were not assessable until the following year of assessment. For salaries tax purposes under section 11B a taxpayer is subject to salaries tax which accrues to him during the relevant year of assessment. However section 11D makes clear that, for this purpose, income "accrues" to a taxpayer only when he becomes entitled to claim payment thereof.' (quoted from headnote to the case)*
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> *BR13/74, IRBRD, vol 1, 159: 'Income accrues to a person when he becomes entitled to claim payment thereof.' (quoted from section 11D(b))*
>
> *D35/85, IRBRD, vol 2, 217: 'The obligation to pay the bonus by reference to a percentage of net profits could not arise until the profits were established.' (quoted from headnote to the case)*

12. In the grounds of appeal, the Representative also noted that the Taxpayer was only appointed director of the Company on 30 May 1995 and thus, as a newly appointed director, he had no prior knowledge of the fee and bonus entitlements paid to him on 2 July 1996. Therefore, this case was one of inadvertence and misunderstanding by a lay person

who simply thought that the fee and bonus received after 31 March were taxable in the following year. The Taxpayer clearly had no intention to omit income from his tax return.

13. In view of the fact that the Taxpayer suffers from impaired hearing – and he may have had difficulty following all of the Representative's contentions – the Board also allowed the Taxpayer to put his case in his own words. The Taxpayer simply said that he could see no reason why he should pay any penalty tax because (1) he has already paid salaries tax on the amount in dispute and, in any event (2) he only received that amount on 2 July 1996 and it was thus taxable in the following year of assessment, namely, 1996/97.

Contentions of the Commissioner

14. The Commissioner's representative, Mrs Tong Watt Po-kuen, emphasised that because the Taxpayer had not lodged any objection to the salaries tax assessment for the year of assessment 1995/96 it was final and conclusive in terms of section 70 of the IRO. She argued that on the facts before us there is no reasonable excuse for the Taxpayer's omission of income from his tax return for the year of assessment 1995/96. Mrs Tong emphasised that the purpose of the Board hearing was to consider the penalty aspect of the appeal: not the correctness of the original assessment.

15. In any event, Mrs Tong challenged the Representative's contention that the director's fee and bonus did not accrue to the Taxpayer until after 31 March 1996. In this regard, she referred us to article 94(a) (set out at fact 5) which provides that directors are entitled to a certain percentage bonus payment on the balance remaining of the Company's profits, after payment of interest on shareholders' capital. As the Company made a substantial profit for the year ended 31 March 1996, as the bonus was charged as an expense in the Company's profit and loss account for that year, and as the amounts were included in the Company's employer's return lodged in respect of the Taxpayer, Mrs Tong argued that the Taxpayer had a right to claim the relevant payments on or before 31 March 1996. She buttressed this argument by reference to fact 7 which showed that the Taxpayer was fully aware of his entitlement to a bonus well before the end of each financial year.

16. Mrs Tong then noted that if the Taxpayer really believed that the amount in dispute did not accrue until the year of assessment 1996/97, then he should have taken steps to rectify the employer's return (see fact 2) which he must know to have been wrong. In the event, he did nothing until the Commissioner commenced action under section 82A.

17. Finally, Mrs Tong contended that, in all the circumstances before us, the amount of additional or penalty tax imposed for the Taxpayer's omission of income from his tax return for the year of assessment 1995/96 was not excessive. In this regard, she submitted that a penalty of $50,000, representing only 17.7% of the tax that would have been undercharged had the Taxpayer's tax return been accepted as correct was lenient (compared with the maximum penalty tax that could be levied under section 82A of 300%).

Reasons for our decision

18. This appeal has caused us some difficulty, not least because during the hearing the Representative focused nearly all his argument on whether the Taxpayer's tax return for the year of assessment 1995/96 was correct. As indicated above, Mrs Tong countered this argument by first stressing that the salaries tax assessment for the year of assessment 1995/96 raised on the Taxpayer is final and conclusive and, therefore, we should only consider the penalty aspect of this appeal; not the correctness of the original assessment.

19. Many previous decisions of the Board of Review support Mrs Tong's view that if a penalty assessment is made under section 82A because a taxpayer has omitted income which is subsequently assessed without objection, then it is not open to the taxpayer to argue in an appeal under section 82B that the return was correct. Perhaps the best illustration of this conclusion for the purpose of this appeal is D36/88, IRBRD, vol 3, 354. In D36/88 the Board decided that a taxpayer who omitted income, which it genuinely believed to be non-taxable, could not argue in an appeal against penalty tax under section 82B that the assessment, which included that income and which had become final and conclusive, was incorrect. In certain cases, it may be that application of this decision could operate harshly but, in the absence of argument to the contrary, it appears to represent the tenor of Board of Review decisions considering this matter.

20. If, contrary to the conclusion in the previous paragraph, the Taxpayer is entitled to argue that his return was correct, we would still be inclined to reject his argument. In this regard, the Representative properly drew our attention to sections 11D and 11B stating that for salaries tax purposes income accrues, and is therefore chargeable to tax, when the taxpayer becomes entitled to claim payment thereof. The Representative then referred us to article 70 of the Company's articles of association and various decisions of the Board of Review, particularly D35/85, IRBRD, vol 2, 217, to support the argument that directors' remuneration was subject to approval by the Company in general meeting and that this only took place on 25 June 1996 when the Company's accounts were accepted by its members. It was only then, the Representative contended, that the Company's obligation to pay the bonus was established. We would counter this argument in the following manner.

21. First, we agree that article 70 states generally that the remuneration of directors of the Company shall be decided in general meeting. But this is subject to article 94(a) which specifically provides that the directors have a right, after payment of certain interest to the shareholders, to a bonus equal to 15% of the balance of the Company's profits. Unlike article 95 relating to the payment of dividends, article 94(a) is not expressed to be subject to approval of the members. And, indeed, approval of the members was not sought. The exact amount of the bonus may not have been known precisely as at 31 March 1996; but all the facts giving rise to the entitlement were established as at that date and the precise amount to be paid seems purely a question of calculation. The subsequent payment on 2 July 1996 is, for this purpose, irrelevant (see sections 11D and 11B).

22. The above conclusion is supported by several facts including: the minutes of the Company's annual general meeting in which the Company's accounts were merely submitted to members for perusal and in which the members did not decided the bonus to be paid to the directors; the Company's accounts for the year ended 31 March 1996 which, in

accordance with generally accepted accounting principles included the bonus payment as a current expense (and not as a provision); and the Company's treatment of the bonus in its employer's return made in respect of the Taxpayer.

23. Second, the strongest case advanced on behalf of the Taxpayer, D35/85, dealt with a bonus containing a strong element of discretion (see page 226). This is in contrast to the case before us where the directors have an entitlement to a bonus when certain conditions are satisfied as at the end of the financial year.

24. All of the above analysis does not, however, dispose of this appeal. Although D36/88 denied the taxpayer the opportunity to argue that the tax return, to which the penalty tax ultimately related, was correct, the case is also authority for the proposition that the Board is entitled to consider the Taxpayer's evidence to decide whether at the time he prepared his tax return he believed he was not chargeable to tax. That evidence is relevant because it may constitute a 'reasonable excuse' within the terms of section 82A for failure to include that income in his tax return. On the facts found by us, the Taxpayer did have such a belief. However, he did not check that belief with his tax representative; nor did he challenge the Company's accounts or the employer's return. In view of the uncertainty surrounding the taxation of his remuneration from the Company, we cannot accept that a simple omission on his part without considering professional advice or taking any follow up action can constitute a reasonable excuse for the purposes of section 82A.

25. Again, this analysis does not dispose of the appeal. We must still consider whether in terms of section 82B(2) the penalty tax raised was excessive in all the circumstances. Our starting point for this enquiry is the Taxpayer's unchallenged evidence that he had an unblemished tax compliance record spanning some 30 years. Next, although we appreciate that the level of omission was significant in terms of both amount and percentage of total earnings, there are various mitigating factors in this case. First, the Taxpayer did not (like many cases before the Board of Review) simply forget to include the omitted income in his tax return. We have found that he did so for the reason that he considered, albeit wrongly, that the income was subject to tax in the following year of assessment. Second, this reason was not totally without foundation. As shown by the case law brought to our attention by the Representative, and in particular D35/85, the question of accrual of income is not straightforward and may be subject to competing tenable views. Third, and perhaps most important, we have had the benefit of hearing the Taxpayer's evidence and considering his demeanour. He gave his evidence in a straight forward way, without artifice. We have accepted his explanation for his omission (although we do not agree with his reasoning). During the hearing, he appeared genuinely confused and even a little agitated because he still could not understand what he had done wrong, even after clear explanation from Mrs Tong. In these circumstances, it does seem excessive in our view to penalise the Taxpayer in the amount of $50,000 (or 17.7% of the undercharged tax) for incorrectly submitting his tax return for the year of assessment.

26. On all the facts before us, paying particular attention to those matters referred to in the previous paragraph, we consider that this case deserves a lesser penalty than that assessed by the Commissioner. In this regard, we are aware of numerous Board of Review

decisions which impose a penalty in this type of case amounting to 10% of the tax applicable to the income omitted from the tax return. Accepting that consistency between Board decisions in this area is desirable, we therefore order that the additional or penalty tax assessed in this case be reduced from $50,000 to $28,000.

27. There is one final matter which we wish to address. When we heard this appeal we were faced with two bundles of documents, the Taxpayer's bundle and the Revenue's bundle. The Taxpayer then proceeded to hand up an unagreed third bundle. All three bundles contained many, but not all, of the same documents and all were paginated differently. Chaos was on the horizon. We thus invited the parties to adjourn the hearing to agree the bundle (this, incidentally, was easily achieved). At the same time the Taxpayer was requested to obtain further documents which were necessary for us to fully consider the merits of this appeal. All this caused us no small amount of inconvenience. We therefore take this opportunity to remind both parties to a Board hearing, and particularly tax representatives, of the need to have a fully and agreed bundle.