

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D67/00

Penalty tax – incorrect return by omitting income – gain from exercise of share option – costs – sections 82A, 82B and 68 of the Inland Revenue Ordinance (‘IRO’), chapter 112.

Panel: Kenneth Kwok Hing Wai SC (chairman), Man Mo Leung and Adrian Wong Koon Man.

Date of hearing: 30 August 2000.

Date of decision: 13 October 2000.

The taxpayer appealed against the Commissioner’s determination to levy additional tax under section 82A of the IRO for making incorrect return by omitting income, being the gain from exercise of share option.

The taxpayer contended that he had no intention to evade tax and just forgot to file in the gain from the exercise of share option as he grabbed the tax return and guidance notes and that he could only afford to spend very little time. He hurriedly filled out the form in ten odd minutes. Further, he also alleged that he had been misled by the Chinese guidance notes 6(2) for leading him into the plight of ignoring or forgetting to report his share options exercising.

Held:

1. The appeal was frivolous and vexatious. First, the Board did not believe that the gain was so difficult to remember. In particular, if the market value of the shares had since plunged, that would make what had hitherto been a gain all the more difficult not to remember. Secondly, the Board did not accept that the taxpayer had been misled by the Chinese guidance notes 6(2) in any way. By 8 July 1996, the taxpayer clearly knew that income derived from exercising his share option had to be reported and that he had omitted to report such income in his return for the year of assessment 1995/96.
2. Significantly, this is the taxpayer’s second incorrect return in respect of the same option within three years of assessment, the first in the year of assessment 1995/96 and the second and current one in the year of 1997/98. Pursuant to sections 68(8)(a) and 82B(3) of the IRO, the Board increased the assessment of additional tax from \$35,000 (6.8%) to \$51,000 (slightly less than 10%). 10% is the absolute minimum in all the circumstances of the case.

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Appeal dismissed.

Yau Mun Wah Stella for the Commissioner of Inland Revenue.

Taxpayer in person.

Decision:

1. This is an appeal against the assessment dated 29 March 2000 by the Commissioner of Inland Revenue, assessing the Taxpayer to additional tax under section 82A of the IRO, chapter 112 in the sum of \$35,000 (‘ the Assessment’) in respect of year of assessment 1997/98 salaries tax.

2. The relevant provision is section 82A(1)(a) of the IRO for making incorrect return by omitting income, being the gain from exercise of share option.

The facts

3. The following facts are agreed by the parties and we find them as facts.

4. The Taxpayer is appealing against the imposition of additional tax of \$35,000 by way of penalty under section 82A of the IRO assessed upon him for the year of assessment 1997/98.

5. A tax return – individuals for the year of assessment 1997/98 (‘ the Return’) was issued to the Taxpayer on 1 May 1998 together with a ‘ Notes on how to complete tax return - individuals’ in Chinese version. In Part D of the Return, the Taxpayer declared his income chargeable under salaries tax as follows:

Name of employer	Period of employment & capacity employed	Nature	Amount
[The Employer]	1-4-1997 to 31-3-1998 - director	Salary/wages	\$1,780,000

In Part D4, he claimed outgoings and expenses of \$1,803 being professional membership fee.

6. An employer’s return of remuneration and pensions for the year ended 31 March 1998, dated 29 June 1998 filed by the employer showed that the Taxpayer had the following income:

Period of employment	Capacity employed	Nature	Amount
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1-4-1997 to 31-3-1998	Director	Salary/wages and bonus	\$1,780,000
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7. On 31 July 1998, the assessor raised the salaries tax assessment based on total assessable income of \$1,780,000 as detailed in paragraph 6 above on the Taxpayer for the year of assessment 1997/98. Particulars of the assessment are as follows:

	\$
Assessable income	1,780,000
<u>Less: Outgoings and expenses</u>	<u>1,803</u>
Net chargeable income	<u>1,778,197</u>
Tax thereon (at 15%)	<u>266,729</u>
<u>Less: Provisional tax already charged</u>	<u>251,620</u>
Balance of tax payable	<u>15,109</u>
<u>Add: Provisional tax for year of assessment 1998/99</u>	<u>263,233</u>
Balance of total tax payable	<u><u>278,342</u></u>

8. The Taxpayer did not lodge any objection against this notice of assessment for year of assessment 1997/98.

9. In response to the enquiries made by the Inland Revenue Department, the Employer provided the following information on 28 December 1998 regarding the exercise of share option by the Taxpayer during the year of assessment 1997/98:

Number of shares exercised	Exercise price per share	Market value of the shares at the date of exercise
2,200,000	\$0.8908	\$2.625

A revised IR56B showing the following details was submitted on 23 December 1998, the information being identical (except the capacity in which the Taxpayer was employed) with those submitted on 29 June 1998 as per paragraph 6 above:

Period of employment	Capacity employed	Nature	Amount
1-4-1997 to 31-3-1998	Deputy managing director	Salary/wages and bonus	\$1,780,000

10. On 11 January 1999, the assessor issued an enquiry letter to the Taxpayer for further details regarding the exercise of shares option.

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11. On 30 January 1999, the Taxpayer submitted a written reply stating that:

- 1 Three million number of shares of [the Employer] were offered in the options granted on 8 February 1994 (with the addition of two hundred thousand shares after the bonus issue adjustment on 25 September 1996).
- 2 For the reported year of assessment 1997/98, 2.2 million shares were taken up by me on 29 August 1997.
- 3 The open market value of the share at (2) above was \$2.625.
- 4 The value/consideration at which I have paid for the shares was \$0.8908 per share.

None of the shares under discussion has been assigned nor released. However, as the current market price is comparatively much lower than the open market value (being four times smaller now) at the exercise of my share options and if Government is to tax me for the virtual gain which has never realized and is currently negative, I shall have to request for deferred payment of any tax which may be chargeable. I propose that any such tax should be payable by me in three equal yearly installments.'

12. A notice of refund of tax for the year of assessment 1997/98 was issued to the Taxpayer on 30 March 1999 to give effect to the rebate of 10% of the final tax payable for the year of assessment 1997/98 under section 87 of the IRO. Particulars of the notice are as follows:

	\$
Assessable income	1,780,000
<u>Less: Outgoings and expenses</u>	<u>1,803</u>
Net chargeable income	<u>1,778,197</u>
Tax thereon (at 15% and after 10% tax rebate)	<u>240,056</u>
<u>Less: Previously charged</u>	<u>251,620</u>
Balance of final tax repayable	11,564
Net provisional tax as previously advised	<u>263,233</u>
Tax payable	251,669
Net tax already charged	<u>278,342</u>
Net balance of tax repayable	<u><u>26,673</u></u>

13. On 4 October 1999, the assessor raised an additional assessment based on the information in paragraphs 9 and 11 above on the Taxpayer for the year of assessment 1997/98. The gain on exercise of share option included in the assessment was calculated as 2,200,000 x (\$2.625 - \$0.8908) = \$3,815,240. Particulars of the assessment are as follows:

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	\$
Revised assessable income (\$1,780,000 + \$3,815,240)	5,595,240
<u>Less: Outgoings and expenses</u>	<u>1,803</u>
Revised net chargeable income	5,593,437
<u>Less: amount previously assessed</u>	<u>1,778,197</u>
Additional net chargeable income	<u>3,815,240</u>
Additional tax thereon (at 15% and after 10% tax rebate)	<u>515,057</u>

14. The Taxpayer did not lodge any objection against the additional assessment for the year of assessment 1997/98.

15. On 18 February 2000, the Commissioner of Inland Revenue gave notice to the Taxpayer under section 82A(4) of the IRO that he proposed to assess him to additional tax for the year of assessment 1997/98 in respect of the gain from exercise of share option from the Employer which was understated by him in his tax return for the year of assessment 1997/98.

16. The Taxpayer sent a written representation to the Commissioner of Inland Revenue on 27 February 2000 pursuant to Section 82A(4)(a) of the IRO.

17. Having considered the representation, by a notice dated 29 March 2000, the Commissioner issued a notice of assessment and demand for additional tax under section 82A in the sum of \$35,000. The additional tax imposed is 6.8% of the amount of tax of \$515,057 which would have been undercharged had the tax return filed on 1 May 1998 been accepted as correct.

18. On 29 April 2000, the Taxpayer gave notice of appeal to the Board of Revenue to appeal against the assessment to additional tax under section 82A.

The appeal hearing

19. At the hearing of the appeal, the Taxpayer appeared in person and addressed us in Cantonese. He told us that previously he also omitted reporting this kind of income in exercising his share option. He said he grabbed the tax return and guidance notes and that he could only afford to spend very little time. He hurriedly filled out this form in ten odd minutes. In respect of the year of assessment 1997/98 only the Chinese version of the guidance notes had been sent to him. The note in the Chinese version on share option, that is, note 6(2), referred to ‘法團’ instead of ‘企業’ or ‘公司’. The note in the English version referred to a ‘corporation’. In his notice of appeal, he claimed that ‘Inland Revenue Department might have in an indirect way been responsible for leading [him] into the plight of ignoring or forgetting to report [his] share options exercising’. He said that he referred also to the Employer’s return, item number 11(j) of which on ‘Gain realized under share option scheme’ was left blank. He said that there was no gain at the time of his return.

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He asserted that it was a genuine case where he really forgot and that he had no intention to evade tax.

20. At the end of the Taxpayer's case, we asked him if there was any reason why we should not increase the penalty tax if we should consider it inadequate. He submitted that he had no intention to evade tax, that it just escaped his attention and it was a genuine case where he really forgot, and that although there was a gain according to law, he had an unrealised loss because the price of the shares was below the price at which he exercised the option.

21. We also asked him if there was any reason why we should not order costs against him if we should dismiss the appeal. He told us he thought he had sufficient grounds to appeal.

22. We told the parties that we were not calling on the Respondent and that we would give our decision in writing.

Our decision

23. The only document in the Respondent's bundle of documents is a copy letter dated 8 July 1996 from the Taxpayer to the Respondent, together with enclosures. In that letter, the Taxpayer wrote in these terms:

‘ I refer to my tax return – individuals for year of assessment 1995/96 dated 20 May 1996 submitted to you and have found that my income derived from exercising my share options right has been inadvertently omitted in filling out the tax return. I am pleased to enclose hereto a copy of the duly corrected return for your action.

Apologies for any inconvenience caused.’

24. It would appear from the enclosures to the Taxpayer's letter dated 8 July 1996 that on 10 February 1996, the Taxpayer acquired 1,000,000 shares at \$0.98 per share and that the then market price was \$1.37 per share. It was clearly beneficial to him to exercise his option or else he would not have done so. On 10 February 1996, he acquired 1,000,000 shares at \$0.39 (\$1.37 - \$0.98) per share below the then market value. The man in the street would say that he made a gain of \$390,000 on that day.

25. What remained after he had acquired 1,000,000 shares on 10 February 1996 was an option to acquire a further 2,000,000 shares (see paragraph 11 above). This was adjusted to 2,200,000 shares on 25 September 1996 on account of bonus share adjustments. We believe the option price was adjusted accordingly from \$0.98 to \$0.8908.

26. On 29 August 1997, the market value of the Employer's shares was \$2.625 per share and the Taxpayer exercised what remained of his option right and acquired 2,200,000 shares

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at \$0.8908 each. On 29 August 1997, the Taxpayer acquired the 2,200,000 shares at \$3,815,240 below market value. This was 214% of his salary/wages of \$1,780,000 for the whole of the year of assessment 1997/98. Such a gain is difficult not to remember. If the market value of the shares had since plunged, this would make what had hitherto been a gain all the more difficult not to remember.

27. We do not accept that the Taxpayer had been misled by the Chinese guidance notes 6(2) in any way and we categorically reject his assertion. By 8 July 1996, the Taxpayer clearly knew that income derived from exercising his share option had to be reported and that he had omitted to report such income in his return for the year of assessment 1995/96. In our view, note 6(2) is plainly correct – a ‘corporation’ is a ‘法團’.

28. In our decision, the return made by the Taxpayer was incorrect by omitting the gain of \$3,815,240 on exercising the share option. None of the matters put forward by the Taxpayer in his notice of appeal and none of the matters put forward by the Taxpayer at the hearing of the appeal amounts in any way to a reasonable excuse. Submitting a **second incorrect** return in respect of the **same** option within three years of assessment is on any reckoning inexcusable.

29. We turn now to the question whether the Assessment is excessive.

30. Significantly, this is the Taxpayer’s **second incorrect** return in respect of the **same** option within three years of assessment, the first in the year of assessment 1995/96 and the second and current one in the year of assessment 1997/98.

31. The due dates for payments of tax in the assessment referred to in paragraph 7 above were 20 January 1999 and 21 April 1999. The due date for payment of tax in the assessment referred to in paragraph 13 above was 15 November 1999. Thus there is a delay of over six to nine months in the collection of the salaries tax from the Taxpayer. At an interest rate of 1% per month, the loss of revenue was 6 to 9%. Approaching the matter from another angle, a surcharge of 5% is routinely imposed for late payments of tax of up to six months and for a further 10% on 105% of the amount of tax for late payments beyond six months. Discount must be given on the basis that the Respondent could have issued the additional assessment shortly after the Taxpayer’s letter dated 30 January 1999. The fact remains that the Taxpayer had had the benefit of the delay in the due date for payment of tax under the additional assessment.

32. In his letter dated 8 July 1996 he apologised for his omission. This time, he is unrepentant and sought to blame the Revenue.

33. The maximum amount for which the Taxpayer is liable is three times the amount of the tax undercharged. In our decision, not only is the additional tax imposed at 6.8% of the amount of the tax undercharged not excessive, it is manifestly inadequate in all the circumstances of this case.

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Increasing the Assessment under sections 68(8)(a) and 82B(3)

34. This is the Taxpayer's **second incorrect** return in respect of the **same** option within three years of assessment and there is actual loss of revenue. 6.8% is manifestly inadequate. Pursuant to sections 68(8)(a) and 82B(3) of the IRO, we increase the Assessment from \$35,000 to \$51,000 which is slightly less than 10%. 10% is the absolute minimum in all the circumstances of this case.

Costs under section 68(9)

35. We consider the Taxpayer's case on appeal to be frivolous and vexatious. But for the fact that the appeal has served the useful purpose of increasing the penalty to what we consider should be the absolute minimum, we would have made an order for costs under section 68(9).