INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D68/04

Salaries tax – section 9 of the Inland Revenue Ordinance ('IRO') – whether losses arising from the sale of share warrants properly deductible from assessable income – whether section 9(5) entitled the appellant to make such a deduction – whether consideration paid for share warrants properly subject to salaries tax.

Panel: Andrew J Halkyard (chairman), Charles Graeme Large and Kumar Ramanathan.

Date of hearing: 24 November 2004.
Date of decision: 23 December 2004.

At all material times, the appellant was an employee of a bank who was eligible to be awarded a discretionary annual performance-related bonus, and to participate in the bank's Equity Investment Plan ('EIP') which enabled the appellant to acquire shares in the bank through the purchase of share warrants.

In 1998 and 1999, the appellant was awarded pre-tax discretionary bonuses, which were fully assessed to salaries tax without objection. In those years, the appellant also contributed certain amounts from his bonuses to the EIP for the purchase of share warrants in the bank. As part of the EIP, the bank also purchased certain share warrants on behalf of the appellant.

On 28 March 2002, the appellant sold the share warrants at a loss, and sought to deduct the loss from his assessable income for the year of assessment 2001/02.

The issue before the Board was the correct tax treatment accorded to the loss realized by the appellant on the sale of the share warrants. Further, the Board considered whether the consideration paid for the share warrants was properly subject to salaries tax in 1997/98 and 1998/99.

Held:

1. The taxpayer was not entitled to deduct the loss under section 9 of the IRO as that provision concerned benefits accrued to a taxpayer and it did not provide for 'negative income' to be deducted from assessable income. In particular, section 9(1)(d) which concerned share options, referred to a 'gain' not a 'loss'. None of the other provisions under the IRO relating to deductions were applicable.

2. Section 9(5) did not entitle the appellant to claim a deduction for the loss arising from the sale of the share warrants. It merely prevented double taxation arising in respect of the *receipt* of the right to acquire shares where a gain may be taxable by virtue of section 9(1)(d) in respect of the *exercise* of the right.

3. *Obiter*. The fact that the appellant did not know precisely how much bonus he would receive before his EIP election or that he was required to make an irrevocable election prior to the determination of the amount of the bonus was irrelevant. The amounts contributed to the EIP accrued to the appellant as a taxable bonus and was deemed to have been received by him since it was dealt with by the Bank on his behalf in accordance with section 11D(a) of the IRO.

4. Accordingly, the appeal was dismissed and the determination of the Deputy Commissioner was upheld.

Appeal dismissed.

Leung Wing Chi for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. This is an appeal against the determination by the Deputy Commissioner of the salaries tax assessment raised on the Appellant for the year of assessment 2001/02. The Appellant claimed that he was entitled to deduct from his assessable income the loss which he sustained in March 2002 when he sold certain Bank A 4-year and 3-year share warrants ('the warrants').

The facts

2. The facts before us, and we so find, are contained in the Deputy Commissioner's determination dated 19 August 2004. In relevant part, these are as follows:

(a) Under his contract of employment ('the contract') with Bank A (formerly known as Bank B Corporation) ('the Bank') the Appellant was eligible to be awarded a discretionary annual performance-related bonus. The Appellant was also entitled under the contract to participate in the Bank's Equity Investment Plan ('EIP'). The EIP enabled eligible employees to acquire shares

in the Bank through purchase of share warrants. Should the employee so elect, the Bank would at its own expense make an additional allocation of share warrants to the employee.

(b) On 23 February 1998 and 22 February 1999 respectively, the Bank confirmed in writing that it had awarded a pre-tax discretionary performance bonus to the Appellant of $578,035 and $520,000 for the calendar years 1997 and 1998 respectively. These figures were confirmed in the employer's returns filed by the Bank in respect of the Appellant for the years of assessment 1997/98 and 1998/99. They were assessed to salaries tax without any objection being raised by the Appellant in respect thereof.

(c) After being verbally informed that the Bank intended to award him a bonus, but prior to the written confirmation in fact b above, the Appellant voluntarily elected to contribute $115,607 (being 20% of his performance bonus for 1997) to the EIP for the purchase of Bank A 4-year warrants. On 15 March 1998 the Bank made an additional purchase of Bank A 4-year warrants on the Appellant's behalf in the amount of $28,902 (equivalent to 25% of the Appellant's contribution).

(d) Similarly, for the following year, the Appellant elected, again on a voluntary basis, to contribute $300,000 from his performance bonus for 1998 to the EIP for the purchase of Bank A 3-year warrants. On 15 March 1999 the Bank purchased in the Appellant's name Bank A 3-year warrants in the amount of $33,000 (equivalent to 11% of the Appellant's contribution).

(e) On 28 March 2002 the Appellant sold the warrants described in facts c and d for a total amount of Currency C 8,593. The Appellant suffered a loss on the sales amounting to $369,200 [as computed by the Commissioner] or $455,312 [as computed by the Appellant].

(f) The total net chargeable income of the Appellant as assessed and confirmed by the Deputy Commissioner for the year of assessment 2001/02 was $1,151,897 (comprising total income less deductions, concessionary deductions and personal allowances).

(g) It is common ground that for the earlier years of assessment 1997/98 and 1998/99 the assessor did not include in the Appellant's assessable income any amount by virtue of section 9(1)(d) of the Inland Revenue Ordinance ('IRO'). However, the assessor assessed the full amount of the bonus as described above at fact b.

Analysis: Year of assessment 2001/02

3. Although the main part of the hearing before us concerned the issues of whether (1) the warrants were share options for the purposes of section 9(1)(d), 9(4) and 9(5) of the IRO, and (2) the consideration paid for the warrants by the Appellant was properly subject to salaries tax in 1997/98 and 1998/99, the sole issue for our decision concerned the correct tax treatment accorded to the loss realized by the Appellant on the sale of the warrants (fact e). In this regard, the Appellant argued that the loss constituted a 'negative income' under section 9(5), and that this should be offset against his other income (fact f) for salaries tax assessment purposes for the year of assessment 2001/02.

4. We agree with the Commissioner's representative, Ms Leung Wing-chi, that the Appellant's argument is misconceived. Section 9 of the IRO defines 'income from employment'. The section enumerates items of assessable income (including, for example, 'rental value' for partly subsidised housing benefit in subsection (c) which clearly cannot be a negative figure). The share option provision, section 9(1)(d), refers to a 'gain', not a loss. We agree with Ms Leung that all the items enumerated in section 9 are concerned with benefits accrued to a taxpayer and that this provision simply does not provide for any 'negative income' to be deducted from the taxpayer's assessable income. In other words, section 9 provides no authority or scope for deduction of losses, expenses and outgoings under salaries tax. Apart from the concessionary deductions and personal allowances (see section 12B and Part IVA of the IRO), these are provided by sections 12 and 12A, which were clearly inapplicable and formed no part of the Appellant's case. Section 9(5) does not provide any authority for the Appellant to claim a deduction for the loss suffered on the warrants. It merely prevents *double taxation* arising in respect of *the receipt of the right* to acquire shares where a gain may be taxable by virtue of section 9(1)(d) in respect the exercise of the right. The Commissioner has never sought, and does not seek, to tax the Appellant in respect of the receipt of any share option or, for that matter, in respect of a gain in respect of the exercise of any share option.

5. In our view, it is clear beyond all argument that the salaries tax assessment raised on the Appellant for 2001/02 as confirmed by the Deputy Commissioner was correct. In short, there is no provision in the IRO that could allow the Appellant to deduct the loss he incurred when he sold the warrants. This is sufficient for us to dismiss this appeal and we so order.

Other issues

6. In light of the above, strictly it is not necessary for us to consider the remaining ground of whether the consideration paid for the warrants (which the Appellant calculates to be $501,763) was properly subject to salaries tax in 1997/98 and 1998/99. However, since much of the hearing before us focused on this issue, we feel it only fair to the parties to provide our views on this matter. We note that both parties agree that the assessor had not relied upon section 9(1)(d) in raising the 1997/98 and 1998/99 assessments (fact g). What the assessor did (and what the Deputy

Commissioner confirmed) was to subject the full amount of the bonuses as described above at fact b to salaries tax.

7. In essence, the Appellant now argues that fact b misstates the position, since in reality the amounts recorded therein should be bifurcated between (1) the amount of cash actually received by him (which he apparently accepts is liable to salaries tax as a bonus) and (2) the amounts he contributed towards the Bank's EIP for each of the two years (which he argues should be subject to the specific provisions relating to share options in section 9(1)(d)). In this regard, the Appellant would ask us particularly to note the fact that:

- He did not know how much bonus he would be given before he elected to participate in the Bank's EIP, although he admitted he was given a verbal 'indication' of the approximate amount a 'day or so' before making an election.

- The election to participate in the EIP took place well before the precise amount of the bonus was determined.

- The amounts contributed to the EIP should not have been included as bonus assessable to salaries tax, since in no way was it convertible into money. Once an election was made it is irrevocable. He could not thereafter receive the full amount of the bonus in cash and he could not sell the EIP warrants until the restriction period had expired.

- The legislative scheme of the IRO is such that the assessor has no option whether to apply section 9(1)(d). If the provision applies, then it should be invoked.

8. In our view, the assessor's taxation of the bonus amounts in fact b was correct. We find that the Appellant was entitled to receive the full amount of the bonuses (see, for instance, the communications of the Bank to the Appellant dated 23 February 1998 and 22 February 1999, the employer's returns filed by the Bank in respect of the Appellant, the Bank's letter to the Commissioner dated 13 November 2003 and the Appellant's letter to the assessor dated 2 July 2003 which stated: 'The payments ('Considerations for Grant') were directly deducted from my bonus in the respective years of grant'). The fact that he did not know precisely how much bonus he would receive before his (voluntary) EIP election, that this election took place before the precise amount of the bonus was determined and that once the EIP election was made it was not (immediately) convertible into money is irrelevant. On the found facts we conclude that the part of the bonus applied to the Appellant's contributions to the EIP in 1997 and 1998 accrued to the Appellant as taxable bonus and is deemed to have been received by him since it was dealt with by the Bank on his behalf in accordance with section 11D(a) of the IRO. There is no evidence before us that the amount of the performance bonus awarded to the Appellant would be altered if he did or did not elect to contribute to the Bank's EIP.

9. Turning now to the Appellant's argument that section 9(1)(d) should be invoked, where on its face it does apply, we agree that the assessor had no discretion in this matter. But this argument does not assist the Appellant – since it cannot affect the proper taxation treatment accorded to the bonuses described above at fact b (which we have concluded was correct). In summary, the facts found show that part of a taxable bonus relating to the Appellant's contributions to the Bank's EIP for 1997 and 1998 was dealt with by the Bank in accordance with the Appellant's instructions and on his behalf.

10. It may be that the Appellant's participation in the Bank's EIP could have given rise to a *further* taxable event under either section 9(1)(d) (if he had realized any gain on the sale of the warrants) or under section 9(1)(a) (as involving the receipt of a perquisite not covered by the specific provisions of section 9(1)(d)). It is sufficient for us to record, in this regard, that although the parties differ as to the correct taxation treatment [to provide a more complete picture we note that the Commissioner (1) rejects the application of section 9(1)(d) on the basis that under the EIP the Appellant obtained no right to acquire shares and (2) apparently accepts that in light of the consideration provided by the Appellant for the warrants, the restrictions placed by the EIP upon their disposal and the lack of information as to the value of the warrants at the time of receipt, no assessable perquisite accrued to the Appellant on receipt of the warrants], this does not alter the fact that the consideration paid by the Appellant for the warrants had properly been subjected to salaries tax as forming part of his taxable bonus.

Order

11. On the basis of our findings and analysis above, we dismiss the appeal and uphold the determination of the Deputy Commissioner. It is left for us to thank the Appellant and Ms Leung for the clear manner in which they advanced their respective arguments.