Case No. D24/94

Penalty tax – late filing of profits tax return – management accounts lodged with Commissioner prior to submission of tax return – quantum of penalty – section 82A of Inland Revenue Ordinance.

Panel: T J Gregory (chairman), Anthony N C Griffiths and Anthony J H Wood.

Date of hearing: 25 May 1994.
Date of decision: 11 July 1994

The taxpayer was not able to file its profits tax return within the time stipulated. The taxpayer applied for an extension of time and also lodged management accounts with the Commissioner. This was followed by the profits tax return. The final date for filing the profits tax return was 15 November 1993, the management accounts were lodged on 12 November 1993 and the tax return with audited accounts was filed on 15 December 1993. The Commissioner imposed a penalty for late filing of the tax return of $80,000 which was approximately 3.2% of the total amount of the tax involved. The taxpayer appealed on the ground that it had a reasonable excuse and that the quantum of the penalty was excessive.

Held:

The taxpayer did not have a reasonable excuse but the quantum of the penalty was excessive. The taxpayer had informed the Commissioner of the amount of its taxable profits within the time stipulated and had filed its tax return soon thereafter. The assessor had been able to issue an assessment to tax based on the management accounts. The taxpayer was late in filing its tax return which entitled the Commissioner to impose a penalty but in the circumstances a penalty of $5,000 would be appropriate.

Appeal partly allowed.

Cases referred to:

Dodge Knitting Co Ltd and Dodge Trading Ltd v CIR 2 HKTC 597
D105/89, IRBRD, vol 6, 384
D29/93, IRBRD, vol 8, 211
D2/88, IRBRD, vol 3, 125
D53/88, IRBRD, vol 4, 10
D2/92, IRBRD, vol 7, 56
D61/90, IRBRD, vol 5, 444
D11/93, IRBRD, vol 8, 143

Woo Sai Hong for the Commissioner of Inland Revenue.
Benny Y B Yeung of Messrs Cheng, Yeung & Co for the taxpayer.

Decision:

1. THE SUBJECT MATTER OF THE APPEAL

The Taxpayer appealed against an assessment to additional tax raised under section 82A of the Inland Revenue Ordinance (the IRO) in respect of the year of assessment 1992/93.

2. THE FACTS AND THE GROUNDS OF APPEAL

2.1 The Facts:

A statement of agreed facts was handed to the Board. This reads:

'(1) The Taxpayer was incorporated in Hong Kong in 1986.

(2) By a notice under section 51 of the IRO dated 1 April 1993, the Taxpayer has been required to file its profits tax return for the year of assessment 1992/93 within one month. However, under the block extension policy, the extended due date for submission is 15 November 1993.

(3) On 12 November 1993, the tax representative, [Firm named] wrote to the Inland Revenue Department ('the Revenue') to request for extension of time for filing the profits tax return for the year of assessment 1992/93 to 15 December 1993 and at the same time sent to the Revenue with unaudited management accounts of the Taxpayer for the same tax year showing a taxable profit of $14,601,826.

(4) The Revenue, by a letter dated 19 November 1993 rejected the request for extension.

(5) On 26 November 1993, an estimated assessment under section 59(3) of the IRO in the amount of $4,170,000 in respect of the year of assessment 1992/93 was issued.

(6) On 29 November 1993, the Revenue gave a notice of additional assessment wherein the additional assessable profit was stated to be $10,431,826. The additional assessable profits together with the previous estimated assessment of $4,170,000 gave rise to a total assessable profit of $14,601,826 which is the taxable profit shown in the unaudited management account.

(7) The Taxpayer paid the tax which it had been assessed to pay under the original and additional demand notes on or before the due dates stated therein which fell

within the normal due dates applicable to taxpayers who have their account closing dates at the end of March like the Taxpayer's but who have submitted their tax returns in time.

(8) On 15 December 1993 the tax representative of the Taxpayer filed the profits tax return and the audited accounts of the Taxpayer and at the same time lodged an objection to the additional estimated assessment dated 29 November 1993 on the ground that the assessment was excessive by $495,605 in accordance with the assessable profit of $14,106,221 reported in the audited accounts.

(9) On 12 January 1994, the Revenue issued a notice of revised assessment and/or notice of revised demand for profits tax wherein the net assessable profit to be taxed was reduced to $14,106,221 which is the assessable profit reported in the audited accounts and the net tax was accordingly also reduced.

(10) On 20 January 1994, the Commissioner gave notice to the Taxpayer in terms of section 82A(4) of the IRO that he proposed to assess the Taxpayer to additional tax by way of penalty in respect of the year of assessment 1992/93.

(11) On 7 February 1994, the tax representative submitted to the Commissioner representation in pursuance of section 82A(a)(ii).

(12) On 28 February 1994, the Commissioner informed the Taxpayer that having considered and taken into account the representation made he has assessed the Taxpayer to additional tax under section 82A of the IRO in the sum of $80,000.

(13) On 25 March 1994, the Taxpayer lodged an appeal to the Board of Review through its new tax representative, [Firm named] against the said assessment for additional tax.'

2.2 The Taxpayer's grounds of appeal:

These, including emphasis, read:

I. That the Taxpayer is not liable to additional tax under section 82A of the IRO since there is no tax undercharged in consequence of its delay to submit the return in time.

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1. Under section 51 of the IRO, an assessor may give notice in writing to any person requiring him within a reasonable time dated in such notice to furnish a tax return. In relation to profits tax, the Commissioner requires that all parts of the form to be completed and returned with a copy of the annual balance sheet, profit and loss account and auditors' report.

2. Under section 82A, if any person who without reasonable excuse fails to comply with the requirement of a notice given to him under section 51(1), he shall be liable to be assessed to additional tax of an amount not exceeding

treble the amount of tax which has been undercharged in consequence of the failure to comply with a notice under section 51(1).

3. On construction of section 82A, there can only be an assessment to additional tax if and only if there has been tax undercharged in consequence of the default.

4. In this case, there has not been any tax undercharged in consequence of the Taxpayer's delay in comply with the notice under section 51(1) and there could not be any assessment to additional tax under section 82A.

5. By a notice dated 1 April 1993, the Taxpayer has been required to file the tax return on or before 15 November 1993. On 12 November 1993, when the Taxpayer realized that it was unable to file the tax return before the due date of 15 November 1993 as required under the Block Extension Scheme of the Revenue, the Taxpayer furnished the Revenue with a copy of an unaudited accounts showing assessable profits of $14,601,826. The Taxpayer, by its auditors, invited the Revenue to issue an estimated assessment basing on the unaudited accounts so that the Revenue could collect the tax payable on the normal due date. This was done to ensure that there would not be any tax undercharged as a result of the delay in the submission of the tax return.

6. The Revenue acknowledged this letter on 19 November 1993.

7. After the Taxpayer's filing of the unaudited accounts on 12 November 1993 as aforesaid, the Revenue did issue an estimated assessment in the amount of $4,170,000 on 26 November 1993 requiring the tax (first instalment) to be paid on 10 January 1994.

   It is not known how the Revenue arrived at this figure whilst they were in possession of the information provided in the letter dated 12 November 1993.

8. On 29 November 1993, the Revenue issued an additional estimated assessment in the amount of $10,431,826 requiring the tax (first instalment) to be paid on 28 January 1994. This, together with the $4,170,000 previously assessed amounted to a total estimated assessable profit of $14,601,826. It is quite clear that it is based on the unaudited management accounts of the Taxpayer.

9. The profits tax return of the Taxpayer was submitted on 15 December 1993, which is just one month after the due date on 15 November 1993 showing an assessable profit of $14,106,221. The assessable profit shown in the audited accounts was in fact less than the estimate by the auditors of the Taxpayer basing on the management accounts which have been furnished to the Revenue as aforementioned.

10. The Revenue, having assessed the Taxpayer's tax return, issued a revised assessment on 12 January 1994 reducing the assessable profit from $14,601,826 to $14,106,221. The Taxpayer had in fact been over-assessed to the extent of $495,605 on the basis of the management accounts.

11. It has been observed that taxpayers who have submitted their tax returns within the official deadline of 15 November 1993 would have their tax due for payment in early February 1994 ('the Normal Due Date'). The Taxpayer had paid its tax before 28 January 1994 and that was before the time when taxpayers which have submitted their tax returns within the official deadline were due to pay tax. In other words, the Government had not even suffered any loss in respect of interest in consequence of the delay in the submission of the return by the Taxpayer.

12. Finally, not only had there been no actual tax undercharged or loss of interest there was no tax which 'would have been undercharged if such failure [to file the return in time] had not been detected' because there was no risk at all that such failure would have gone undetected, the auditors of the Taxpayer having furnished the Revenue with a copy of an unaudited accounts and invited the Revenue to issue an estimated assessment basing on that.

II. Alternatively, if the first ground of appeal fails, that the additional tax assessment is excessive in the circumstances.

The demand for additional tax under section 82A of the IRO issued by the Revenue dated 28 February 1994 in the amount of $80,000 is excessive in the circumstances as the Revenue has failed to give regard or sufficient regard to the circumstances hereunder:

1. That the Government has not suffered any actual or risk of loss in revenue as a result of the late filing of the return which was because of the steps taken by the Taxpayer in submitting the management accounts and the Taxpayer repeats paragraphs 5 to 11 (inclusive) of the first ground of appeal.

2. That, as the tax representative of the Taxpayer has said in their representation, the delay was caused by events not entirely within the Taxpayer's control.

    a. In respect of the year ending 31 March 1992, the Taxpayer's business grew dramatically in size and profitability with turnover increased over 4 times from $29,000,000 to $130,000,000 and profits from $3,700,000 to $14,000,000 as compared to the year ending 31 March 1991. In order to cope with the accounts more efficiently and effectively due to the sudden expansion in business, the management proposed to computerize the accounting work.

    b. Unfortunately, during the initial stage of computerization, the staff was not familiar with the system and errors were often made requiring adjustments.

    c. The situation was aggravated by the break down of the computer system in August 1992 for two months. The system was later scrapped as

having been found unserviceable and the accounting work was resumed by the manual system. This has resulted in serious delay in the preparation of the final accounts which were only ready on 12 November 1993.

3. That the delay was only by one month.

3. THE CASE FOR THE TAXPAYER

3.1.1 At the hearing of the appeal the Taxpayer was represented by his tax representative which had filed the notice and grounds of appeal, refer paragraph (13) of the agreed facts.

3.1.2 No witness was called on behalf of the Taxpayer.

3.2 Having read the agreed facts, the representative made the following submission.

3.2.1 The Taxpayer's grounds of appeal were in the alternative:

3.2.1.1 That the Taxpayer was not liable to additional tax under section 82A.

3.2.1.2 Alternatively, that the additional tax is excessive having regard to the circumstances.

3.2.2 The important facts were:

3.2.2.1 The Taxpayer submitted to the Revenue before the due date (as extended under the block extension scheme) its unaudited management accounts as the submission of its profits tax return ('the return'), refer paragraph (3) of the agreed facts.

3.2.2.2 The Revenue made an estimated assessment of tax based on those unaudited management accounts, refer paragraph (6) of the agreed facts.

3.2.2.3 There was no substantial difference between the taxable profit shown in the unaudited management accounts and the audited accounts. The profit shown in the management accounts exceeded the profit shown in the audited accounts by around 3%, that is, $500,000 when the taxable profits were in the order of $14,000,000, refer paragraphs (8) and (9) of the agreed facts. The difference was explained by the management accounts not making any provision for depreciation or bad debts.

3.2.2.4 The Taxpayer discharged the assessed profits tax not later than the date on which it would have been required to pay the tax had it submitted the return within time, refer paragraph (7) of the agreed facts.

3.2.3 The first ground of appeal, namely that there is no liability under section 82A:

3.2.3.1 Having made a phrase by phrase analysis of section 82A(l)(ii) the representative stated that the Taxpayer's submission was that there is no tax which has been undercharged under either sub-section (a) or sub-section (b).

3.2.3.2 To assist in this analysis the Board was referred to Dodge Knitting Co Ltd and Dodge Trading Ltd v CIR 2 HKTC 597. Two paragraphs from the head note were read, namely:

> *'Both taxpayer companies failed, without reasonable excuse, to submit returns and notify the Commissioner of their chargeability to tax under sections 51(1) and 51(2) of the Inland Revenue Ordinance for a number of years. They were ultimately assessed to profits tax in respect of all the relevant years and the Commissioner also imposed additional tax under section 82A.*
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> *The taxpayers appealed. They claimed that penalties under section 82A could not be levied upon a taxpayer who fails to submit returns, or who fails to notify the Commissioner of his liability to tax, but who ultimately submits correct returns and pays his full tax liability. Their argument was that, in such a case, no tax has been "undercharged" within meaning of section 82A.'*

Thereafter, the following passage from the judgment of Liu J, at 611:

> *'The sub-paragraph divides also into 2 limbs: the first deals with an actual undercharge in the case of a detected failure under section 51(1) or section 51(2); the second limb deals with a hypothetical undercharge if such failure "had not been detected" in a case where failure was in fact detected. The two limbs are again mutually exclusive for the diagonally opposite occurrences but devised to provide the same sanction for both eventualities.'*

3.2.3.3 The first limb: Was there tax actually undercharged in consequence of the Taxpayer's failure to comply with section 51(1)?

3.2.3.3.1 It was submitted that this first limb referred to tax undercharged as a consequence of a taxpayer's failure to file a return was tax on assessable profits which could not be ascertained at the time when the return should have been filed as opposed to assessable profits which would have been ascertained if the taxpayer's return had been filed in compliance with the section 51(1) notice.

3.2.3.3.2 The Board was referred to D105/89, IRBRD, vol 6, 384: the facts were that the deadline for filing the return was on 31 October 1988, that the Revenue raised an estimated assessment of $3,000,000 on 29 December 1988, that the Revenue raised a further estimated assessment of $3,000,000 on 19 April 1989, that the taxpayer filed the return on 28 April 1989, approximately 6 months late, and which return disclosed taxable profits of $4,699,546. No management

accounts were submitted before the deadline to comply with the section 51(1) notice. In that case it was argued that the taxpayer was not liable to additional tax at all having regard to the two estimated assessments. Three paragraphs from this decision were read to the Board:

> *'17. Sub-section (ii) of section 82A(1) deals with failure to comply with a section 51 (1) notice (and also with failure to comply with a section 51(2) which is of no relevance in this case). The first question we ask ourselves is this: When did failure first occur? The answer on the facts must be: on the last stroke of midnight on 31 October 1988 (see paragraph 3 above). Default in terms of section 82A(l)(d) - failure to comply with the requirements of a notice given under section 51(1) thereupon occurred. And if:*
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> *(a) such failure was 'without reasonable excuse', and*
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> *(b) no prosecution under section 80(2) (d) had been instituted,*
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> *then, in our view, the Commissioner was, in terms of the statute, authorised to exercise his power under section 82A.*
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> *18. Assume that the Commissioner were to consider on 1 December 1988 (before any estimated assessments had been made) exercising his powers under section 82A(l)(ii). He would obviously have had practical difficulties: he would not have before him any figures for assessing the tax that would have been undercharged if such failure had not been detected. So, in practical terms, he must wait until the assessable profits are ascertained. But, once the assessable profits are ascertained, then he would have in hand the means for computing the tax that would have been undercharged if the failure to lodge the return by 31 October 1988 had not been detected.*
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> *19. Giving the statute a sensible construction, we fail to see how the exercise of the assessor's powers under section 59(3) to make estimated assessments in the absence of a return could have been intended as having the effect of cutting down on the Commissioner's powers to make additional assessments under section 82A(1). The foundation for imposing liability under sub-section (ii) of section 82A(1) is the failure to comply with a section 51(1) notice. The consequence of such failure is that the assessable profit (in this case amounting to $4,699,526) was not ascertained at a time when it would have been ascertained if there had been compliance; this leads in turn to the consequence that tax on $4,699,526 was not charged when otherwise it would have been charged.*

> *What more is needed to bring the situation within the words in sub-section (ii): [the "second limb" of sub-section (ii)]: "or which would have been undercharged if such failure had not been detected"?'*

3.2.3.3.3 D105/89 makes it clear that:

3.2.3.3.3.1 a failure to comply with a section 51(1) notice occurs on the stroke of midnight on the last day on which the taxpayer is obliged to comply with that notice and that from thence onward the Revenue was unable to ascertain the tax undercharged until the filing of a return by the taxpayer; and

3.2.3.3.3.2 the correct construction of section 82A is that the exercise of the assessor's power to make estimated assessments in the absence of a return does not cut down the Commissioner's power to make additional assessments under section 82A(1).

3.2.3.3.4 In Dodge, for which the stated case makes it clear that only the second limb was in issue, the learned judge used a similar approach and said, in the opinion of the representative, obiter, that by necessary implication, the failure to file a return would have the effect of filing a 'nil' return and the amount of the tax undercharged would be the shortfall between the tax payable and no tax, the consequence of a 'nil' return. Dodge is not authority on the first limb.

3.2.3.3.5 Not only was the learned judge's comment obiter, but also the taxpayers had for a number of years failed without reasonable excuse to submit returns and to notify the Commissioner that they were chargeable to tax. Further, they are ultimately assessed to profits tax in respect of all relevant years. No management accounts had ever been filed within time and the assessor had no means to make the estimated assessments. Therefore, on the facts the court was perhaps justified in holding that the failure to file a return had the effect of a 'nil' return.

3.2.3.3.6 The feature distinguishing this appeal from D105/89 is the provision of the management accounts to the Revenue before the deadline for filing the return. The management accounts provided a basis which enabled the Revenue to ascertain the correct assessable profit of the Taxpayer at the deadline for filing the return, that is, at the time when the assessable profit was to be ascertained had there been compliance. The management accounts were filed before the deadline.

3.2.4 Section 51(1):

3.2.4.1 This provides that an assessor may give notice in writing to any person requiring him within the time stated in such notice to furnish a return containing such particulars and in such form as may be specified by the Board of Inland Revenue.

3.2.4.2 The notice under section 51(1) requires the return to be accompanied by a certified copy of the balance sheet, auditor's report, and profit and loss account in respect of the basis period, and a tax computation with supporting schedules showing how the amount of assessable profits (or loss) has been arrived at.

There is no requirement to provide such accompanying documents in the case of non-corporate taxpayers. Therefore, it is clear that assessable profits can be ascertained in the absence of audited accounts. The Board was asked to distinguish between compliance with the requirement in a section 51(1) notice and the ability of the Revenue to ascertain the tax.

3.2.5 D29/93, IRBRD, vol 8, 211:

3.2.5.1 The submission of the Revenue in that appeal included the following (paragraphs 8.1.4 and 8.1.5):

> *'For the purpose of computing the amount of tax payable the "assessment profit" of a taxpayer has to be determined. The computation of "assessable profit" necessarily starts with the actual profits of the taxpayer. To those profits must be added the nondeductible items and deducted from the profit must be the non-taxable items. The auditor's report and financial statements, all of which are readily available from corporate taxpayers, provide reliable and accurate information as to the profit of a company and the other data relevant to the assessment of tax. They conveniently serve as documents supporting the profit figure reported by the corporate taxpayers.*
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> *The presence of audited accounts does not lessen the assessor's work imposed upon him by section 59. In discharging his duties the assessor has to examine and scrutinise the return and accounts, irrespective of whether the accounts are audited, as is the case for corporate taxpayers or unaudited, as is the case for non-corporate taxpayers.'*

In other words, the Revenue's position was that although there had been a failure to comply with the formalities of the filing of a return, the assessable profits was ascertained at the time when the return ought to have been filed.

3.2.5.2 However, the Taxpayer cannot be regarded as having filed a 'nil' return, whereby there was no tax undercharged in consequence of the failure.

3.2.6 Interest:

One possible undercharge of tax in consequence of the failure to comply with a section 51(1) notice may be interest. In this appeal there was no loss in interest on the tax because the Taxpayer paid the tax within the deadline which would have applied had the return been filed as required by the section 51(1) notice served on it, refer paragraph 7 of the agreed facts.

3.2.7 Was there tax which would have been undercharged if the failure to file the return had not been detected?

3.2.7.1 In Dodge the Court was asked to determine the following question:

> *'Whether the second limb of sub-paragraph (ii) of section 82A(1) of the Inland Revenue Ordinance only applies to situations where the failure to comply with section 51(1) and (2) were only detected after the expiration of the limitation period under section 60 of the Ordinance.'*

3.2.7.2 The question was answered in the negative and the court upheld the decision of the Board.

3.2.8 In D2/88, IRBRD, vol 3, 125:

3.2.8.1 The following was said at page 130:

> *'Section 82A specifically covers the situation where the failure to comply has in fact been detected. It creates a hypothetical set of circumstances in which it is to be assumed that the failure has gone undetected. If a person either fails to submit a tax return when so required or fails to inform the Commissioner of his liability to be assessed and such failures go undetected, it is clear that the taxpayer would altogether avoid paying any tax. Accordingly the amount of tax which would have been undercharged if such failure had not been detected is 100% of the tax liability of the taxpayer. Accordingly we find no substance in this part of Counsel's submission and find in favour of the Commissioner.'*

3.2.8.2 Was there the same risk of non-detection in this appeal? In this appeal the submission of the unaudited management accounts by the Taxpayer eliminated the risk that the failure to file the return would have gone undetected. The tax representative's letter dated 12 November 1993 requesting an extension of time within which to file the return and the provision of the management accounts put the Revenue on actual notice of the fact that there would be a failure to file the return within time, refer paragraph (3) of the agreed facts. Accordingly, the 'hypothetical set of circumstances' referred to by the Board in this decision cannot apply.

3.2.9 Will the Taxpayer go unpunished for its failure?

The Taxpayer was still liable under section 80(2)(d) and the appropriate step in the circumstances would be for the Commissioner to compound the offence under section 80(5). Compounding, as opposed to exercising section 82A, would have been the correct course.

3.3 The second ground of appeal, namely that the additional tax was excessive in the circumstances.

3.3.1 There is no tariff for the additional tax save that it cannot exceed three times the tax undercharged.

3.3.2 Each case has to be determined on its own merits.

3.3.3 The following are factors to be considered:

3.3.3.1 Whether there was criminal intent in a taxpayer's failure to comply with its obligations.

It was submitted that it was clear, and that the Revenue would accept, that there was no criminal intent whatsoever on the part of the Taxpayer.

3.3.3.2 Whether the Revenue had had to resort to an investigation or the preparation of an assets betterment statement or, otherwise, had had difficulty in assessing the tax.

Factually, the Revenue had not been required to carry out any investigations or to prepare an assets betterment statements nor did they have difficulties in assessing the tax because they had been assisted by having the management accounts.

3.3.3.3 Whether a taxpayer's default has persisted for a number of years.

The Taxpayer was not one who persistently failed to file returns.

3.3.3.4 Whether the delay in filing the return was substantial.

The filing of the return was only one month late.

3.3.3.5 Whether there had been an actual, as opposed to hypothetical, loss of revenue.

The Government has not suffered any actual or even risk of loss in revenue. There was no loss even in interest since the tax was paid no later than the time when the Taxpayer would have had to pay the tax had it filed the return in time.

3.3.3.6 The conduct of the taxpayer; what the taxpayer had done to mitigate the situation.

The Taxpayer, through its tax representative, had done all it could to mitigate the situation. It was the filing of the management accounts which assisted the Revenue in ascertaining the correct tax liability and ensuring that the tax was not paid late.

3.3.3.7 Special circumstances applicable to a taxpayer's falling short of a reasonable excuse but which would explain the failure of the taxpayer.

The Commissioner ought to have taken into account all of the above factors and been compassionate towards the difficulties of the Taxpayer, namely, that it was, accountingwise, unable to cope with the rapid growth in size in the tax year, by over 4 times, its attempt at computerization and the breakdown of its computer.

3.4 Had the matter been dealt with by way of a summons under section 80, it would not have been surprising if the Magistrate had only imposed the statutory fine of $5,000 as this is not the sort of case in which the penalty is to be measured as a percentage of the tax. It would merit no more than a token fine.

3.5 Against this background, the additional tax of $80,000 is excessive.

4. THE CASE FOR THE REVENUE

4.1 During the course of his submission the representative sought to introduce a board decision which he described as 'not yet published'. Unfortunately, he was not prepared to allow the Taxpayer's representative to peruse a copy of this decision, citing section 4 of the IRO. In those circumstances the Board had no alternative but to decline to allow him to refer to this decision. Whilst the Board does not know whether the Revenue has been advised that the decision in question is to be published or whether that was an assumption on the part of the representative, it would not have been beyond the capabilities of the Revenue to produce a suitably edited copy.

4.2 The submission on behalf of the Revenue was to the following effect:

4.2.1 The facts:

4.2.1.1 The appeal was against the assessment to additional tax imposed under section 82A of the IRO for the year of assessment 1992/93.

4.2.1.2 A profits tax return for the year of assessment 1992/93 was issued to the Taxpayer on 1 April 1993.

4.2.1.3 The Taxpayer closed its accounts on 31 March 1993 for the year of assessment 1992/93. For the year of assessment 1992/93 those taxpayers who closed their accounts between 1 January and 31 March 1993 were entitled to an extension to 15 November 1993 under the 'Block Extension Scheme'. The Circular from the Commissioner explaining the arrangements for the year of assessment 1992/93 contained the following paragraph:

> '*<u>Failure to lodge returns by the extended due date</u>*
>
> *'12. In all cases where returns are not lodged by the extended due date estimated assessments will be issued or penalty proceedings commenced. The opportunity is also taken to ask you to remind your client that any failure, without reasonable excuse, to file returns in a*

timely manner or to report chargeability may result in section 80 or 82A action being taken.'

Assessors had been directed to enforce this policy strictly.

4.2.1.4 Under cover of a letter dated 12 November 1993, stated to have been received by the Revenue on 15 November 1993, the Taxpayer's then tax representative lodged the Taxpayer's unaudited management accounts, disclosing a profit of $14,601,826, and requested an extension of the time within which to lodge the return until 15 December 1993. The return for the year of assessment 1992/93 was not enclosed with this letter.

4.2.1.5 15 November 1993 was the last day of the block extension period applicable to the Taxpayer, refer paragraph 4.2.1.3 above.

4.2.1.6 By letter dated 19 November 1993 the Revenue rejected the request for the extension of time.

4.2.1.7 By letter dated 25 November 1993 the then tax representative requested a duplicate profits tax return for the year of assessment 1992/93. This was sent to the tax representative.

4.2.1.8 On 26 November 1993 an estimated assessment was issued under section 59(3) of the IRO in the amount of $4,170,000 in respect of the year of assessment 1992/93. This estimated assessment was issued under the computerized automated estimated assessment system for taxpayers who have not submitted a valid return for the year of assessment 1992/93.

4.2.1.9 On 29 November 1993 the assessor raised an additional assessment on the Taxpayer in the amount of $10,431,826. This sum reflected the difference between the taxable profit as shown in the unaudited management accounts submitted on 15 November 1993 and the profit stated in the estimated assessment issued on 26 November 1993.

4.2.1.10 On 15 December 1993 the then tax representative lodged an objection to the additional estimated assessment dated 29 November 1993 on the ground that the assessment was excessive by $495,605 in accordance with the assessable profit of $14,106,221 reported in the audited accounts. On the same date, the return, the audited accounts and tax computation with supporting schedules were lodged.

4.2.1.11 On 12 January 1994 the Revenue issued a notice of revised assessment and/or notice of revised demand for profits tax in which the net assessable profit to be taxed was reduced to $14,106,221, namely the assessable profit reported in the audited accounts and the net tax was reduced correspondingly.

4.2.1.12 On 20 January 1994 the Commissioner gave notice to the Taxpayer in terms of section 82A(4) of the IRO that he proposed to assess the Taxpayer to additional tax by way of penalty in respect of the year of assessment 1992/93.

4.2.1.13 On 7 February 1994 the tax representative, pursuant to section 82A(a)(ii), submitted representations on behalf of the Taxpayer. It was said that the sudden expansion in business and problems encountered in computerization of its accounts had resulted in the delay in the preparation of the final accounts which were only ready on 12 November 1993.

4.2.1.14 On 28 February 1994 the Commissioner informed the Taxpayer that having considered and taken into account the representations made on its behalf he had assessed the Taxpayer to additional tax under section 82A of the IRO in the sum of $80,000.

4.2.1.15 On 25 March 1994 the Taxpayer lodged an appeal to the Board of Review against the said assessment to additional tax through its legal representatives.

4.2.2 The submission for the Taxpayer on liability to penalty:

4.2.2.1 The Taxpayer's case was that on the correct construction of section 82A there can only be an assessment to additional tax if there has been tax undercharged in consequence of the default. It had been submitted that there had not been any tax undercharged in consequence of the Taxpayer's delay in complying with the notice under section 51(1) whereby there could not be any assessment to additional tax under section 82A.

4.2.2.2 It was at this point that the representative sought to refer to the 'as yet unpublished' board decision, refer paragraph 4.1 above.

4.2.2.3 The Board was then referred to D105/89:

4.2.2.3.1 The passage at page 388, refer paragraph 3.2.3.3.2 above, was read.

The representative added that in this appeal the failure occurred at the stroke of midnight on 15 November 1993.

4.2.2.3.2 At page 389:

> *'What more is needed to bring the situation within the words in sub-section (ii): [the "second limb" of sub-section (ii)]: "or which would have been undercharged if such failure had not been detected"?'*
>
> *20. Plainly, the second limb of sub-section (ii) empowers the Commissioner to act upon a hypothesis: to assess as if the failure had not been detected. As the Board in D2/88, IRBRD, vol 3, 125 said at page 130:*

> *"Section 82A specifically covers the situation where the failure to comply has in fact been detected. It creates a hypothetical set of circumstances in which it is assumed that the failure has gone undetected. If a person either fails to submit a tax return when so required or fails to inform the Commissioner of his liability to be assessed and such failures go undetected, it is clear that the taxpayer would altogether avoid paying tax. Accordingly, the amount of tax which would have been undercharged if such failure had not been detected is 100% of the tax liability of the taxpayer."*

In D2/88 there had been failure by the taxpayer to comply with a section 51(1) notice and, in the absence of a return, the assessor had made estimated assessments. Ultimately returns were furnished and the taxpayer had discharged his profits tax liability in full. The Commissioner nevertheless exercised his powers under section 82A to impose additional tax. The taxpayer appealed to the Board of Review. The argument of counsel on behalf of the taxpayer that in the circumstances no tax had been "undercharged" was rejected. The Board's decision was upheld on appeal: see Dodge Knitting Co Ltd and Dodge Trading Ltd v CIR 2 HKTC 597.'

4.2.2.4 D53/88, IRBRD, vol 4, 10, at page 13

> *'The amount of the tax undercharged as a result of the delay in the filing of the return was $770,235. It has already been held in previous Board of Review decisions that it is not relevant to take into account the amount of the estimated tax assessed. The amount of the penalty is calculated with reference to the amount of tax which was not charged as a result of the tax return not being filed on the due date. In this case, the amount of tax undercharged was 100% of the tax which was eventually assessed for that year.'*

4.2.2.5 The fact that unaudited management accounts were submitted does not make any difference. D29/93, IRBRD, vol 8, 211:

4.2.2.5.1 at page 214:

> *'The Taxpayer in this case submitted an inaccurate first return on 29 November 1991 declaring an assessable profit of $34,522,830. The revised second return which was submitted on 19 February 1992 declared an assessable profit for the relevant period of $32,503,206.'*

The Board pointed out that this extract was from the taxpayer's grounds of appeal.

4.2.2.5.2 at pages 219, 221 and 223, quotations from the facts:

'(9) On 29 November 1991, the return as mentioned in fact (6) above declaring an assessable profit of $34,522,830 was submitted by the tax representatives in their new name firm identified by hand to the department, together with a detailed management profit and loss account.

(10) On 29 November 1991, an estimated assessment for the year of assessment 1990/91 was issued to the company under section 59(3) of the Inland Revenue Ordinance. A copy of the notice of assessment and demand for profits tax was also sent to earlier tax representative identified.

(15) Through its tax representatives, the Taxpayer submitted audited accounts together with notice of objection on 19 February 1992, showing an assessable profit for the year of assessment 1990/91 at $32,503,206.

(18) The additional estimated assessment was also revised on 2 March 1992 by the department to $26,933,206 as per the profit shown in the audited accounts less the amount already assessed under the first estimated assessment.

(23) The Commissioner on 19 May 1992, issued to the Taxpayer a notice of assessment and demand for additional tax under section 82A for the year of assessment 1990/91 in the amount of $400,000.'

4.2.2.5.3 The taxpayer, through its representative, lodged an appeal to the Board on 18 June 1992 on the issue of liability for the penalty under section 82A of the IRO. The Board made the following comments at page 235:

'Whether or not the Revenue, as a matter of practice, allow a grace period for the filing of returns after the expiration of the block extension is something which, in the opinion of the Board, is irrelevant to this appeal. The relevant agreed fact is that the return in question was filed on 19 February 1991, namely four days after the expiration of the alleged grace period. Accordingly, the Board is not required to make any finding as to whether or not this additional grace period is, in fact, allowed by the Commissioner.'

4.2.2.5.4 The Board agreed that there is a liability for penalty once the date for block extension has expired.

4.2.2.5.5 The Board confirmed the additional tax imposed on the taxpayer when management accounts reporting a profit of $34,000,000 were filed and the audited accounts, reporting a profit of $32,000,000 were filed four days after the expiration of the alleged grace period.

4.2.2.6 The return:

One of the paragraphs appearing on the profits tax return reads:

> *'All sections of this form must be completed and returned to me within one month from the date of this notice, together with a certified copy of your balance sheet, auditor's report, and profit and loss account in respect of the basis period, and a tax computation with supporting schedules, showing how the amount of assessable profits (or loss) has been arrived at.'*

The submission of management accounts does not satisfy those conditions. Additionally, when the management accounts were lodged the Taxpayer did not lodge the tax computation and its supporting schedules.

4.2.2.7 Grace period:

At a meeting between the Commissioner and the representatives of the Hong Kong Society of Accountants in December 1992 it was agreed that the grace period for consideration of section 82A penalty action has been removed. All cases in which the return is filed after the due date or extended due date may be considered for section 82A penalty action and assessors had been instructed accordingly.

4.2.3 The submission on reasonable excuse:

4.2.3.1 The Taxpayer had said that during the initial stage of computerisation its staff was not familiar with the system and errors were often made. The situation had been aggravated by the breakdown of the computer system in August 1992. The system was later scrapped and the manual system was reinstated.

4.2.3.2 D2/92, IRBRD, vol 7, 56 at page 58:

> *'With due respect to the representative we are unable to accept his submission that there was a reasonable excuse. The Inland Revenue Ordinance imposes an obligation upon all taxpayers to file their tax returns on time. In this case the taxpayer was able to carry on its business, paying its bills and collecting its accounts receivable from its customers. It is well known that problems can arise when accounts are changed from a manual system to a computer system. The taxpayer chose to computerize its accounts and chose the computer and the software. We have no doubt that if the taxpayer had really wanted to fulfil its obligations under the Inland Revenue Ordinance it could have done so.'*

4.2.3.3 D61/90, IRBRD, vol 5, 444, at page 449:

> *'The Board has consistently stated that it is the duty of a taxpayer to ensure that its accounting records are maintained up-to-date and that the returns required to be made by taxpayers under the Ordinance are made within the time limits specified in the Ordinance.'*

4.2.4 Quantum:

4.2.4.1 The representative confirmed that there was no suggestion that the Taxpayer had endeavoured to evade tax.

4.2.4.2 When assessing the penalty the Commissioner had already taken a lenient view. The penalty which he has imposed is $80,000 which is approximately 3.2% of the total amount of the tax involved which is $2,468,588.

4.2.4.3 D2/92, IRBRD, vol 7, 56 at page 59:

> *'Section 82A of the Inland Revenue Ordinance refers to the word "detect" in a hypothetical manner. What section 82A is trying to say is that the amount of the penalty calculated by reference to the amount of tax which is involved and which would not have been paid if the Taxpayer had never filed a tax return and if the Inland Revenue Department had never taken any action. This is purely hypothetical and a method of calculating the maximum penalty. In this case the Inland Revenue did take action and the Taxpayer did file a tax return. However the Taxpayer was late in filing its tax return. The question to be answered is pure and simple. Is a penalty of approximately 10% of the amount of the tax involved or approximately 3.3% of the maximum penalty excessive in the circumstances?'*

4.2.4.4 The representative was satisfied that the penalty of $80,000 imposed by the Commissioner was not excessive. $80,000 was 3.24% of the amount of the tax involved or 1.08% of the maximum penalty (3 × $2,468,588 = $7,405,764).

4.2.4.5 It is beyond doubt that estimated assessments do not affect the liability of a taxpayer to penalties under section 82A. Likewise, estimated assessments do not affect the quantum of any penalty imposed under section 82A. The penalty is imposed because the Taxpayer failed to comply with its obligations under the IRO and the Commissioner had decided to exercise the discretion granted to him under section 82A of the IRO. In this case the failure by the Taxpayer was to file the return within the stipulated time which expired on 15 November 1993.

4.2.4.6 The Commissioner elected not to invoke section 80.

4.2.4.7 D53/88, IRBRD, vol 4, 10:

A penalty of 15% of the tax undercharged was held not excessive.

4.2.4.8 D11/93, IRBRD, vol 8, 143:

A penalty of 20% of the tax undercharged was held not excessive.

4.2.4.9 D2/92, IRBRD, vol 7, 56:

This case involved computer failure. A penalty of 10% was held not excessive.

4.2.4.10 D29/93, IRBRD, vol 8, 211:

The penalty was 7.4% of the tax undercharged.

4.3 Summary:

The representative submitted that he had provided adequately demonstrated that:

4.3.1 The Taxpayer had failed to comply with the requirements of a notice under section 51(1) requiring the Taxpayer to furnish the profits tax return for the year of assessment 1992/93 within the permitted time.

4.3.2 No reasonable excuse has been offered.

4.3.3 It could not be said that the assessment to additional tax was excessive.

5. REPLY FROM THE TAXPAYER

5.1 The Commissioner's circular:

A distinction could and should be drawn between a taxpayer complying with the section 51(1) notice and a taxpayer putting the Revenue in a position in which the tax due could be ascertained.

5.2 The Decisions:

5.2.1 D105/89 and Dodge were accepted. However, for the reasons advocated during the submission for the Taxpayer this appeal should be distinguished on its facts.

5.2.2 Reasons were given as to why the Board should ignore the other decisions cited by the Revenue.

5.3 Question from the Board:

The representative did not dispute that there had been a default.

6. REASONS FOR THE DECISION

6.1 Section 82A:

6.1.1 It is perfectly clear that the correct interpretation of section 82A is that a taxpayer is at risk of being assessed to penalty if the section 51(1) notice served on him is not fully complied with by the date specified therein, or such other date as may apply by operation of the applicable block extension or any extension afforded on request by the assessor.

6.1.2 It is an agreed fact that the last date on which the Taxpayer's return for the year of assessment 1992/93 had to be lodged was 15 November 1993. It is an agreed fact that it was not so filed. Accordingly, and with respect to the Taxpayer's representative, the first of the alternative grounds of appeal is misconceived.

6.1.3 The fact that a taxpayer has put the Revenue on notice that a liability to tax existed and has paid the proper amount of tax on or before the date(s) when such tax would have been payable had the return been filed within time is irrelevant to the application of section 82A. If the notice is not complied with it is within the discretion of the Commissioner as to which of the penal provisions of the IRO he should invoke. The Board has no right to question the exercise by the Commissioner of his discretion to invoke section 82A, as opposed to prosecuting or compounding under section 80.

6.2 A reasonable excuse:

The Board is satisfied that its earlier decisions that delay caused by problems encountered with a computer system do not constitute a reasonable excuse, refer D2/92, are correct.

6.3 The quantum of the penalty:

The only question for consideration in this appeal is whether, in the circumstances, the penalty was excessive.

6.3.1 The Board notes that:

6.3.1.1 The Revenue accepts that the Taxpayer was not seeking to evade tax.

6.3.1.2 This is not one of a series of failures on the part of the Taxpayer to file a return within time.

6.3.1.3 A request for an extension of one month, admittedly at the 11th hour, was rejected even though the management accounts had been filed.

6.3.1.4 It is an agreed fact that the tax payable by the Taxpayer for the year of assessment 1992/93 was paid within the time it would have been payable had the return been filed within time.

6.4.2 The Board appreciates that the tax computation and its supporting schedules was not lodged until the return was lodged but the only likely practical effect of that is that the profit disclosed by the management accounts is likely to exceed the taxable profit, as was the fact in this appeal.

6.4.3 The first estimated assessment was issued after the management accounts had been filed but this assessment, according to the Revenue's representative, was the product of a computer system and it was superseded almost immediately by a revised assessment based on the profit disclosed by the management accounts, refer paragraph (5) and (6) of the agreed facts.

6.4.4 Taking all of these factors into account the Board is satisfied that the Taxpayer has been treated with undue harshness and that whilst some penalty is merited a penalty of $80,000 is, in the particular circumstances applicable to this appeal, excessive.

7. DECISION

The Board allows the Taxpayer's appeal against the quantum of the penalty imposed by the Commissioner and directs that the notice of assessment and demand for additional tax under section 82A of the IRO dated 28 February 1994 be amended to impose additional tax of $5,000 in lieu of the $80,000 specified therein.