

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D47/90

Penalty tax – quantum of penalties – company director – carry forward losses – section 82A of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), E J V Hutt and Jack Samuel Yuen.

Date of hearing: 14 September 1990.

Date of decision: 26 November 1990.

The taxpayer was a director of a limited company who had filed certain incorrect profits tax returns in respect of the company of which he was a director. In respect of some years the tax returns showed significant losses which were carried forward to be offset against future profits. Following an investigation by the Inland Revenue Department it was found that the tax returns which has been filed were incorrect and that the company had paid substantially less tax than it should have done. The assessable profits of the company were adjusted accordingly and assessments issued. The Commissioner then proceeded to impose penalties on the taxpayer in respect of the incorrect tax returns which he had submitted on behalf of the company. The penalties average 141% of the tax undercharged. The taxpayer appealed to the Board of Review and submitted that the penalties were excessive.

Held:

The penalties were not excessive in the circumstances. It was noted that the incorrect tax returns had resulted in carrying forward losses and that the penalties had been imposed in respect of tax in subsequent years.

Appeal dismissed.

Case referred to:

D63/88, IRBRD, vol 4, 68

Chan Kim Mou for the Commissioner of Inland Revenue.

Taxpayer in person.

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### Decision:

This is an appeal by a private individual who was a director of a limited company. This Commissioner imposed an additional tax assessment under section 82A of the Inland Revenue Ordinance upon the individual in respect of an incorrect tax return which the individual had declared to be correct in his capacity as a director of the limited company. The facts are as follows:

1. The Taxpayer and his wife were the major shareholders and directors of the limited company. The company was incorporated in 1963 as a manufacturer of knit-wear mainly for export.
2. The profits tax returns for the company for the years of assessment 1979/80, 1982/83 and 1983/84 were all signed by the Taxpayer and submitted through the authorised representative which was a firm of certified public accountants.
3. The assessor made some adjustments to the returned profits/(losses) and issued to the company an assessment for the year of assessment 1979/80 and computations of loss for the years of assessment 1982/83 and 1983/84. The company raised no objection to the assessment and did not dispute the computations of losses.
4. On 1 February 1985, the Taxpayer attended an interview at the Inland Revenue Department. The penalty provisions of the Inland Revenue Ordinance were explained to the Taxpayer who identified the profits tax returns for the three years in question which had been signed by himself. He agreed to confirm the correctness of the profits/(loss) figures reported in the profits tax returns within one week after checking the same with his accountants.
5. On 5 February 1985, the Taxpayer accompanied by another individual attended an interview at the Inland Revenue Department. During the interview, the taxpayer said that he wished to settle the investigation as soon as possible. He said that he would be willing to pay tax on the profits shown in the audited accounts of the company and to abstain from claiming the returned losses for the years of assessment 1982/83 and 1983/84 in order to have a quick settlement of the investigation case. The Taxpayer denied that he had knowledge of understatements of profits in respect of the company and said that the profits tax returns for the years of assessment 1979/80, 1982/83 and 1983/84 previously filed by him were correct.
6. Two officers of the Inland revenue Department visited the premises of the company on 11 February 1985. The Taxpayer and his accountants were unable to supply further information and explanations on certain selected entries

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appearing in the director's current account and suspense account in the books of the company.

7. In reply to a letter dated 11 February 1985 from the Inland Revenue Department, the Taxpayer submitted the accounting books and records of the company for examination.
8. By letter dated 14 September 1988, the Taxpayer confirmed that part of the directors' advances to the company came from sale income of woollen yarns and textile quotas.
9. In the course of the investigation, certain estimated or additional assessments were raised on the company for the years 1979/80 and 1982/83 and notices of objection to the same were lodged by the Taxpayer on behalf of the company.
10. On 4 August 1989, the Taxpayer attended an interview at the Inland Revenue Department. The Taxpayer was told that the company was found to have understated its income from the sale of textile quotas and woollen yarns. He was further told that certain purchases of woollen yarns and textile quotas recorded in the books of the company were doubtful.
11. By a letter dated 8 November 1989, the Inland Revenue Department requested the Taxpayer to give explanations regarding the account irregularities of the company. The Taxpayer gave no reply to the letter from the Inland Revenue Department. Based on the account irregularities a revised computation of the loss for the year of assessment 1982/83 was issued and assessments for the years of assessment 1983/84 to 1984/85 and an additional assessment for the year of assessment 1986/87 were issued on 10 January 1990. Objections to these assessments were lodged by the Taxpayer on behalf of the company.
12. By letter dated 10 January 1990, the Inland Revenue Department proposed to the taxpayer a computation of revised additional assessment in settlement of the objection to the additional assessment for the year of assessment 1979/80. The Taxpayer accepted on behalf of the company the proposed revised additional assessment for the year of assessment 1979/80 in settlement of the objection.
13. On 7 February 1990 the Taxpayer and his assistant attended an interview at the Inland Revenue Department to seek explanations regarding the assessments for the years of assessment 1983/84 to 1986/87 inclusive. The Taxpayer said that he was prepared to withdraw the notices of objection to the assessments in question and would not furnish any information in respect of the account irregularities of the company as requested in the Revenue's letter of 8 November 1989. The Taxpayer was again reminded about the penalty action which could be instituted following agreement to the basic tax liability.

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14. By letter dated 9 February 1990 the Taxpayer on behalf of the company notified the Inland Revenue Department of withdrawal of objections to the assessments for the years of assessment 1983/84 to 1986/87 inclusive.
15. The following is a comparative table of the assessable profits/agreed loss of the company before and after the investigation:

<u>Year of Assessment</u>	<u>Profits/ (Loss) before Investigation</u> \$	<u>Profits/ (Loss) after Investigation</u> \$	<u>Profits Understated</u> \$	<u>Loss Overclaimed</u> \$
1979/80	65,439	244,577	179,118	-
1982/83	(726,045)	(45,245)	-	(680,800)
1983/84	<u>(682,464)</u>	<u>160,566</u>	<u>160,566</u>	<u>(682,464)</u>
Total	<u>(1,343,070)</u>	<u>359,878</u>	<u>339,684</u>	<u>(1,363,264)</u>

16. The amount of tax undercharged is as follows:

<u>Year of Assessment</u>	<u>Profits Tax Undercharged</u> \$
1979/80	30,450
1983/84	19,027
1984/85	22,643
1985/86	115,366
1986/87	<u>122,564</u>
Total	<u>310,050</u>

17. The Acting Commissioner of Inland Revenue was of the opinion that the Taxpayer had without reasonable excuse made incorrect profit tax returns in respect to the company for the years of assessment 1979/80, 1982/83 and 1983/84. On 23 April 1990 the Acting Commissioner gave notice to the Taxpayer under section 82A of the Inland Revenue Ordinance that he proposed to assess the Taxpayer to additional tax in respect of the incorrect returns submitted by him for the years in question.

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18. The Taxpayer made written representations to the Acting Commissioner on 22 May 1990. After taking into account the representations made by the Taxpayer, the Acting Commissioner issued notices of assessment for additional tax under section 82A of the Inland Revenue Ordinance on 26 June 1990 as follows:

<u>Year of Assessment</u>	<u>Profits Tax Undercharged</u> \$	<u>Additional Tax under Section 82A</u> \$	<u>Percentage of Penalty Tax</u> %
1979/80	30,450	45,600	150
1983/84	19,027	28,500	150
1984/85	22,643	32,300	143
1985/86	115,366	154,600	134
1986/87	<u>122,564</u>	<u>154,000</u>	<u>126</u>
Total	310,050 =====	415,000 =====	134

19. On 27 July 1990 the Taxpayer gave notice of appeal against the section 82A assessments to additional tax.

At the hearing of the appeal, the Taxpayer appeared in person. He said that he had no intention to evade tax and had no knowledge of taxation law. He said that at first he did his own books and subsequently an accounts clerk was employed and this is why there were some discrepancies in the books. He said that the errors were the result of wrong entries and mistakes made by his accounts clerk. He said that he had no intention to evade or omit tax and as he had never evaded or omitted tax, he should not be asked to pay any penalty.

The Taxpayer went on to say that the financial situation of himself and the company was very critical and he had exhausted all his resources in paying tax. He said that neither he nor the company had any spare capacity to afford to pay any additional tax.

The representative for the Commissioner submitted that the Commissioner was not alleging that the Taxpayer had intentionally evaded tax. He said that ample opportunity had been given to the Taxpayer to explain the irregularities in the accounts. He said that ignorance of the law is no excuse and furthermore on the facts of this case it is unlikely that the Taxpayer had no knowledge of the Inland Revenue Ordinance. Furthermore he pointed out that the Taxpayer had the benefit of professional advice from the auditors of the company. He also submitted that the present financial hardship of the Taxpayer and his company was not relevant in considering whether the penalties were excessive or not. He drew the attention of the Board to Board of Review decision D63/88, IRBRD, vol 4, 68.

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With regard to the quantum of the penalties the representative for the Commissioner pointed out that the maximum penalty provided under the Inland Revenue Ordinance is three times the total tax undercharged. He said that in the present case the additional tax imposed by way of penalty is only 44% of the maximum that can be imposed. He pointed out that the Taxpayer must have been aware of the fact that the sales had been credited to directors' advances, that the quota income had been understated and that some doubtful purchases had been included. The use of such arrangements for the purposes of understating the profit and overstating the losses had resulted in an understatement of the tax payable and this was a serious matter. During the course of the investigation the Taxpayer had given little assistance to the assessor about the accounting methods used by him.

In reply to the submissions on behalf of the Commissioner the Taxpayer repeated that he had no intention to make understatements in the tax returns. He said the irregularities in the accounts were caused by false or incorrect entries made by his accounts clerk.

We agree with the representative for the Commissioner that this is a comparatively serious case. Having seen and heard the Taxpayer we agree that he is not an ignorant man with no knowledge of business accounting and taxation. Even if he were, he had the benefit of professional advice from his auditors. We likewise found little sympathy with the submission made by the Taxpayer that the errors and irregularities were mistakes by his bookkeeper. The bookkeeper was under the direct supervision of the Taxpayer as a director of the company. Furthermore the Taxpayer informed us that at one time he maintained the books of account of the company himself. In such circumstances we find no sympathy with the argument that the fault lay with the bookkeeper. Indeed even if it were the bookkeeper's fault, it would not exonerate the Taxpayer because it is the duty of those who make tax returns to ensure before signing them that they are correct. It is no excuse to say that someone else made a mistake.

Apparently the Taxpayer chose to maintain the accounts of the company in such a way that the quota income was not properly stated therein, that certain transactions were doubtful, and that certain income items were posted to the director's account. Though the Commissioner had not alleged tax evasion, on the facts before us the Taxpayer was not far away from being charged with evasion. The way in which he chose to maintain the company's accounts was at best extremely negligent.

The fact that the Taxpayer may have limited financial resources available does not have any bearing on the quantum of the penalties imposed. The penalties imposed are a multiple of the tax which was involved and the tax involved is based on the profits made. It is a hollow argument for the Taxpayer to say that he now does not have available the profits which the company made and which he omitted to include in the tax returns which he filed.

This case has one unusual and interesting point in it. That is that the effect of the incorrect tax returns was that the company had substantial carry forward losses. Section 82A of Inland Revenue Ordinance refers to the imposition of penalties of an amount not

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exceeding three times the amount of tax which would have been undercharged in consequence of the incorrect returns if they had been accepted as correct. Where the sum is a negative amount that is a loss, the amount which would have been undercharged has been correctly assessed by the Acting Commissioner as being the tax which was under assessed in future years based on the loss as claimed in the tax returns and which had originally been accepted by the assessor when he received the tax returns and believed them to be correct. This point was not raised by the Taxpayer but we think it appropriate that we should mention it in our decision.

For the reasons given and taking into account all of the circumstances of this case we find that the penalty assessments imposed upon the Taxpayer are not excessive and dismiss the appeal.