

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D78/89

Penalty tax – personal representatives of deceased businessman – assets betterment statement – understatement of profits – whether penalties excessive – section 82A of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Philip Fu Yuen Ko and Gordon M MacWhinnie.

Date of hearing: 5 October 1989.

Date of decision: 28 November 1989.

The personal representatives of the estate of a deceased appealed against the quantum of penalty tax assessments imposed following an assets betterment statement procedure and investigation of the profits of the deceased. It was submitted by the personal representatives that they had misunderstood the likely quantum of the penalties which would be imposed and had understood that they would be based on a calculation of interest on the tax undercharged where the original taxpayer was deceased.

Held:

The facts of this case were unusual. A peculiar method of assessing the profits of the business had been used, but as the profits had been agreed with the Revenue, it was not open for the personal representatives to challenge the same. In all of the circumstances, the penalties were excessive and should be reduced.

Appeal allowed in part.

Lau Hin Chung for the Commissioner of Inland Revenue.

Taxpayers in person.

Decision:

This is an appeal by the personal representatives of the estate of a deceased who had been carrying on a retail business during her life time. The personal representatives of the deceased ('the Taxpayers') were her son and daughter-in-law respectively. The assessments appealed against were section 82A penalty tax assessments for the years of assessment 1981/82 to 1986/87 inclusive imposed on the estate of the deceased on the ground that the deceased had made incorrect tax returns. In addition the daughter-in-law is appealing against the imposition and quantum of a section 82A penalty

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tax assessment imposed on her for making an incorrect profits tax return for the year of assessment 1987/88 in respect of the business of the deceased.

The facts are as follows:

1. The Taxpayers, being husband and wife, are the son and daughter-in-law respectively of the deceased who died in 1988 at the age of 83. The Taxpayers are the personal representatives of the estate of the deceased.
2. The business in question was registered as having commenced in 1922 under a business registration application in 1952. In late 1979 a new certificate was applied for by the deceased as the sole proprietress of the business as from early 1980.
3. Profits tax returns for the business were filed as follows:

<u>Year of Assessment</u>	<u>Basis Period Ended</u>	<u>Date of Issue Return</u>	<u>Date of Receipt of Return</u>	<u>Profit (Loss) per Return</u> \$	<u>Assessed Profit (Loss) after Adjustment</u> \$	<u>Return Signed by</u>
1980/81	31-3-81	16-2-84	17-4-84	30,464	30,464	Deceased
1981/82	31-3-82	16-2-84	17-4-84	52,762	52,762	Deceased
1982/83	31-3-83	31-8-83	6-12-83	34,422	40,654	Deceased
1983/84	31-3-84	2-4-84	13-9-84	43,523	50,390	Deceased
1984/85	31-3-85	1-4-85	5-11-85	47,637	50,505	Deceased
1985/86	31-3-86	1-4-86	4-11-86	48,519	48,519	Deceased
1986/87	31-3-87	1-4-87	18-6-87	9,117	9,117	Deceased
1987/88	31-3-88	6-4-88	26-8-88	(335,774)	-	Daughter-in-law

4. In February 1987 enquiries were initiated into the tax affairs of the Taxpayers. The Taxpayers were interviewed by the officers of the investigation unit of the Inland Revenue Department on 10 February 1987. During the interview, the daughter-in-law admitted to have assisted in the management and operation of the business but stated that she was not its true proprietress. However, she stated that various licences required for carrying on the business had been changed to her own name during the years 1981 and 1982. She also stated that her personal bank accounts had been used for the business.

5. On 18 August 1987 the Taxpayers and the deceased were interviewed by officers of the investigation unit of the Inland Revenue Department. During the interview a schedule of understatements of profits of the business were submitted by the Taxpayers and the deceased. The schedule showed an understatement of profits of \$451,960 for the business covering the period from 1 April 1980 to 31 March 1987.

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6. The assessor raised the following additional profits tax assessments for the business for the years of assessment 1980/81 and 1981/82:

<u>Year of Assessment</u>	<u>Date of Issue</u>	<u>Additional Assessable Profit</u> \$
1980/81	17-3-87	300,000
1981/82	12-2-88	600,000

The deceased objected to these additional assessments on the ground of excessiveness.

7. On 4 July 1988 an assets betterment statement for the deceased covering the period from 1 April 1980 to 31 March 1987 showing a discrepancy of \$3,210,550 was issued to the Taxpayers in their capacity as personal representatives of the estate of the deceased with a covering letter inviting them to make written representations thereto.

8. On 29 July 1988 the following estimated additional profits tax assessments were raised on the business:

<u>Year of Assessment</u>	<u>Estimated/Additional Assessable Profits</u> \$
1982/83	483,522
1983/84	539,765
1984/85	222,029
1985/86	380,999
1986/87	657,790
1987/88	730,000 (Estimated)

The Taxpayers through their tax representatives objected to all of these estimated/additional assessable profits on the ground of excessiveness.

9. On 5 December 1988 the tax representatives filed, on behalf of the Taxpayers, written representations to the assets betterment statement.

10. On 24 January 1989 the Taxpayers were interviewed together with their tax representatives by the investigation officers of the Inland Revenue Department and various items of the assets betterment statement were discussed.

11. By letter dated 2 February 1989 the tax representatives filed further representations relating to the assets betterment statement.

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12. On 23 February 1989 the Taxpayers were again interviewed together with their tax representatives by the investigation officers. During this interview, a revised assets betterment statement covering the period from 1 April 1981 to 31 March 1987 showing a total discrepancy of \$2,083,287 was produced by the Inland Revenue Department. It was proposed that the case be settled on the basis of this revised assets betterment statement and revised assessable profits of \$400,000 for the year of assessment 1987/88. The Taxpayers accepted this proposal and signed the revised assets betterment statement.

13. The following is a comparative table of the assessable profits of the business before and after investigation and the amount of tax undercharged:

<u>Year of Assessment</u>	<u>Profits assessed Before Investigation</u> \$	<u>Profits assessed After Investigation</u> \$	<u>Profits Understated</u> \$	<u>Tax Undercharged</u> \$
1981/82	52,762	737,908	685,146	108,472
1982/83	40,654	544,393	503,739	80,893
1983/84	50,390	424,592	374,202	61,830
1984/85	50,505	99,534	49,029	11,865
1985/86	48,519	339,518	290,999	56,326
1986/87	9,117	189,289	180,172	30,630
1987/88	(Loss of 335,774 returned)	400,000	400,000	66,000
<b>Total</b>	<u>251,947</u>	<u>2,735,234</u>	<u>2,483,287</u>	<u>416,016</u>

14. On 24 April 1989 notices under section 82A(4) of the Inland Revenue Ordinance were given by the Commissioner of Inland Revenue to the Taxpayers informing them of his intention to assess additional tax in respect of the incorrect returns filed for the business for the years of assessment 1981/82 to 1987/88.

15. After receiving written representations filed by the tax representatives on behalf of the Taxpayers, the Commissioner of Inland Revenue on 7 June 1989 issued notices of assessment and demand for additional tax under section 82A for the years of assessment 1981/82 to 1987/88 to the Taxpayers in the following amounts:

<u>Year of Assessment</u>	<u>Tax Undercharged</u> \$	<u>Amount of Additional Tax under Section 82A</u> \$	<u>Percentage of Penalty Tax</u> %
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1981/82	108,472	135,500	125
1982/83	80,893	102,100	126
1983/84	61,830	73,100	118
1984/85	11,865	13,100	110
1985/86	56,326	58,600	104
1986/87	30,630	29,900	98
1987/88	<u>66,000</u>	<u>61,700</u>	<u>93</u>
Total	<u>416,016</u>	<u>474,000</u>	114

All of the foregoing section 82A penalty tax assessments were in the name of the Taxpayers as personal representatives for the estate of the deceased with the exception of the final assessment for 1987/88 which was in the name of the daughter-in-law alone.

16. The Taxpayers duly gave notice of appeal to the Board of Review against these section 82A assessments.

At the hearing of the appeal the Taxpayers appeared on their own behalf and represented themselves. They stated that they considered that they had been misled by the officers of the Inland Revenue Department because when they agreed to settle the liability of the business to profits tax they had been told by an officer of Inland Revenue Department that a penalty of up to three times the amount of tax undercharged might be imposed but that in this case as the deceased had passed away it was most probable that the amount of the penalty would be based on a calculation of interest on the tax undercharged.

In his submission, the representative for the Commissioner confirmed that it was accepted practice in the Inland Revenue Department to base the quantum of penalties where a taxpayer was deceased on a calculation of interest on the amount of tax undercharged but also pointed out that in all cases taxpayers were warned that the maximum amount of the penalty could be as much as three times the amount of tax undercharged and that the final decision in every case must be taken by the Commissioner or his Deputy.

The Taxpayers decided not to give evidence and likewise the representative for the Commissioner decided not to call evidence to rebut the submissions made by the Taxpayers.

The Taxpayers went on to say that they had agreed to settle the case because they thought that they would be able to afford to pay the penalty and the amount of tax on the basis indicated to them that is the penalty would be calculated by reference to an interest component on the tax undercharged. The Taxpayers said that the problems in this case had arisen because the deceased had not kept proper accounts herself and she did not like to disclose to the Taxpayers all of the details relating to the business.

The Taxpayers said that when the deceased had died she had left behind a sum of approximately \$800,000 in cash. There is some confusion with regard to the value of the

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estate and it was not clear from the submissions made by the Taxpayers as to whether the sum of cash in fact belonged to the deceased or to the Taxpayers or otherwise. However, what is relevant and important is that it was apparently the impression of the Taxpayers when settling this case with the Inland Revenue Department that they calculated that the amount of the tax plus the amount of the penalties would total approximately \$700,000 and that they would be able to pay this out of cash which was available to them from one source or another.

The difference between the two figures of \$700,000 and \$800,000 was accounted for by the Taxpayers' explanation that there were various expenses including funeral expenses and substantial accountants fees which had to be paid in addition to the tax and penalties. The Taxpayers mentioned that the fees charged by the accountants to sort out the accounts had been approximately \$90,000.

The representative for the Commissioner said that in assessing the penalties the Commissioner had taken into consideration the circumstances of this case, including the old age, poor health and subsequent death of the deceased, the past history of the deceased and the Taxpayers and the business, and the cooperation shown by the Taxpayers during the investigation. He pointed out that one of the two Taxpayers, the daughter-in-law had actually managed and controlled the business.

He pointed out that the profits had been understated by some 98% of the true profits. He said that the profits under-disclosed had been based on the assets betterment statement with the exception of the final year which had been assessed by applying an average gross profit rate on the total bank deposits which had produced the figure of about \$400,000 profit instead of the amount of the returned loss.

The representative for the Commissioner said that it had been made quite clear to the Taxpayers that the amount of the penalty could be as high as three times the tax undercharged and that they were fully aware of the fact that it was only the Commissioner or Deputy Commissioner who could assess the amount of the penalties. Whatever may happen in other cases and may have been indicated to the Taxpayers was not relevant because it was not binding on the Commissioner or the Deputy Commissioner.

This is not an easy case and the Board wishes to put on record that the facts are unusual. First we have the situation of a deceased being a very old lady but apparently a lady who did exercise some control over her business and affairs. On the other hand we have the fact that the daughter-in-law was closely involved in the management of the business and signed the tax return for the final year.

According to such papers as were produced before the Board of Review in the course of the hearing, it would appear that the assets of the estate of the deceased were considerably less than \$800,000. Indeed according to the estate duty affidavit filed by the Taxpayers the net value of the estate of the deceased would appear to be negative. However, this is after taking into account the tax liabilities of the estate of the deceased.

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We note that in the notes of interview with the Taxpayers when they called to see the investigation officers of the Inland Revenue Department there are full details of statements made regarding the maximum amount of liabilities which might be as high as three times the tax undercharged. However, there is no mention in the notes of the further statement which we are satisfied was made namely that in cases of deceased taxpayers the normal penalties would be calculated on an interest on tax undercharged basis. In our opinion such indications, whether or not binding on the Commissioner and his Deputy, should be included in notes of interview. We see no reason why in the course of settling cases, investigation officers should not indicate frankly and openly to taxpayers what are the usual levels of penalties provided it is made clear to taxpayers that such indications are not binding and that matters must be decided by the Commissioner or his Deputy in due course. That is what happened in this case and we can see nothing wrong in it. However, we consider that a note to this effect should have been included in the notes of the interview.

After very carefully taking into account all of the facts of this case we have decided that the amount of the penalties imposed is excessive and should be reduced from the total sum of \$474,000 to a total sum of \$300,000 as follows:

Year of Assessment	Amount of S82A Additional Tax as assessed by Commissioner	Percentage of Penalty Tax by Commissioner	Amount of S82A Additional Tax as reduced by the Board	Percentage of Penalty Tax by the Board
	\$	%	\$	%
1981/82	135,500	125	85,760	79
1982/83	102,100	126	64,620	80
1983/84	73,100	118	46,266	75
1984/85	13,100	110	8,291	70
1985/86	58,600	104	37,089	66
1986/87	29,900	98	18,924	62
1987/88	<u>61,700</u>	<u>93</u>	<u>39,050</u>	<u>59</u>
Total	<u>474,000</u>	114	<u>300,000</u>	72

In the course of the hearing the Board was a little confused with regard to the manner in which the profit of \$400,000 had been assessed for the final year of assessment 1987/88. It appeared to the Board that this was an arbitrary sum which had little relevance to the accounts and figures of the business. The representative for the Commissioner said that all of the deposits into the bank account had been totalled and this had been deemed to be the turnover of the business. A percentage of the notional percentage which had appeared from the assets betterment statements in preceding years was then used as the percentage for the average gross profit rate. It appeared to the Board that the average gross profit rate was very high and that by applying this to the notional turnover figure, a very high profit level had been reached because it appeared to have disregarded the overhead expenses of the business. The figure was also far in excess of the loss claimed by the Taxpayers. The Board finds it hard to understand why more accurate accounts of the

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business could not have been produced or more accurate figures could not have been used to reach this arbitrary assessment because the year in question was 1987/88 and the assessment was only being made on 23 February 1989, a period less than twelve months after the close of the financial period in question and when there should have been available more accurate records and documents. As the Taxpayers acting on professional advice had decided to settle the case and accepted that the profits for the business in the final year in question amounted to \$400,000, it is not now open for the Taxpayers or this Board to challenge the figure but it would appear that maybe a better method of calculating the profit for the year of assessment 1987/88 might have been adopted by the assessor.