INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D105/89

Penalty tax – failure to file tax return on time – two estimated assessments – whether maximum amount of penalty reduced by estimated assessments – section 82A(1)(ii).

Panel: Henry Litton QC (chairman), Colin Cohen and Geoffrey Hui.

Dates of hearing: 20 and 21 February 1990.
Date of decision: 14 March 1990.

The taxpayer was a limited company which failed to file its profits tax return as required by section 51(1) of the Inland Revenue Ordinance. An estimated assessment was issued followed by a second estimated assessment. The taxpayer lodged objection against the second estimated assessment and submitted a profits tax return to substantiate the objection. The Commissioner imposed a penalty upon the taxpayer of approximately 30% of the tax undercharged which was considered to be 100% of the tax payable by the taxpayer in respect of the year of assessment in question. The taxpayer appealed and argued that the amount of tax undercharged should be reduced by either or both of the amounts of tax assessed in the estimated assessments.

Held:

The amount undercharged crystallised immediately when the time limit imposed for the filing of the return expired. At that moment in time the full amount of tax was undercharged. Furthermore, the Ordinance provides an alternative amount being the tax which would have been undercharged if such failure had not been detected. For both of these reasons, the Commissioner was correct when he had assessed the penalty. Furthermore, the amount of the penalty was not excessive in the circumstances.

Appeal dismissed.

Cases referred to:

D2/88, IRBRD, vol 3, 125
Dodge Knitting Co Ltd v CIR 2 HKTC 597

Ngai See Wah for the Commissioner of Inland Revenue.
William A Ahern of Deacons for the taxpayer.

Decision:

Introduction

1. This is an appeal made under section 82B of the Inland Revenue Ordinance against an additional assessment made by the Commissioner under section 82A of the Ordinance.

Facts

2. The Taxpayer is a limited company incorporated in Hong Kong in mid-1976 and has been carrying on the business of garment trading and manufacturing. The Taxpayer closes its account books on 31 March each year.

3. On 6 April 1988, the Assistant Commissioner issued a profits tax return for the final assessment 1987/88 and provisional payment 1988/89 to the Taxpayer under section 51(1) of the Ordinance. The time limit for lodging the return was one month. The time limit was informally extended (by means of a circular letter to the Taxpayer's tax representative) to 31 October 1988.

4. On 29 December 1988, the assessor, not having received the return 1987/88 for the year of assessment from the Taxpayer, raised an estimated profits tax assessment for the year of assessment 1987/88 under section 59(3) of the Ordinance in the amount of $3,000,000. No objection was lodged by the Taxpayer against this assessment, and on 1 March 1989 the first instalment of the demand for profits tax for the year of assessment 1987/88 (and provisional tax 1988/89) was paid.

5. On 19 April 1989 and in the absence of a profits tax return for 1987/88 being submitted, the assessor raised on the Taxpayer a further estimated assessment ('additional assessment') for 1987/88 in the amount of $3,000,000.

6. On 28 April 1989, the tax representative of the Taxpayer lodged an objection on behalf of the Taxpayer against the additional assessment for the year of assessment 1987/88 and submitted a profits tax return for the year of assessment 1987/88 showing assessable profits of $4,699,546. On 10 May 1989 the balance of the first estimated assessment was paid.

7. The returned assessable profits were agreed and the estimated additional assessment for the year of assessment 1987/88 issued on 19 April 1989 was revised accordingly.

8. The Taxpayer has a record of failing to submit profits tax returns within the time stipulated:

Year of Assessment	Date of Issue	Extension Allowed To	Date of Submission
1985/86	1-4-1986	30-10-1986	16-2-1987
1986/87	1-4-1987	31-10-1987	23-2-1988
1987/88	6-4-1988	31-10-1988	28-4-1989

9. The Commissioner was of the opinion that the Taxpayer had without reasonable excuse failed to comply with the requirement of a notice under section 51(1) of the Ordinance for the year of assessment 1987/88 by failing to submit a profits tax return within the period stipulated. By a notice dated 6 October 1989, the Commissioner informed the Taxpayer that he intended to assess the Taxpayer to additional tax under section 82A of the Ordinance for the year of assessment 1987/88.

10. On 25 October 1989, the tax representative submitted to the Commissioner on behalf of the Taxpayer representations under section 82A(4)(a)(ii) of the Ordinance. In essence, what was submitted was:

(a) that the books of accounts were handed to the auditors by the Taxpayer at an early date after the accounts closed: 25 October 1988;

(b) that there had been drastic increase in volume in the Taxpayer's business;

(c) that on account of the 'complexity of the transactions and the manpower shortage of both the Taxpayer and the auditors' due to the brain drain, the auditors were unable to complete the audit until April 1989;

(d) that the Taxpayer was an honest and industrious manufacturer always mindful of its obligations under the Ordinance.

11. On 20 November 1989, the Commissioner issued a notice of assessment and demand for additional tax under section 82A of the Inland Revenue Ordinance in the sum of $250,000. This was on the basis of 30% of the tax undercharged, amounting to $845,918; the $845,918 figure being 18% of the assessable profit of $4,699,546.

12. On 14 December 1989, the tax representative gave notice of appeal to the Board on behalf of the Taxpayer against the assessment of additional tax for the year of assessment 1987/88 on the grounds (i) that the Taxpayer had reasonable excuse for failing to lodge the return in time and (ii) the additional tax imposed was, in all the circumstances of the case, excessive.

The Hearing

13. At the commencement of the hearing the Taxpayer's representative Mr Ahern stated that he was abandoning the first ground of appeal (that there was 'reasonable excuse' for failing to lodge the return) and that his principal submission was that, on a proper construction of the provisions of section 82A(1)(ii), the Taxpayer was not liable to additional tax at all having regard to the two estimated assessments totalling $6,000,000 that were made.

14. Alternatively, Mr Ahern argued that the amount of tax undercharged was not $845,918 (18% of the assessable profit of $4,699,546) but a lesser sum, taking into account the fact that tax had already been charged on the first estimated assessment. According to this alternative argument the liability for additional tax would work out, according to Mr Ahern, as follows:

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Assessable profit as finally determined	4,699,546
Less: First estimated assessment	3,000,000
	$1,699,546
Amount of tax undercharged:	17% x $1,699,546
	= $288,922

[Mr Ahern was in error regarding the standard rate for corporations at the relevant time which was not 17% but 18%]

Taxpayer's Argument

15. The foundation of the Taxpayer's argument is this:

(a) Liability to additional tax where there has been a failure to comply with section 51(1) – failing to furnish a return within the time stated in the notice – is laid down in section 82A(1)(ii).

(b) The section says that the taxpayer is 'liable to be assessed under this section 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) … or which would have been undercharged if such failure had not been detected' (Emphasis added).

(c) Here the 'consequence' of the failure to comply with the section 51(1) notice was that the assessor made successively two estimated assessments under section 59(3): on 29 December 1988 and on 19 April 1989 with the result that profits tax has not been undercharged. In fact, after the second estimated assessment, it has been overcharged.

(d) Hence, the Commissioner was not empowered to make the additional assessment on 20 November 1989: or, at the most, he was empowered to make his assessment only on the basis of the formula set out in paragraph 14 above.

16. The way Mr Ahern summarised his argument was this:

The 'consequence' of the failure to comply with the section 51(1) notice is the undercharging of tax. This undercharging is measured by the difference between the total estimated assessments in this case (that is, $6,000,000) and the actual assessable profit (which was only $4,699,546). It must follow that there was no 'tax undercharged' in terms of section 82A(l)(ii).

Section 82A(l)(ii)

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:

(a) such failure was 'without reasonable excuse', and

(b) no prosecution under section 80(2)(d) had been instituted,

then, in our view, the Commissioner was, in terms of the statute, authorised to exercise his power under section 82A.

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.

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(l). The foundation for imposing liability under sub-section (ii) of section 82A(l) 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'?

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 v CIR 2 HKTC 597.

21. Whilst the precise point as now formulated by Mr Ahern might not have been put on behalf of the taxpayer in the Dodge Knitting case (supra), the proper construction of the second limb of sub-section (ii) was exhaustively analysed. The effect of Mr Ahern's arguments is to ask us to adopt a construction of the statute different from that of the Board and Mr Justice Liu in the Dodge Knitting case. This we decline to do.

22. Our decision on the matter effectively disposes of Mr Ahern's alternative argument (paragraph 14 above) as well. In our view the Commissioner was, on 6 October 1989, when he gave notice under section 82A (see paragraph 9 above), empowered to assess the Taxpayer to additional tax.

'Excessive In The Circumstances'

23. The additional tax of $250,000 amounts to 30% of the tax undercharged or 10% of the maximum which the Commissioner could have imposed.

24. No director of the Taxpayer or anyone else in a decision-making position in the Taxpayer was called as a witness at the hearing to explain why there was such a lengthy delay in lodging the return. The Taxpayer's accountant gave evidence to the effect that by 25 October 1988 books had been submitted to the auditors and she could not explain why the returns were not lodged until the end of April 1989, after the second estimated assessment had been made.

25. From the financial statements in evidence before us it appears that there was an increase in the monetary value of business conducted in the year ending 31 March 1988 as compared with the previous year but the bulk of this was in the sale of temporary quotas. Nothing justifies the statement in paragraph 10(b) above that there had been a drastic increase in volume in the Taxpayer's business; at last, none that could constitute a reason for the late filing of the profits tax return for the year ending 31 March 1988. As to the suggestion of 'manpower shortage of both the Taxpayer and the auditors' (paragraph 10(c) above) no evidence was led to this effect.

26. The burden is on the Taxpayer to satisfy us that in the circumstances of the case the additional assessment amounting to 30% of the tax undercharged was excessive. This burden the Taxpayer has filed to discharge.

27. The appeal is accordingly dismissed.