Case No. D124/95

Penalty tax – profits tax – incorrect tax returns – tax returns signed on behalf of company.

Panel: William Turnbull (chairman), Gerald Hin Tsun To and Dianthus Tong Lau Mui Sum.

Date of hearing: 11 January 1996.
Date of decision: 14 March 1996.

The taxpayers signed the profits tax return in respect of the company. The Commissioner was of the opinion that the taxpayers had, without reasonable excuse, made incorrect profits tax returns in respect of the company, and demanded additional tax by way of penalty from the taxpayers. The taxpayers cooperated in the investigation and sought to argue for a more lenient penalty.

Held:

The norm for cases where taxpayers have failed in their obligations under the Inland Revenue Ordinance is a starting point of 100% of the amount of tax involved. That the company had already been penalised is not an unnatural result of deliberately failing to keep true and correct accounts.

Appeal dismissed.

Case referred to:

D4/89, IRBRD, vol 4, 172

Yeung Kwai Cheong for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

This is an appeal by two Taxpayers who signed tax returns on behalf of a limited company which under declared the profits of the company. The facts are as follows:

1. The company was incorporated in 1980 and carried on the business of 'import & export'. It dealt in toys and various types of goods including garments.

2. The First Taxpayer signed the profits tax return in respect of the company for the year of assessment 1987/88 in his capacity of a Director of the company. The Second Taxpayer signed the profits tax returns for the years of assessment 1988/89 to 1993/94 in his capacity of a Director of the company.

3. By prior appointment, two investigation officers from the Inland Revenue Department visited the office of the company on 11 November 1993. They were met by the First Taxpayer, the Second Taxpayer, the Manager and the auditor of the company. The Manager is also a director of the company. The First Taxpayer and the Manager are sons of the Second Taxpayer. The investigation officers said that they wanted to examine the company's accounting records relating to rebates. The Manager explained to the investigation officers that rebates were deducted from the suppliers invoices and the net amounts recorded as purchases; small amounts of rebates received in cash were put into the company's petty cash fund for use as the company's petty expenses such as food for staff, travelling, etc. For this kind of rebates, both the receipt and the expenses were not recorded. During the meeting, a copy of the current suppliers list, copies of some correspondence between suppliers and customers and copies of the company's payment vouchers for the purchases were given to the investigation officers at their request.

4. At the close of the meeting on 11 November 1993, the investigation officers asked the company to prepare a computation of the rebates received in cash which the company has used as the company's petty cash fund. By a letter dated 14 December 1993, the Manager put in writing the explanation regarding the rebates received in cash. He estimated the rebates received in cash which were used in the company's petty cash fund were $1,168,476 for six years from 1987/88 to 1992/93.

5. On 29 December 1993, the investigation officer invited the Second Taxpayer to attend an interview and requested him to bring along certain documents. By a letter dated 6 January 1994, the Second Taxpayer requested that the interview be postponed so that he could engage a tax representative. Under cover of a letter dated 18 February 1994, he submitted the documents requested and authorised the Manager to act on his behalf.

6. An estimated additional profits tax assessment for the year of assessment 1987/88 in the amount of $1,000,000 was issued to the company on 28 February 1994. A notice of objection was lodged on 23 March 1994 on the ground that the assessment was excessive.

7. On 1 March 1994, the Second Taxpayer, accompanied by the Manager, attended an interview with two investigation officers at the Inland Revenue Department. The Second Taxpayer supplied information concerning the company and his own financial affairs at the request of the investigation officers. When the profits tax returns of the company for the years of

assessment 1988/89 to 1992/93 were shown to him, the Second Taxpayer confirmed that they were signed by him and the profits reported were correct except for the cash rebates.

8. By letter dated 7 March 1994, the investigation officer requested the Second Taxpayer to provide further information in relation to his financial affairs and also detailed computations and documents to support the amount of rebates estimated by the Manager in his letter of 14 December 1993. Separate enquiry letters were issued on 8 March 1994 to the First Taxpayer and the Manager concerning their own financial affairs.

9. In response to the Manager's and the First Taxpayer's request, the investigation officer allowed extension of time to 7 May 1994 for replying to the above letters. The First Taxpayer and the Manager provided information in respect of their own financial affairs on 7 May 1994 and 4 August 1994 respectively. Despite further extension to 16 May 1994, no reply was received from the Second Taxpayer by the extended date.

10. On 27 June 1994 and 5 October 1994, the investigation officers issued reminders requesting the Second Taxpayer to reply to the letter dated 7 March 1994.

11. By letter dated 14 October 1994, the Manager submitted a reply on behalf of the Second Taxpayer and provided the information/documents requested by the investigation officer, including a list of certain suppliers of the company and the estimated amount of rebates received from them during the years of assessment 1991/92 and 1992/93.

12. The investigation officer did not accept the Manager's computation of rebates. On 30 November 1994, estimated profits tax assessments were raised on the company as follows:

Year of Assessment	**Estimated Additional Assessable Profits $**
1988/89	700,000
1989/90	1,100,000
1990/91	1,600,000
1991/92	2,000,000
1992/93	2,100,000

By notices dated 14 December 1994, the company lodged objections against these assessments on the ground of excessiveness.

13. On 14 December 1994, the Manager attended an interview with two investigation officers. During this interview, the Manager was advised that the names of two suppliers, who used to pay rebates to the company, were not included in his computation of rebates. The Manager agreed to forward a revised computation of rebates.

14. By a letter dated 14 January 1995, the Manager contended that the estimated profits tax assessments for the years of assessment 1988/89 to 1992/93 raised on the company were excessive. In the reply dated 16 January 1995, the investigation officer explained the reasons for not accepting the Manager's previous computation of rebates and clarified the various points raised by him. On 17 January 1995, the Manager submitted another letter in response to the investigation officer's comments. It was subsequently arranged that the tax was to be paid by instalments.

15. On divers dates, the First Taxpayer, the Second Taxpayer and the Manager confirmed the statements of their assets and liabilities as at 31 March 1993 complied by the investigation officer.

16. Following negotiations with the investigation officer, the Manager submitted two revised computations in February and March 1995 showing net rebates of $2,137,096 and $4,005,991 respectively for the years of assessment 1987/88 to 1993/94. After taking into account the rebates already included in the accounts for the year of assessment 1993/94, the profits understated for the years of assessment 1987/88 to 1993/94 were agreed at $3,720,000.

17. On 24 March 1995, the Second Taxpayer and the Manager attended an interview with two investigation officers. During the meeting, they signed an agreement confirming the total additional profits of $3,720,000 in respect of the company for the years of assessment 1987/88 to 1993/94.

18. In accordance with the agreed profits, revised additional profits tax assessments for the years of assessment 1987/88 to 1992/93 and additional profits tax assessment for the year of assessment 1993/94 were issued to the company on 31 March 1995.

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

Year of Assessment	**Profits before Investigation**	**Profits after Investigation**	**Profits Understated**	**Tax Undercharged**

	$	$	$	$
1987/88	161,343	301,343	140,000	25,200
1988/89	1,151,194	1,401,194	250,000	42,500
1989/90	1,329,014	1,759,014	430,000	70,950
1990/91	3,381,879	4,051,879	670,000	110,550
1991/92	5,654,500	6,474,500	820,000	135,300
1992/93	5,025,074	5,965,074	940,000	164,500
1993/94	4,681,123	5,151,123	470,000	82,250
	21,384,127	25,104,127	3,720,000	631,250

20. The Commissioner was of the opinion that the First and the Second Taxpayers had, without reasonable excuse, made incorrect profits tax returns in respect of the company for the years of assessment 1987/88 to 1993/94. On 1 May 1995, he gave notices to them under section 82A(4) of the Inland Revenue Ordinance (the Ordinance) that he proposed to assess the First and Second Taxpayers to additional tax by way of penalty.

21. By letter dated 12 May 1995, the Manager made representations on behalf of the Taxpayers.

22. After taking into accounts the Taxpayers' representations, the Commissioner, on 12 June 1995, issued notices of assessment and demands for additional tax under section 82A on the Taxpayers in respect of the incorrect profits tax returns in the following amounts:

Year of Assessment	Section 82A Additional Tax $
1987/88	26,500
1988/89	44,600
1989/90	70,600
1990/91	103,100

1991/92	118,400
1992/93	135,000
1993/94	64,700
	562,900

23. By notice dated 11 July 1995, the Taxpayers through the Manager gave notice of appeal to the Board of Review against the assessments to additional tax under section 82B of the Ordinance.

At the hearing of the appeal the two Taxpayers were represented by the Manager.

The representative submitted that the Inland Revenue Department officer had alleged that rebates received by the company were omitted from the accounts of the company. He said that for reasons which he would give in his submission the Taxpayers did not agree with this allegation. He said that it was true that rebates had been omitted from the accounting records of the company. He said that the accounting records of the company could show that some rebates received were deducted from the purchase price paid by the company for goods and only the net purchase price was recorded in the accounts of the company. He said that the company had always emphasised this fact in its representations to the Inland Revenue Department. He explained that the company dealt with over 2,000 suppliers and the amounts of individual invoices were usually small amounts so that the system of deducting the rebates from the purchase figures before entering them into the accounts was the most efficient. He said that if this had not been the practice then the ledger accounts would have been much greater. He then said that he understood that this procedure was not against the provisions of the Inland Revenue Ordinance.

The representative then said that if there were omissions then only rebates received in cash of small amounts were not recorded. He went on to say that such small amounts were a petty cash float and had been used to pay petty business expenses such as lunch boxes for the 11 staff, red packets of the 11 staff, and reimbursement to the directors of expenses which they had incurred on behalf of the company and which had not been entered into the company's accounts.

He sought to place the blame on the auditors by saying that the accounts of the company were audited and the auditors had not suggested that the rebates should be shown as a separate item in the profit and loss accounts of the company. In answer to a question from the Board the representative said that this omission had not been brought to the attention of the auditors and it was pointed out to the representative that it would be difficult for the auditors either to comment on or advise with regard to something about which they knew nothing.

The representative said that the Taxpayers had cooperated with the Inland Revenue Department after the inquiries were made by the Inland Revenue Department but that in spite of this cooperation the Commissioner did not consider a more lenient penalty. He requested the Board to reduce the penalty. The representative then elected to give evidence and offer himself for cross examination. The evidence given by the witness was in line with the submission which he had made. It included statements with regard to the knowledge of the Taxpayers with regard to the affairs of the company. He produced in evidence copies of ledger accounts and supporting vouchers and invoices relating to a number of transactions where the company had received commissions or rebates from suppliers. These had been duly entered into the accounts of the company and had been carefully and meticulously calculated and recorded. None of them related to the cash discounts and rebates which did not appear in the accounts.

The representative for the Commissioner submitted that as a result of an investigation carried out by the Inland Revenue Department it was found that the two Taxpayers had submitted incorrect tax returns for the company. He pointed out that following the investigation the Taxpayers and the company had reached a compromise agreement with the Inland Revenue Department under which it was agreed that during the years in question the company had received unrecorded commission income of some $3,720,000 with tax payable thereon of $631,250. The Commissioner was of the opinion that the Taxpayers had committed offences without reasonable excuse and after taking into account the representations made on their behalf had imposed penalty tax under section 82A of the Inland Revenue Ordinance of $562,900 being 89% of the tax undercharged. He submitted that the company's accounting system was not a mitigating factor and commented on the facts. He drew attention to Inland Revenue Board of Review Decision D4/89, IRBRD, vol 4, 172 where the Board had said that failure to keep proper accounts and file correct returns merited a penalty equal to the amount of tax undercharged. He said that the Commissioner had taken into account all of the relevant facts including the cooperation of the Taxpayers in the course of the enquiry and had imposed a penalty of less than 100%. He submitted that in the circumstances the quantum of the penalty was not excessive. He did not ask the Board to increase the quantum of the penalty.

We have no hesitation in dismissing this appeal and confirming the additional penalty tax assessments against which the two Taxpayers have appealed. Indeed in the opinion of this Board the penalties are too low. The norm for cases where taxpayers had failed in their obligations under the Inland Revenue Ordinance is a starting point of 100% of the amount of tax involved. The representative for the Commissioner informed us that the Commissioner had taken into account all of the relevant circumstances including the cooperation given by the Taxpayers during the course of the investigation. We can only assume that the level of cooperation and other factors not known to us were sufficient to influence the Commissioner in favour of the Taxpayers.

This is not a case of an unsophisticated taxpayer failing to keep correct accounts and failing in his obligation under the Inland Revenue Ordinance. On the evidence given before us by the representative for the Taxpayer who was the manager and a director

of the company, the company kept sophisticated and accurate accounts. Indeed the copies of the ledger accounts, invoices and vouchers produced in evidence before us showed a very high level of accounting practice and expertise. The transactions were meticulously recorded in the accounts of the company. Details of rebates, commissions and other incidental expenses were carefully calculated and recorded. However in relation to cash discounts the company chose to adopt totally different practice and procedure. We find this hard to understand. Apparently in a company which appears to have maintained excellent accounts the directors decided to have what can only be described as a 'slush' fund. They chose to allow suppliers to pay them cash discounts which were not recorded in any of the books of the company. We were told that records regarding these cash discounts were kept for period of one month and then destroyed. We were told that the money was used, inter alia, to buy lunch boxes for the staff. However in the carefully maintained and prepared audited accounts there is an item relating to 'messing' which the representative for the Taxpayers confirmed related to food for the staff. It is strange that such accurate records would be maintained for recorded. We then have the statement with regard to 'red packets' for the 11 staff. There were no records kept regarding these 'red packets' which obviously formed part of the remuneration of the employees. Then we have the statement that part of the cash rebates and discounts was paid to the directors as reimbursement of expenses which they incurred in relation to the business of the company. This again is hard to understand or believe. In the audited accounts of the company there is a significant sum of money shown as business entertainment and an even more significant sum shown as overseas travelling expenses. We are asked to believe that this well run company with its excellent accounts had a separate unrecorded 'petty cash' fund out of which substantial additional sums were paid to staff and to directors as expenses. Frankly we find this hard to believe.

The main thrust of the submission on behalf of the Taxpayers was that the company had already been penalised by having to pay higher tax than it otherwise would have had to pay if proper accounts had been kept. With due respect to those concerned with regard to the affairs of the company, that is a not unnatural result of deliberately failing to keep true and correct accounts.

For the reasons given we dismiss this appeal and confirm the additional assessments against which the Taxpayers have appealed. We place on record that we do not wish this case to be taken as a precedent that we consider the penalties to be reasonable. They appear to us to be too low but we have not been asked by the representative for the Commissioner to increase the same. As stated above we assume that there were mitigating circumstances known to the Commissioner which persuaded him to impose such low penalties.