Case No. D142/01

Profits tax – whether there was basis for re-opening the assessment of profits tax made more than a year – taxpayers are bound by the approach adopted in their submitted financial statements to the Inland Revenue Department (' IRD') – definition of ' mistake, errors or omissions' – sudden change of the case before the Board – proper explanation or supporting evidence is required – sections 70 and 70A of the Inland Revenue Ordinance (' IRO').

Panel: Ronny Wong Fook Hum SC (chairman), John Peter Victor Challen and Gerald To Hin Tsun.

Dates of hearing: 29 October and 20 November 2001.
Date of decision: 21 January 2002.

The taxpayer, a solicitors' firm which had ceased business, appealed against the decision of the Commissioner that there was no basis for re-opening the assessment of profits tax made more than a year under section 70A of the IRO.

The facts appear sufficiently in the following judgment.

Held:

1. Interpretation of the words ' errors or omissions' in section 70A was considered in Extramoney Ltd v CIR [1997] 2 HKC 38 at page 50 by Patrick Chan J.

2. The Court of Final Appeal in CIR v Secon Limited and Ranon Limited, IRBRD, vol 15, 795 made it clear that where a taxpayer may properly prepare its financial statements on either of two alternative bases, the Commissioner is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen to adopt.

3. The Board was perturbed by the emergence of the new case at the resumed hearing. Given the fact that the taxpayer was a professional firm versed in the law, the Board found it difficult to see why this case was never advocated in the correspondence passing between the taxpayer and the Revenue. The amount involved was not insignificant.

4. Given the nature of the new case, one would expect strong objections against the

assessment first made by the IRD, which invited the taxpayer to raise any objection within one month of the notice of assessment.

5. However, the taxpayer did not put forward any objection within that period. At the very least, this case should have found its way to the instructions to its representing counsel when he first appeared before the Board. No proper explanation of why there was a sudden change of the case was given before the Board.

6. The evidence submitted to the Board showed that the taxpayer had chosen to draw up and submit its financial statements on the accrual basis and that was its adopted approach in relation to its accounts when it ceased business.

7. Having done so, any ' change of the mind of the taxpayer in connection with how any part of the accounts should be made up' cannot be regarded as an error or omission in relation to the accounts previously submitted by the taxpayer to the Revenue.

8. The Board was not satisfied that the taxpayer had discharged its onus of proving the facts asserted in relation to this new case.

9. The Board found that the position was accurately stated by the taxpayer in its notice of appeal.

10. The taxpayer made a decision on the basis of the factual situation at the time. The fact that a different view is now taken on the basis of hindsight does not mean that the original view was a ' mistake' or an ' error' .

11. The Commissioner was correct in holding that there was no basis for re-opening the assessment under section 70A of the IRO.

Appeal dismissed.

Cases referred to:

Extramoney Ltd v CIR [1997] 2 HKC 38
CIR v Secon Limited and Ranon Limited, IRBRD, vol 15, 795

Fung Ka Leung for the Commissioner of Inland Revenue.
Victor Dawes instructed by Messrs Danny Lau & Lam, Solicitors, for the taxpayer.

Decision:

Background

1. Mr A and Mr B had hitherto carried on a solicitors practice in the name of Company C (' the Firm').

2. By notice dated 1 September 1998, Mr B informed the IRD the date on which the business of the Firm would cease.

3. By letter dated 23 December 1998, the Firm requested the IRD to restore its business registration certificate although the Firm ' has ceased business' . The Firm explained that such restoration was to enable the Firm to continue operating its bank accounts for the purpose of receiving payment from their clients in respect of their outstanding bills.

4. On 26 April 1999, Mr A as ' precedent partner' of the Firm submitted its profits tax return for the year of assessment 1998/99. It reported to the IRD assessable profits for the year at $4,145,747. According to the profit and loss account annexed to this return, the income of the Firm for the year ended 31 December 1998 amounted to $6,232,533 comprising of $5,985,887 by way of ' professional fees income' ; $242,335 by way of ' sundry income' and $4,311 by way of ' interest income' . These accounts were prepared by Accountants' Firm D.

5. On the basis of the return so submitted, the Commissioner by notice dated 2 June 1999 informed the Firm that the assessor had assessed its assessable profits for the year of assessment ended 31 March 1999 at $4,145,747. The Firm was invited to raise any objection within one month of that notice. The Firm did not put forward any objection within that period. By virtue of section 70 of the IRO, that assessment became final and conclusive for all purposes of the IRO.

6. In 1998, the Firm acted for various clients in Taiwan (' the Taiwan Clients') with the view of acquiring a company listed in Hong Kong. The Firm sent to those clients bills totaling $2,218,440. Commencing from 21 December 1998, the Firm pressed the Taiwan Clients for payment. Further reminders were sent on 2 June 1999 and 20 October 1999. Apart from one bill, no payment was received from the Taiwan Clients.

7. By letter dated 5 June 2000, Mr A objected against the 2 June 1999 assessment on the ground that bad debts amounting to $2,160,000 had not been taken into account. This was

rejected by the Revenue on 15 June 2000 as the objection was not received within the one-month period.

8. By letter dated 18 September 2000, the Firm applied under section 70A of the IRO to correct the assessment for the year of assessment 1998/99 on the following grounds:

(a) ' ... the bad debts were not included in the financial statements submitted to your department. Furthermore, some direct costs paid by [Mr A] were omitted in the accounts.'

(b) ' Although we have tried our best to collect the accounts receivable of our company after we submitted the accounts to your department on 30th April 1999, we must account for the outstanding balance of accounts receivable for some clients as bad debts after our final action on 20th October 1999 since we have entirely lost contact with those clients.'

9. In further correspondence with the IRD, Mr A stated that ' Before we submitted the accounts to your department on 30th April 1999, we still had contact with one of those clients and were promised that those outstanding bills would be settled within a short period. After our final reminder made on 20th October 1999, we lost contact with those clients except one of them – [Mr E]. Only the outstanding bill of HK$35,500 were received by us from [Mr E] with discount of HK$6,500 recently. We consider further legal action would increase the cost of our company since those debtors were not resident of Hong Kong' .

10. By his determination dated 29 June 2001, the Commissioner rejected the Firm's application to re-open the assessment under section 70A of the IRO. This is the Firm's appeal against such refusal.

Section 70 and the applicable principles

11. Section 70A(1) of the IRO provides that:

> ' *Notwithstanding the provisions of section 70, if, upon application made within 6 years after the end of a year of assessment or within 6 months after the date on which the relative notice of assessment was served, whichever is the later, it is established to the satisfaction of an assessor that the tax charged for that year of assessment is excessive* ***by reason of an error or omission in any return or statement submitted in respect thereof****, or by reason of any arithmetical error or omission in the calculation of the amount of the ... assessable ... profits assessed or in the amount of the tax charged, the assessor shall correct such assessment'.* (emphasis applied).

12. In Extramoney Ltd v CIR [1997] 2 HKC 38 at page 50 Patrick Chan J (as he then was) considered the interpretation to be given to the words ' errors or omissions' in section 70A and said this:

> *' In my view, for the purpose of s. 70A, the meaning of "error" given in the Oxford English Dictionary (p. 277) would be appropriate, that is, "something incorrectly done through ignorance or inadvertence; a mistake". I do not think that a deliberate act in the sense of a conscientious choice of one out of two or more courses which subsequently turns out to be less than advantageous or which does not give the desired effect as previously hoped for can be regarded as an error within s. 70A. It is even worse if the deliberate act is motivated by fraud or dishonesty. But the question of fraud or dishonesty need not arise.*
>
> *Hence, in the context of the present case, if there is a change of opinion of the auditors or accountants in respect of the accounts, the first opinion cannot be regarded as an error or omission within the section. Similarly if there is a change of mind of the directors of the company in connection with how any part of the accounts should be made up, the previous decision will not be regarded as an error or omission. Nor is it an error or omission if it is merely a difference in the treatment of certain items in the accounts by those preparing or approving the accounts. If this were permitted, the director or officer of a company will be tempted at a later stage to try and "improve" the company's accounts or change his own decisions if this is to his advantage. This would be contrary to the spirit of the Ordinance that there should be finality in taxation matters. The whole statutory scheme provided in the Ordinance simply cannot work.'*

13. In CIR v Secon Limited and Ranon Limited, IRBRD, vol 15, 795, the Court of Final Appeal made it clear that where a taxpayer may properly prepare its financial statements on either of two alternative bases, the Commissioner is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen to adopt. Lord Millett NPJ at page 799 said this:

> *' Both profits and losses therefore must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the Ordinance. Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principles of commercial accounting and in conformity with the Ordinance, no further modifications are required or permitted. Where the taxpayer may properly draw its financial statements on either of two alternative bases, the Commissioner is both entitled and bound to ascertain the assessable profits on whichever basis the taxpayer has chosen*

to adopt.'

The hearing before us

14. At the inception of the hearing before us, Mr Dawes for the Firm was content to rest his case on the following statement of Patrick Chan J (as he then was) in Extramoney (above cited):

> *' I think it would be unwise to attempt to give a comprehensive definition of what is or is not an error or omission which can cater for all situation ... I accept that in some cases where it can be proved that the* ***profits stated in the accounts of a taxpayer had in fact not been made****, it may be* ***sufficient to show that there has been an error justifying a correction to the assessment****. However, each case must be considered in its own factual matrix.'* (emphasis of Mr Dawes).

15. After hearing Mr Dawes' opening submissions, we invited Mr Dawes to consider whether it is prudent to call no evidence. Mr A was then called at short notice.

16. Mr A told us in chief that since the beginning of his Firm in about 1991 or 1992, accounts were prepared on receipt basis. The Firm adopted the accrual basis for the year ended 31 December 1998 due to its switch of accountant. It was put to Mr A that in its financial statements for the year ended 31 December 1996, the Firm stated as its principal accounting policies that ' Revenue is recognised when it is probable that the economic benefits will flow to the company and when the Revenue can be measured reliably, on the rendering of services, based on the stage of completion of the transaction, provided that this and the costs incurred as well as the estimated costs to completion can be measured reliably' . It was further pointed out to Mr A that according to the Firm' s profit and loss account for the years ended 31 December 1996 and 31 December 1997, the Firm had written off bad debts in the sums of $413,049 and $181,798. Mr A then conceded that he was not familiar with the particulars or contents of the Firm' s accounts. He just signed and handed the same to the Firm' s accountant. Mr A also admitted that part of the bad debts written off for 1996 and 1997 (for example, the sum of $413,049 for 1996) included uncollected profits costs billed and later written off as bad debts. This would suggest that the Firm' s profit and loss accounts for those years were presented on the accrual basis and not on the receipt basis.

17. At the resumed hearing before us, Mr A informed us that inquiries made by him during the adjournment revealed the nature of the error. The Firm had to submit annual report to the Law Society for professional insurance purposes. It was unnecessary to make any provision for bad debts in that report. The selfsame report was unwittingly used for submission to the Revenue despite his instruction to the accountant that there be provision for bad debts. It was put to him that he stated in the notice of appeal before this Board that ' I did not object to the notice of assessment because the debtors were still in contact. I cannot conclude that the debts were bad by that time' .

Mr A explained that at that point of time, he could only contact the Taiwan Clients by mobile phone. The chance of recovery was dim. Those Taiwan Clients disappeared between August and December 1999.

18. The Firm called Mr F. Mr F worked for Accountants' Firm D in 1998 and was the supervisor of one Mr G. Mr G handled the accounts of the Firm. He left Accountants' Firm D in May 1999. He discovered that there was error in relation to the Firm's accounts shortly before he gave evidence before us. Mr G received instructions not to include the bills in the accounts or to claim bad debts in respect of those bills. Mr G had forgotten to do so. The accounts were prepared on an accrual basis. Mr H signed off the accounts. He would have reviewed the working papers before he did so. Mr F was however not sure whether Mr H would have reviewed the tax computation as annexed.

Our decision

19. We are perturbed by the emergence of the new case at the resumed hearing before us. Given the fact that we are dealing with professionals versed in the law, we find it difficult to see why this case was never advocated in the correspondence passing between the Firm and the Revenue. The amount involved is not insignificant. Had instructions been given to Mr G as now contended, one would expect strong objections against the assessment of 2 June 1999. At the very least, this case should have found its way to the instructions to Mr Dawes when he first appeared before us. No attempt was made to place before us the Firm's report to the Law Society. Mr A gave us no explanation as to why he made no reference to this when he first appeared before us. We attach no weight to the evidence of Mr F as he does not appear before us to have personal knowledge of the alleged instructions to Mr G. The evidence submitted by the Firm showed that the Firm had chosen to draw up and submit its financial statements on the accrual basis and that was its adopted approach in relation to its accounts when the Firm ceased business. Having done so, any 'change of the mind of [the Firm] in connection with how any part of the accounts should be made up' cannot be regarded as an error or omission in relation to the accounts previously submitted by the Firm to the Revenue (see Extramoney cited above). In these circumstances, we are not satisfied that the Firm had discharged its onus of proving the facts asserted in relation to this new case.

20. We are of the view and we so find that the position is accurately stated by the Firm in its notice of appeal before this Board: '[The Firm] did not object to the notice of assessment because the debtors were still in contact. [The Firm] cannot conclude that the debts were bad by that time'.

21. The Firm made a decision on the basis of the factual situation at the time. The fact that a different view is now taken on the basis of hindsight does not mean that the original view was a 'mistake' or an 'error'. The Commissioner is correct in holding that there is no basis for re-opening the assessment under section 70A of the IRO.

22. For these reasons, we dismiss the Firm' s appeal.