INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D14/91

Penalty tax – failure to file correct business profits tax returns – quantum of penalties – section 82A of the Inland Revenue Ordinance.

Panel: T J Gregory (chairman), Ambrose Lau Hon Chuen and Ronald Leung Ding Bong.

Date of hearing: 12 March 1991.
Date of decision: 30 May 1991.

The taxpayer was the sole proprietor of a restaurant which commenced business in 1985. Prior thereto he had previously carried on a restaurant business. He filed incorrect tax returns and following an investigation it appeared that he had underdeclared his taxable profits by some 92%. The Commissioner imposed penalty tax under section 82A of the Inland Revenue Ordinance on the taxpayer of an amount equivalent to approximately 100% of the tax undercharged. The taxpayer appealed on the ground that the penalties were too great because he had no intention to deceive, it was his first offence, he had cooperated with the Inland Revenue Department and had a poor financial situation. Furthermore he had no accounting knowledge.

Held:

The taxpayer had previous experience of running a restaurant business and the quantum of the penalties of approximately 100% were not excessive bearing in mind that the taxpayer had omitted some 92% of his taxable profits.

Appeal dismissed.

Cases referred to:

D63/88, IRBRD, vol 4, 68
D2/88, IRBRD, vol 3, 125
D54/88, IRBRD, vol 4, 15

Woo Shu Sum for the Commissioner of Inland Revenue.
Philip Leung Chi Hung of Arthur W C Mo & Co for the taxpayer.

Decision:

1. THE SUBJECT MATTER OF THE APPEAL

The Taxpayer appealed against the quantum of penalty assessments raised under section 82A of the Ordinance for the years of assessment 1985/86, 1986/87 and 1987/88 ('the relevant years').

2. THE FACTS

The facts which are not in dispute were as follows:

2.1 Throughout each of the relevant years the Taxpayer was the sole proprietor of a restaurant which had commenced business in 1985.

2.2 The profits tax returns ('the returns') filed by the Taxpayer for the relevant years were accepted by the assessor and the assessments were made in accordance with the returns. The information extracted from the returns is as follows:

Year of Assessment	Basis Period	Date of Filing	Returned and Assessed Profit(Loss) $
1985/86	[date of commencement] to 31-3-1986	1-8-1986	(98,472)
1986/87	1-4-1986 to 31-3-1987	7-7-1987	110,634
1987/88	1-4-1987 to 31-3-1988	23-6-1988	169,232

2.3 No election was made by the Taxpayer for the year of assessment 1985/86 but for the years of assessment 1986/87 and 1987/88 he elected for personal assessment.

2.4 The information extracted from the personal assessment returns is as follows:

Year of Assessment	Basis Period	Date of Filing	Business Profits $
1986/87	1-4-1986 to 31-3-1987	3-8-1988	12,162*
1987/88	1-4-1987 to 31-3-1988	30-8-1988	169,232

(*profits for the year less loss brought forward,
that is, $110,634 - $98,472)

2.5 The Taxpayer was interviewed by two investigation officers of the Revenue on 17 January 1989. He was accompanied by a tax representative employed by a firm of certified public accountants who were the auditors of the Taxpayer's business for the relevant years. After the usual warnings the Taxpayer disclosed that he did not keep any accounting records for his business and that the accounts which had been prepared had been prepared on the basis of information provided by him to his then auditors. Having identified his signature on the returns he stated that the accounts annexed to the returns were estimates only. He acknowledged that the 10% service charges, cash tips and the proceeds of tea and chips sales were not included in the turnover of the business for the relevant years.

2.6 On 7 June 1990 the Taxpayer attended a closing interview with the investigation officers. He stated that invoices given to customers excluded the 10% service charges and the cost of tea and chips. He stated that all receipts, disregarding their nature, as well as the customers' cash tips were paid into the business' bank account on the next day. During this interview the Taxpayer agreed a betterment profit of $2,400,000 for the relevant years and agreed to have that betterment profits evenly distributed over each of the relevant years.

2.7 On 26 July 1990 an original profits tax assessment for the year of assessment 1985/86 and additional profits tax assessments for the years of assessment 1986/87 and 1987/88, based on the agreed betterment profit, were issued.

2.8 The assessable profits before and after investigation and the amount of tax undercharged is as follows:

Year of Assessment	Profit(loss) Assessed before Investigation $	Profit Assessed after Investigation $	Profit Understated $	Loss Overclaimed $	Tax Undercharged $
1985/86	(98,472)	800,000	800,000	98,472	136,000
1986/87	110,634	800,000	689,366	-	136,000
1987/88	169,232	800,000	630,768	-	115,942
	181,394	2,400,000	2,120,134	98,472	387,942

2.9 On 17 September 1990 the Commissioner issued a notice under section 82A(4) of the Ordinance and, having received the written representations made on behalf of the Taxpayer, on 14 November 1990 raised the following additional tax assessments under section 82A of the Ordinance:

Year of	Tax	Section 82A	Percentage of

Assessment	Undercharged $	Additional Tax $	Penalty Tax %
1985/86	136,000	141,000	104
1986/87	136,000	137,000	101
1987/88	115,942	113,000	97
	387,942	391,000	101

2.10 On 4 December 1990 the Taxpayer gave notice of appeal against these additional tax assessments on the grounds of appeal being that:

> ' … although the tax is validly chargeable, it is excessive having regard to the circumstances. In particular, this is the first time [the Taxpayer] committed the offence and that is mainly due to misapprehension.'

3. SUBMISSION ON BEHALF OF THE TAXPAYER

The Taxpayer did not attend the appeal but was represented by an accountant.

3.1 The Board was advised that the Taxpayer's business had commenced in 1985 but that books were not kept. Accounting data was handed over to a firm of accountants, a firm different from that of the Taxpayer's representative, for the preparation of annual accounts and to deal with the tax. The Taxpayer had not disputed any assessments and had paid the tax assessed.

3.2 The Taxpayer was interviewed by the Revenue on 17 January 1989 when he made a full disclosure of his assets. He also acknowledged that he had not included tips, the 10% service charges nor the receipts from the sale of tea and chips as he did not regard these as taxable. Further he agreed to and did pay $150,000 as a deposit against any tax to be assessed.

3.3 An enquiry letter dated 2 November 1989 from the Revenue had been received and promptly answered.

3.4 On 2 June 1990 the Taxpayer was interviewed for the second and final occasion by the Revenue. At this interview he agreed to be taxed on an assets betterment basis and accepted the figure of $2,400,000, which roughly corresponded with the unreported income.

3.5 The section 82A notice had been received and promptly answered. On 14 November 1990 the assessments of the penalties, totalling $391,000 against tax undercharged of $387,942, were raised. The Taxpayer regarded these penalties as excessive, hence the appeal.

3.6 This was the Taxpayer's first offence. It occurred because he had regarded the unreported income as non-taxable. He had been very cooperative with the Revenue including the payment of a deposit. The quantum was considered excessive as in a more serious case of which the representative was aware the penalty had only been 90%.

3.7 On behalf of the Taxpayer the representative requested a reconsideration of the quantum of the penalty.

3.8 In answer to questions from the Board the representative stated that the grounds for reduction were the fact that this was the first offence that has arisen through an omission. He confirmed that the Taxpayer had had a previous business but when asked whether the Taxpayer should have been aware of his obligations his reply was that he was an old fashioned Chinese businessman who did not concern himself with such matters.

4. SUBMISSION BY THE REVENUE

The submission by the Revenue was in writing. The representative of the Revenue addressed the specific submissions made on behalf of the Taxpayer:

4.1 Ignorance of the law and misconception as to chargeability to tax of tips, the service charges, and receipts from tea and chip sales.

It was submitted that it was well established that ignorance of the law was no excuse. The Taxpayer's lack of awareness of the provisions of the Ordinance and his duties thereunder do not absolve him from liability to additional tax. The Board was referred to D63/88, IRBRD, vol 4, 68.

The Board's attention was drawn to the fact that the Taxpayer had run a similar business from 1979 to 1983 whereby, when he started his present business, he should have been aware of the provisions of the Ordinance.

The investigation did not produce any direct evidence that the understatement of profits referred to receipts from the items referred to. Even if he were genuinely ignorant he had never consulted the Revenue about the assessability of such receipts nor reflected them in his personal assessment returns of 1986/87 and 1987/88.

4.2 Lack of accounting knowledge and reliance on the yearly engaged accountants to attend to his taxation affairs.

The Taxpayer had a primary obligation to keep proper business records whilst he was in business. The accounts prepared were prepared on the basis of information provided by him. Accordingly, he should bear the consequences of his failure to file correct returns. Having regard to his own assets position,

the Taxpayer should have been aware that the returned profits were not commensurate with the growth in his assets during the relevant years.

4.3 Immediate rectification of his misconception.

It was submitted that this was irrelevant. Although the Taxpayer had made correct business profits tax returns for the subsequent years of assessment that was doing no more than every taxpayer was required to do and those returns were made whilst his affairs were being investigated.

4.4 Cooperation and payment of deposit.

The Taxpayer did not take any initiative to rectify the position nor forward a proposal for settlement despite his own admission of the irregularities. He acted passively. He shifted his responsibility to compute the true profits to the assessor and unnecessarily burdened the assessor with the responsibility to ascertain the correct tax liability. The consequence was that the case was only settled some seventeen months after the first interview. The Commissioner would have taken what cooperation there was into account when assessing the penalty.

4.5 Poor financial situation as a result of declining profitability.

A person liable to tax cannot escape payment by alleging an inability to pay the tax. Ability is to be distinguished from liability. Declining profitability is not a valid ground of appeal. The Revenue had already permitted the Taxpayer to pay both the tax and the penalties by seven monthly payments. As at the date of the appeal the Taxpayer had met the payment schedule and only two instalments remained to be paid.

4.6 No wilful intention and first offence.

The Revenue did not regard the Taxpayer as one who had wilfully sought to evade tax, a serious offence which would normally involve prosecution. Had the Revenue taken the view that he had been wilfully seeking to evade tax a different course might have been taken. The fact that this was a first offence was reflected in the quantum of penalty.

4.7 In summary the Taxpayer had acknowledged that he had understated his true profits to the extent of 92% and, thereby, not paid the tax that was due, totalling $387,942, at the time when the tax was due for payment. The Ordinance permits a maximum penalty of 300% of the tax which had been undercharged.

In the present case the maximum penalty would have amounted to $1,163,826. Factually the Commissioner had assessed penalties totalling $391,000, namely one-third of the maximum permitted.

4.8 It was submitted that no reasonable excuse for the making of incorrect returns had been put forward nor any reason whereby the amounts of the additional tax should be regarded as being excessive.

4.9 In answer to questions from the Board the representative stated that the Taxpayer's own assets as at 31 March 1988 were $3,728,681.

5. REPLY OF THE REPRESENTATIVE

5.1 The Taxpayer's representative challenged the basis upon which the Commissioner had raised the penalty. He stated that he was aware of a case where the sum of $14,000,000 was omitted from returns and in which the investigation had taken eighteen months. The penalty amounted to 90%. In answer to a question from the Board the representative stated that he had not seen a report on that particular case and was unable to refer the Board to any relevant authorities.

5.2 The Board drew the Taxpayer's representative's attention to two reports, namely D2/88, IRBRD, vol 3, 125 at page 131, and D54/88, IRBRD, vol 4, 15. The representative stated that he had no comments to make on these decisions.

6. REASONS FOR THE DECISION

6.1 It is for the taxpayer to satisfy the Board that there was a reasonable excuse for incorrect returns having been filed and/or that the amount of the additional tax was excessive having regard to all of the circumstances.

6.2 At his first interview with the Revenue the Taxpayer stated that he was born in 1939 in China, that he came to Hong Kong in 1962 and, having worked in the packing section of a garment factory for some ten years, he had opened a restaurant which closed when the premises in which it was operated were demolished. He had been compensated. Some two years after that business was closed he opened the present business. The business employed some thirty to forty employees. All receipts were banked on a daily basis. The 10% service charges were distributed amongst the employees on 1, 11 and 21 of each month and varied according to the recipient's position. These payments were drawn from the bank accounts.

6.3 This is not a case involving an individual who had set up in business for the first time. The Taxpayer had had a prior and similar business. Disregarding deemed knowledge of the law, the Board does not believe that a person who has been in business since 1979 can be unaware of the basic provisions of the Inland Revenue Ordinance.

6.4 Annual accounts were prepared on the basis of information provided by the Taxpayer to the accountant instructed to prepare those accounts. If the information provided included bank statements the Board wonders what reason the Taxpayer gave to the accountants for the exclusion from the annual turnover of the tips, 10% service charges and the receipts for the tea and chip sales, receipts which, according to the Taxpayer's version of the events, were banked the following day.

6.5 The accounts prepared by the Taxpayer's accountants show business receipts in the year ended 31 March 1986 of $5,142,698, in the year ended 31 March 1987 of $5,496,554.5 and for the year ended 31 March 1988 of $6,044,525. Obviously, the business was fairly substantial, receipts being on average $100,000 per week. There can be no excuse for the Taxpayer's failure to take steps to be satisfied that, first, his method of keeping accounting records would enable proper accounts to be prepared and, secondly, to ascertain which, if any, of the receipts of his business were or were not taxable receipts.

6.6 Nothing submitted on behalf of the Taxpayer at the hearing of the appeal constitutes a valid excuse for the Taxpayer having made incorrect returns.

6.7 So far as the quantum of penalty is concerned the Board does not think that this is an insignificant case. Factually, the agreement reached by the Taxpayer with the Revenue constitutes an admission that for the relevant years, 92% of the taxable profits were omitted from the returns. The Commissioner has chosen to impose a penalty which, averaged over the three years in question, is very near to one-third of the maximum penalty that could have been imposed. In view of the published decisions of the Board as to the starting point for the quantum of penalties, and particularly D54/88, IRBRD, vol 4, 15, the Board does not consider that the amount of the penalty imposed is excessive.

7. DECISION

For the reasons given this appeal is dismissed.