INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D163/98

Penalty Tax – whether assessments not challenged conclusive – whether incorrect tax returns – whether reasonable excuse – Inland Revenue Ordinance sections 70 and 82A.

Panel: Andrew Halkyard (chairman), Vernon F Moore and Herbert Tsoi Hak Kong.

Date of hearing: 13 January 1999.
Date of decision: 22 February 1999.

The taxpayer was an insurance agent subject to profits tax. In the view of the assessor, the taxpayer understated his profits chargeable to tax because he made many claims for deduction of expenses that could not be substantiated. It was compromised that the taxpayer's deduction for expenses be restricted to one-third of his commission income. However, the Commissioner further raised penalty tax on the taxpayer, which amounted to 61% of the tax undercharged on the ground that he had, without reasonable excuse, made incorrect tax return. On appeal, the taxpayer argued that his tax returns were correct. The appeal was settled on invitation by the Board.

Obiter:

Profits tax assessments which are not objected are final and conclusive. (section 70 of IRO; D10/81, D4/89 applied)

Nonetheless, the level of penalty tax was too high in the circumstances. (D4/89 considered)

Quaerere:

Whether it could be concluded that the taxpayer had made 'without reasonable excuse' an incorrect return 'by omitting or understating anything in respect of which he is required by (section 82A(1) of) the IRO to made a return' because he had claimed deductions to which he could not justify entitlement.

Appeal compromised.

Cases referred to:

D10/81, IRBRD, vol 1, 404
D4/89, IRBRD, vol 4, 172

Kwok Hon Chuen for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. This is an appeal against assessments to additional or penalty tax raised under the provisions of section 82A(1) of the Inland Revenue Ordinance ('IRO') for the years of assessment 1990/91 to 1995/96 inclusive. The Taxpayer claimed that he should not be assessed to penalty tax because he had not made incorrect tax returns by understating profits liable to profits tax and, therefore, the Commissioner was incorrect in concluding that he had, without reasonable excuse, made incorrect tax returns.

2. On the date fixed for hearing this appeal, we heard argument from both parties. Upon conclusion of argument, the Board invited both parties to consider a settlement to this appeal. Following an adjournment, the parties tabled a statement of agreed terms signed by both parties to settle the appeal. The parties requested the Board to endorse the statement.

3. Having heard the contentions of both parties during the hearing, the Board is satisfied that the statement of agreed terms is acceptable in all the circumstances. Accordingly, the Board orders that the additional tax assessments made under section 82A(1) against which the Taxpayer has appealed be revised on the basis set out in the statement of agreed terms.

4. In light of what we have learned during the hearing, we consider it may be useful to make various observations. We make these in the light of our belief that this is not an isolated case, and may well be one of many. We appreciate, however, that a settlement reached by both parties – albeit one endorsed by the Board of Review – is just that. It is not a precedent.

Background

5. The Taxpayer was an insurance agent subject to profits tax. In his profits tax returns he did not understate his income from his business. In the view of the assessor he did, however, understate his profits chargeable to tax because he made many claims for deduction of expenses that simply could not be substantiated. After an exchange of correspondence between the parties, the assessor proposed that the Taxpayer's deduction for expenses be restricted to an arbitrary one-third figure of his commission income. Profits tax assessments were raised on this basis. The Taxpayer raised no objection thereto. Under

section 70 of the IRO these assessments are 'final and conclusive for all purposes of this Ordinance as regards the amount of such assessable income or profits'.

Penalty action taken against the Taxpayer

6. Prior to the profits tax assessments referred to above being finalised, the assessor informed the Taxpayer that agreement to the profits tax assessments did not necessarily preclude penalty action by way of additional tax. In the event, the Commissioner raised penalty tax on the Taxpayer. This amounted to approximately 61% of the tax undercharged had the assessor accepted the Taxpayer's profits tax returns as accurate.

Our initial reaction in this appeal

7. Even before reading the Commissioner's submission to us, we were mindful of many cases, such as D10/81, IRBRD, vol 1, 404, where another Board of Review had stated:

> *'If a taxpayer agrees to an assessment for tax ... and he pays ... the tax as assessed, he must be taken to admit that it relates to a liability for which he is chargeable to tax. His liability under the assessment cannot be re-opened. It has become final and conclusive: Section 70. In [such] a situation, the Appellant cannot, in contesting a claim [under section 82A] that he has filed an incorrect return without reasonable excuse, be heard to say that he is not chargeable for the tax on which he has been assessed since the validity of the assessment is conclusively presumed against him.'*

In relation to the level of penalty tax, we were also mindful of many other cases, such as D4/89, IRBRD, vol 4, 172, where another Board of Review had stated:

> *'As a general rule, the penalty to be imposed where a taxpayer has failed ... to keep proper accounts and file true and correct tax returns is an amount equal to the amount [namely, 100%] of tax which has been undercharged.'*

On the basis of both these lines of authority, we wondered what the Taxpayer could say to us to justify either annulling or reducing the penalty tax assessments raised on him.

Our considered reaction in this appeal

8. As this appeal proceeded, all members of the Board began to appreciate that the level of penalty tax assessed to the Taxpayer was simply too high. Even though the percentage of penalty tax assessed was 61%, which is well below the normal penalty of 100% arising from investigation cases, we find that the 100% benchmark could not usefully be compared with the facts before us.

9. In the typical case, such as D4/89, profits understated by a taxpayer are computed following painstaking efforts made by an investigation officer. All income and outgoings

are checked and double-checked by reference to all known bank accounts and other repositories of funds associated with the taxpayer. The process is thorough, tedious and time consuming. Contentious items are subject to detailed scrutiny and argument by both taxpayer and tax collector alike. An assets betterment statement is finally prepared and assessments made in accordance therewith.

10. Compare that process with the one before us. There was no thorough investigation.

11. Granted, detailed enquiry letters were sent to the Taxpayer by the assessor and attempts were made by the Taxpayer to answer those letters. In the event, the Taxpayer could not answer all those enquiries to the satisfaction of the assessor. The Taxpayer says that he simply could not answer those letters in the detail required and, in this regard, we found that the enquiries were very detailed. A compromise was then reached and profits tax assessments raised on the basis of an admittedly arbitrary formula. Penalty tax was then assessed in the percentage amount indicated above.

12. On appeal, the Taxpayer argued that his tax returns were correct. Unfortunately for him, cases such as D10/81 quoted above appear to preclude him from contesting this point before us. In this regard, however, we note that the Taxpayer had properly returned all components of his income in his tax returns. We therefore queried whether it could be concluded that the Taxpayer had, in terms of section 82A(1)(a), made '<u>without reasonable excuse</u>' an incorrect return '<u>by omitting or understating anything in respect of which he is required by this Ordinance to make a return</u>' because he had claimed deductions to which he could not justify entitlement. Where outgoings contained in a taxpayer's accounts are claimed falsely, or even recklessly without regard to whether they properly qualify for deduction, we do not doubt that section 82A(1) can apply. The answer, however, is much less obvious in a case where deductions are simply disallowed by the assessor because the taxpayer can not justify deductibility to the extent required of him.

13. In any event, and putting to one side the threshold question noted in the previous paragraph, should we totally ignore the quality of the tax returns in penalty tax cases such as this? We think not. It may be, contrary to our reaction, that the penalty tax raised in this case was too low because the Taxpayer's profits tax returns in terms of claiming deductible expenditure were pure fantasy. Conversely, it may be that the penalty was way too high because, as argued by the Taxpayer, he incurred each and every expense he claimed but simply could not substantiate these to the assessor; and thus he agreed to settle the profits tax assessments for he had no other practical alternative.

14. Faced with this dilemma, we found that we did not have sufficient information before us to judge the quality of the Taxpayer's returns. The Commissioner's representative did not address us on this matter. Perhaps he considered, on the authorities, that he did not need to do so. But whatever the reason for this approach, we were not prepared, on the facts before us, simply to say that because the Taxpayer cannot deny the correctness of his returns,

he must therefore have conducted himself in such a way that the substantial penalty tax raised upon him was appropriate in the circumstances.

15. We have set out the background to this appeal and the development of our reactions thereto in order to illustrate the difficulties we perceived in reaching a just result. In the event, we considered that the parties knew best how to settle this appeal, if indeed, having heard the arguments of the other side, a settlement could be reached. The parties have done this. We thank them for it.

16. It is left to us to thank the representatives of the Taxpayer and the Commissioner for the open-minded and flexible approach they took throughout the conduct of this appeal. We have no hesitation in endorsing the settlement reached by them.