INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D17/01

Penalty tax – incorrect tax return – Practice Notes ' Locality of Profits' .

Panel: Ronny Wong Fook Hum SC (chairman), Ho Kai Cheong and Henry Lau King Chiu.

Date of hearing: 9 February 2001.
Date of decision: 26 April 2001.

The taxpayer registered in the name of a company a business of ' manufacturer/import/export trading' . A subcontracting and processing agreement was signed with a PRC party. The entire manufacturing process was carried out in the Mainland.

Between July 1994 and September 1999, the taxpayer submitted six returns in respect of his earnings. There was no evidence of any professional assistance being obtained in the preparation of these returns. When being investigated by the Revenue, the taxpayer co-operated fully with the Revenue.

The Revenue was of the view, as expressed in the Department' s Practice Notes on ' Locality of Profits' dated November 1992 and March 1998, that in the case of a Hong Kong business which enters into a co-operative/processing agreement with a third party in China whereby the third party provides land and/or labour and the Hong Kong business provides raw materials and technical know-how, its profit on the sale of the manufactured goods should be apportioned with 50% of the profits being chargeable to profits tax. The taxpayer argued that he should not be liable for 50% of the profits as there was no production or sale in Hong Kong.

On 24 May 2000, after duly warned by the assessors on the possibility of additional tax, the taxpayer reached an agreement with the Revenue in relation to his assessable profits for the six years in question. The Revenue subsequently imposed additional tax by virtue of the incorrect returns submitted by the taxpayer.

Held:

1. On the basis of D96/97, IRBRD, vol 12, 520, the taxpayer cannot re-open his agreement on 24 May 2000 and contest the incorrectness of the six returns which he previously submitted. The basis for imposition of addition tax rests on the

incorrectness of the returns. An intent to defraud the Revenue is not a pre-requisite for such imposition.

2. On the basis of D24/84, IRBRD, vol 2, 136, the taxpayer cannot put forward as a reasonable excuse for the incorrectness of his returns his ignorance of the law in relation to the locality of profits.

3. Each case must be considered in the light of its own facts. Investigation commenced in February 2000 and a settlement was reached in May 2000. The taxpayer co-operated throughout the investigation. Furthermore, his liability was grounded on an area of the law which the Revenue accepts in their Practice Notes as one which ' has produced the most controversy' . The Board is therefore of the view that the Revenue erred in principle when assessing additional tax at 96% of the tax undercharged. The Board is of the view that a fair assessment in the circumstances of this case is 75% of the tax undercharged for each relevant year of assessment.

Appeal allowed in part.

Cases referred to:

D24/84, IRBRD, vol 2, 136
D96/97, IRBRD, vol 12, 520

Yue Wai Kin for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. On 17 September 1991, the Taxpayer registered in the name of Company A a business of ' manufacturer/import/export trading' .

2. Between 28 July 1994 and 20 September 1999, the Taxpayer submitted six returns for the years of assessment 1993/94 to 1998/99 in respect of his earnings and those of his wife. There is no evidence of any professional assistance being obtained in the preparation of these returns.

3. The Revenue commenced investigations into the Taxpayer' s activities on 2 February 2000. At inception of the investigation, the Taxpayer informed officers from the Revenue that:

> ' [Company A] was engaged in the manufacture of low price disposable plastic products, such as plastic bags and glove, made of polyethylene. A subcontracting and processing agreement was signed with the PRC party. The entire manufacturing process was carried out in the Mainland.'

4. The Taxpayer co-operated fully with the Revenue in the course of their investigation. Available records were readily furnished to the Revenue for their consideration.

5. The Revenue is of the opinion that the Taxpayer' s activities produced profits which arose in or derived from Hong Kong. Reliance is placed on the Department' s Practice Notes on ' Locality of Profits' dated November 1992 and March 1998. In paragraph 5 of the November 1992 Practice Notes, the Revenue expressly recognised that ' The question of the locality of trading profits has produced the most controversy.' In paragraphs 12 and 13 of the same Practice Notes, the Revenue expressed the views that in the case of a Hong Kong business which enters into a co-operative/processing agreement with a third party in China whereby the third party provides land and/or labour and the Hong Kong business provides raw materials and technical know-how, its profit on the sale of the manufactured goods should be apportioned with 50% of the profits being chargeable to profits tax.

6. By a letter dated 10 April 2000, the Taxpayer argued that he should not be liable for 50% of the profits as there was no production or sale in Hong Kong. At the same time, the Taxpayer expressed the wish of a speedy resolution of his disputes with the Revenue.

7. On 24 May 2000, after duly warned by the assessors on the possibility of additional tax, the Taxpayer reached an agreement with the Revenue in relation to his assessable profits for the six years in question. As a result of this agreement, his tax position is as follows:

Year of assessment	**Profits before investigation** $	**Profits after investigation** $	**Profits understated** $	**Tax undercharged** $
1993/94	115,431	472,225	356,794	53,519
1994/95	140,147	821,506	681,359	102,203
1995/96	214,104	1,035,805	821,701	123,255
1996/97	179,696	1,568,346	1,388,650	210,153
1997/98	209,036	1,983,467	1,774,431	262,569
1998/99	332,151	1,930,046	1,597,895	239,684

The Taxpayer was duly assessed on the basis of these revised profits on 30 June 2000.

8. By notice dated 21 August 2000, the Commissioner notified the Taxpayer of his intention to impose additional tax by virtue of the incorrect returns submitted by the Taxpayer for the years of assessment 1993/94 to 1998/99. After considering representations of the Taxpayer,

the Commissioner by notice dated 9 October 2000 imposed additional tax in amounts summarised below:

Year of assessment	**Profits understated** $	**Tax undercharged** $	**Additional tax imposed** $	**Relationship between additional tax and tax undercharged**
1993/94	356,794	53,519	60,000	112%
1994/95	681,359	102,203	113,000	111%
1995/96	821,701	123,255	128,000	104%
1996/97	1,388,650	210,153	204,000	97%
1997/98	1,774,431	262,569	240,000	91%
1998/99	1,597,895	239,684	205,000	86%
		991,383	950,000	96%

9. This is the Taxpayer' s appeal against the additional tax so imposed.

10. The Taxpayer and his wife appeared before us. They both gave sworn testimony. Whilst they displayed considerable passion in their submissions, their testimony is of little relevance to the issues which we have to consider. The Taxpayer obviously took great pride from the fact that he built up Company A from scratch. He asserted that he duly reported his profits in Hong Kong and China. He prepared his accounts without any professional assistance. He had no intention whatsoever in evading tax. The Taxpayer' s wife complained that the Revenue should have challenged the Taxpayer' s position when the first relevant return was submitted in 1994. She does not understand why the Taxpayer should be penalised. She emphasised that in any event this is the Taxpayer' s first transgression and the additional tax imposed is far too high.

11. The Revenue cited two authorities for our consideration.

(a) In D24/84, IRBRD, vol 2, 136, the Board pointed out that '*Anyone who carries on business has obligations in respect to that business which include obligations under the Inland Revenue Ordinance. Such obligations cannot be avoided by saying that the taxpayer was ignorant, illiterate or unable to understand what the obligations required. Likewise it is no excuse to say that qualified accountants were employed and that this exonerated the Appellant. Qualified accountants can do no more than act on the information provided to them and in accordance with the instructions given to them. The client and not the accountant must take full legal responsibility for what the client signs.'*

(b) In D96/97, IRBRD, vol 12, 520, the Revenue commenced its investigation in 1993. Various unsuccessful attempts were made to settle the dispute. The issues ended up before a Board of Review. The Board ruled in favour of the Revenue. Additional assessments under section 82A were issued in August 1996. The taxpayer was assessed on the basis of 99.9% of the tax undercharged. The taxpayer sought to appeal those assessments out of time. The Board held that it has no jurisdiction to extend time for the purpose of an appeal against a section 82A assessment. The Board pointed out that in hearing an appeal against an assessment of additional tax under section 82A, it has no power to challenge the original assessment of the profits tax. The Board further observed that ' the usual tariff for cases of this type is about 100% of the tax undercharged' .

12. On the basis of D96/97, the taxpayer cannot re-open his agreement on 24 May 2000 and contest the incorrectness of the six returns which he previously submitted. The basis for imposition of additional tax rests on the incorrectness of the returns. An intent to defraud the Revenue is not a pre-requisite for such imposition.

13. On the basis of D24/84, there is no doubt that the taxpayer cannot put forward as a reasonable excuse for the incorrectness of his returns his ignorance of the law in relation to the locality of profits.

14. Each case must however be considered in the light of its own facts. The so-called usual tariff referred to in D96/97 must not be blindly applied. A comparison of the facts between that case and the instant case indicates that they are far apart. There was no co-operation at all in D96/97. Investigation commenced in 1993. The taxpayer' s primary liability was not crystallised until after a contested hearing in November 1996. In this case investigation commenced in February 2000. A settlement was reached in May 2000. The taxpayer co-operated throughout the investigation. Furthermore, his liability is grounded on an area of the law which the Revenue accepts in their Practice Notes as one which ' has produced the most controversy' . We are therefore of the view that the Revenue erred in principle when assessing additional tax at 96% of the tax undercharged.

15. We are of the view that a fair assessment in the circumstances of this case is 75% of the tax undercharged for each relevant year of assessment.

16. We therefore allow the Taxpayer' s appeal and direct that the assessment be revised accordingly.