# Case No. D21/05

**Penalty tax –** whether or not the additional tax was excessive – whether or not the period of time taken for investigation and the raising of estimated assessment was excessive – whether or not a period of 56 to 64 months for the purpose of calculating the amount for commercial restitution is justified and excessive.

Panel: Benjamin Yu SC (chairman), Susan Beatrice Johnson and Jason Yeung Chi Wai.

Dates of hearing: 29 and 30 November 2004.
Date of decision: 7 June 2005.

The appellants commenced a partnership business in restaurant in 1984. The appellant did not challenge the findings of the Board in its decision delivered in February 2004. Additional tax has been levied on to the appellants and on to the partnership business. The appellants' complaint is that the amount of additional tax was, in each case, excessive and not in accordance with the penalty policy published by the Revenue. The additional tax levied was about 150% of the tax, which was undercharged.

The appellants argued that this is a case where the appellants fully cooperated with the Revenue. The appellants emphasized that there was no suggestion that the appellants were hiding any asset and the only issue all along was whether the cash deposits in the appellants' bank account were derived from off-shore profits. The appellant also complained of the time taken by the Revenue in the investigation. The appellant argued that the present case should fall within the category of full disclosure in the penalty policy published by the Revenue. The appellant lastly argued that even if the case fell within the category of 'incomplete or belated disclosure', the range of penalty should be between 110% and 150% and pointed to the fact that the maximum for group (b) in the full disclosure category was only 75%.

**Held:**

1. There has been no appeal from the decision of the Board and its finding must bind the parties to that appeal. In our view, it must follow from that decision that the appellants had failed, during the relevant years of assessment, to make a full report on their assessable profits. It would, in these circumstances, be difficult to treat these cases as ones where the appellants made full disclosure promptly on challenge. In our view, the Commissioner was justified in taking 100% of the tax undercharged as the starting

point in the present case (D118/02, IRBRD, vol 18, 90 and D53/88, IRBRD, vol 4, 10 considered).

2. The Board accept the appellant's submission that the position of the appellants have fundamentally remained the same throughout the period of investigation. The Board are of the view that in the circumstances of the present case, the period of time taken for investigation and the raising of estimated assessment was excessive. It would not be fair to visit the consequences of any delay caused as a result of the prolonged investigation on the appellants in the form of increasing the amount of additional tax on account of commercial restitution.

3. The adoption of a period of 56 to 64 months for the purpose of calculating the amount for commercial restitution is unjustified and excessive, especially when applied to the more recent years of assessment. The Board accept that this is a case where there has been persistent failure on the part of the appellants to perform their obligations. The Board would also take the view that the tax undercharged in respect of the earlier years would warrant a higher rate on account of commercial restitution. The Board is not, however, satisfied that a rate of 7% per annum compounded monthly should be applied in the circumstances of the present case.

4. Bearing all the circumstances in mind, the Board is of the opinion that the additional tax on the Restaurant D should be reduced to approximately 140% of the amount of tax undercharged and the tax on the individual appellants should be reduced to approximately 120% of the tax undercharged.

**Appeal allowed in part.**

Cases referred to:

D118/02, IRBRD, vol 18, 90
D53/88, IRBRD, vol 4, 10
D34/88, IRBRD, vol 3, 336

Dennis Law, instructed by Messrs Tony Kan & Co for the taxpayers.
Wong Wing Yu and Tang Yee Man for the Commissioner of Inland Revenue.

**Decision:**

**The appeals**

1. Mr A (the Appellant in BR No 67 of 2004) and Mr B are brothers-in-law (the Appellant in BR No 68 of 2004). In about 1984, they commenced a restaurant business in Island C, called Restaurant D. The two of them comprising the partnership are the Appellants in BR No 66 of 2004. Each of the Appellants challenge the imposition of additional tax levied on them by the Commissioner of Inland Revenue ('the Commissioner') under section 82A of the Inland Revenue Ordinance ('IRO').

2. In respect of the partnership business in the name of the Restaurant D, the additional tax levied by the Commissioner and under challenge in the relevant appeal is as follows:

| **Year of assessment** | **Amount of additional tax** |
|---|---|
| 1990/91 | $177,000 |
| 1991/92 | $488,000 |
| 1992/93 | $757,000 |
| 1993/94 | $126,000 |
| Total | $1,548,000 |

3. In the case of Mr A, the additional tax levied by the Commissioner and under challenge in the relevant appeal is as follows:

| **Year of assessment** | **Amount of additional tax** |
|---|---|
| 1993/94 | $409,000 |
| 1994/95 | $884,000 |
| 1995/96 | $398,000 |
| 1996/97 | $20,000 |
| Total | $1,711,000 |

4. In the case of Mr B, the additional tax levied by the Commissioner and under challenge in the relevant appeal is as follows:

| **Year of assessment** | **Amount of additional tax** |
|---|---|
| 1993/94 | $324,000 |
| 1994/95 | $81,000 |

| | |
|---|---|
| 1995/96 | $600,000 |
| 1996/97 | $222,000 |
| Total | $1,227,000 |

5. The facts which led to the charge of additional tax are common to each of the appeals. At the request of the Appellants, these appeals have been heard together and we now give our decision on these appeals.

6. We should record at the outset that Mr Law, who acted for all the Appellants, made it clear that the Appellants do not contend that the Commissioner was not entitled to levy additional tax on the Appellants. The Appellants' complaint is that the amount of additional tax was, in each case, excessive and not in accordance with the penalty policy published by the Revenue. The additional tax levied in the three appeals was about 150% of the tax which was undercharged.

**The facts**

7. The parties agreed statements of fact with documents annexed. We summarise the relevant facts below:

(1) As stated above, the partnership business commenced in 1984. The business was a prosperous one. The partners incorporated their business in June 1992 as Company E.

(2) In respect of the years of assessment 1990/91 to 1993/94, the Restaurant D submitted on divers days profits tax returns showing assessable profits as follows:

| **Year of assessment** | **Assessable profits** |
|---|---|
| 1990/91 | $496,984 |
| 1991/92 | $554,611 |
| 1992/93 | $745,733 |
| 1993/94 | $813,268 |

(3) After the incorporation of the limited company, the two original partners, Mr A and Mr B drew directors' fees from the limited company and separately submitted their individual tax returns to the Commissioner. On divers days, Mr A submitted tax returns showing assessable income particularised below:

| **Year of assessment** | **Assessable income** |
|---|---|
| 1993/94 | $220,000 |
| 1994/95 | $490,000 |
| 1995/96 | $567,467 |

| | |
|---|---|
| 1996/97 | $705,338 |

Mr B also submitted tax returns showing assessable income particularised below:

| **Year of assessment** | **Assessable income** |
|---|---|
| 1993/94 | $220,000 |
| 1994/95 | $490,000 |
| 1995/96 | $567,467 |
| 1996/97 | $706,538 |

(4) The Revenue commenced investigation into the tax affairs of the Appellants some time in 1996. By a letter dated 29 April 1996, the assessor invited Mr A and Mr B to the offices of the Revenue for an interview.

(5) On 30 May 1996, Mr A and Mr B attended the interview accompanied by a tax representative. We have been supplied with a copy of the notes of the interview. According to the notes, that meeting lasted roughly 3½ hrs. The taxpayers disclosed particulars of their family and of their businesses. They also disclosed particulars of bank accounts held under the name of Mr A and those under the name of Mr B as well as those held under the names of other members of their family. During this meeting, the taxpayers stated that they had made substantial profits from off-shore fish trading. The amount of profits was estimated to be $15,000,000 (being $5,000,000 for the period from 1986 to 1989 and $10,000,000 from 1990 to 1996). Also at this meeting, the taxpayers accepted that the reported turnover of the restaurant business had omitted to take account of the service charges; and further that the taxpayers had not informed the Revenue of two items of expenditure in the restaurant business, namely payment to casual workers and certain consultation fee. After this meeting, the taxpayers submitted revised employees' remuneration returns through their tax representative.

(6) In November 1997, the Revenue asked the taxpayers for further information. The taxpayers replied by a letter dated 15 December 1997. On the question of offshore profits, that letter stated that the sale and purchase and accounting were all done by their trading partner in the mainland and the taxpayers were therefore unable to provide any documentary proof. The letter further stated that the profits for the year 1996 to 1997 was $1,000,000 and asserted that the trading ceased in March 1997.

(7) The matter rested until a meeting between the taxpayers and the Revenue's representatives (including chief assessor Mr Wong) in April 2000. The

taxpayers wished to know the progress of the investigation and what further information the Revenue required. The chief assessor explained that the Revenue had analysed the bank transaction records of the taxpayers and found a large amount of cash deposit. The source of those deposits could be from the restaurant business, or from offshore trading, or other sources not known to the Revenue. He further explained that because the partnership business did not have the accounting records of the earlier period - which, according to the taxpayers, were damaged due to flooding - the Revenue had prepared an assets betterment statement for each taxpayer. The chief assessor intimated that on the basis of the assets betterment statement, each taxpayer had under-reported profits of $4,000,000 for the year of assessment 1993/94. Mr A pointed out that the profit was derived from the offshore fish trading business carried out in the high seas. He described the modus operandi of this business and the chief assessor suggested that the taxpayers should continue to look for concrete documentary proof to support their claim that the income was derived from outside the jurisdiction.

(8) In March 2001, Mr B's bank account was frozen by the Revenue. This prompted a letter of 26 March 2001 and a visit by the tax representatives of the taxpayers to the Revenue on 24 April 2001. During this meeting, the tax representative stated that the tax review on the taxpayers had dragged on for a long time, and that the main issue was his client's belief that any discrepancies found were sourced from their offshore activities which should not be taxable. He reiterated that no documentary evidence could be provided in support. At this meeting, two draft assets betterment statements were presented to the tax representatives for discussions.

(9) On 13 August 2001, the Revenue produced draft assets betterment statements itemizing the following income which the taxpayers alleged to be income generated by offshore trading:

| **Year** | **Amount** |
|---|---|
| 1990 | $1,800,000 |
| 1991 | $2,360,000 |
| 1992 | $2,520,000 |
| 1993 | $2,870,000 |
| 1994 | $1,960,000 |
| 1995 | $1,330,000 |
| 1996 | $960,000 |
| Total | $13,800,000 |

(10) There were further meetings at which the taxpayers did not dispute the quantum but maintained that the profits were off-shore. The matter proceeded to the Commissioner making determinations on the taxpayers' objections. The taxpayers appealed to this Board. The appeals were heard by the Board (differently constituted) on 3 and 4 November 2003 and the Board handed down its decision on 5 February 2004.

(11) At the hearing before this Board, the taxpayers raised two issues. One issue was a question of law, as to whether the Revenue was justified in assessing the alleged understated profits of the business by the use of assets betterment statements. That issue was resolved in favour of the Revenue. The other issue was one of fact, namely whether the understated profits were generated by overseas trading which were not susceptible to tax under the IRO. Evidence was given at the hearing by Mr A. The Board rejected his evidence and expressed surprise over the incredibility of his testimony. As the taxpayers failed to discharge the burden of proof under section 68(4) of the IRO of showing that the determinations appealed against were incorrect, all the appeals were dismissed and the Commissioner's determinations were confirmed.

(12) The Commissioner, after providing an opportunity to the taxpayers to make representations, decided to impose additional tax by way of penalty under section 82A of the IRO.

(13) As noted above, the additional tax levied was about 150% of the tax that was undercharged:

**Restaurant D**

| **Taxable year** | **Before investigation taxable income** | **Additional taxable profits** | **After investigation additional tax** | **Penalty / additional tax under section 82A** |
|---|---|---|---|---|
| | ($) | ($) | ($) | ($) |
| 1990/91 | 496,984 | 680,000 | 118,550 | 177,000 |
| 1991/92 | 554,611 | 2,060,000 | 325,338 | 488,000 |
| 1992/93 | 745,733 | 3,340,000 | 504,727 | 757,000 |
| 1993/94 | 813,268 | 560,000 | 84,000 | 126,000 |
| | 2,610,596 | $6,640,000 | $1,032,615 | $1,548,000 |
| | | | | 150.00% |

**Mr A**

| Taxable year | Before investigation taxable income | Additional taxable profits | After investigation additional tax | Penalty / additional tax under section 82A |
|---|---|---|---|---|
| | ($) | ($) | ($) | ($) |
| 1993/94 | 220,000 | 1,740,000 | 273,300 | 409,000 |
| 1994/95 | 490,000 | 3,930,000 | 589,500 | 884,000 |
| 1995/96 | 567,467 | 1,770,000 | 265,500 | 398,000 |
| 1996/97 | 705,338 | 90,000 | 13,500 | 20,000 |
| | 1,982,805 | $7,530,000 | $1,141,800 | $1,711,000 |
| | | | | 149.85% |

**Mr B**

| Taxable year | Before investigation taxable income | Additional taxable profits | After investigation additional tax | Penalty / additional tax under section 82A |
|---|---|---|---|---|
| | ($) | ($) | ($) | ($) |
| 1993/94 | 220,000 | 1,360,000 | 216,300 | 324,000 |
| 1994/95 | 490,000 | 360,000 | 54,000 | 81,000 |
| 1995/96 | 567,467 | 2,670,000 | 400,500 | 600,000 |
| 1996/97 | 706,538 | 1,000,000 | 150,000 | 222,000 |
| | 1,984,005 | $5,390,000 | $820,800 | $1,227,000 |
| | | | | 149.48% |

**Penalty policy**

8. Before we turn to address the parties' arguments, it is necessary to note that the Revenue has published a document setting out its policy in deciding on the level of penalty. This policy is, of course, not binding on the Board; but the Revenue would, as a matter of fair administration, normally adhere to that policy when deciding on the level of penalty. For cases, such as the present, which involve field audit and investigation, the document states:

> ' 2. The scale of penalty to be imposed on a taxpayer is basically a function of the nature of omission or understatement of income or profit, the degree of his co-operation or disclosure and the length of the offence period. For the purposes of maintaining consistency in penalty calculation, the following penalty loading table is used:

| Category of Disclosure and Work Involved | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Nature of Omission / Understatement** *(see Note 1 Below)* | **Full Voluntary Disclosure** | | **Disclosure with FULL Information Promptly on Challenge** | | **Incomplete or Belated Disclosure** | | **Disclosure Denied** | |
| | Normal Loading | Max. incl. C.R. | Normal Loading | Max. incl. C.R. | Normal Loading | Max. incl. C.R. | Normal Loading | Max. incl. C.R. |
| **Group (a)** | 15 | 60 | 75 | 100 | 140 | 180 | 210 | 260 |
| **Group (b)** | 10 | 45 | 50 | 75 | 110 | 150 | 150 | 200 |
| **Group (c)** | 5 | 30 | 35 | 60 | 60 | 100 | 100 | 150 |

*(see Notes 2 and 3 below)*

*Note 1*: **Group (a)** - cases where the taxpayers show intentional disregard to the law and adopt deliberate cover-up tactics involving the preparation of a false set of books, padded wage rolls and fictitious entries or multiple omissions over a long period of time.

**Group (b)** - cases with slightly less serious acts of omission resulting from recklessness including the "hand in the till" type of evasion, failure to bring to account sales of scrap, and sheer gross negligence.

**Group (c)** - cases where the taxpayers fail to exercise reasonable care and omit profits/income such as lease premium, one-off commission, etc.

*Note 2*: The penalty loading is expressed as a percentage of the tax undercharged.

*Note 3*: For cases completed after 30 November 2003, the CR (commercial restitution) is at 7% per annum monthly compounded for periods up to and including 30 November 2003 and at the best lending rate monthly compounded for periods after 30 November 2003.'

**Taxpayers' case**

9. The taxpayers' case is that the penalty was excessive and not in accordance with the penalty policy published by the Revenue, Mr Law for the taxpayers argued that this is a case where the taxpayers fully co-operated with the Revenue. He emphasized that there was no suggestion that the taxpayers were hiding any asset and the only issue all along was whether the cash deposits in the taxpayers' bank accounts were derived from off-shore profits. Mr Law also complained of the

time taken by the Revenue in the investigation. He argued that the Revenue could have used the assets betterment method in 1997 and should not have prolonged the investigation. He called the Board's attention to the fact that the taxpayers were, in each instance, quick in responding to the Revenue's query, but their promptness was not reciprocated by the Revenue.

10. Mr Law argued that the present case should fall within the category of full disclosure category in the penalty policy published by the Revenue. He argued that even if the case fell within the category of 'incomplete or belated disclosure', the facts do not fall within group (a) and queried why for group (b), the range of penalty should be between 110% and 150%, and pointed to the fact that the maximum for group (b) in the full disclosure category was only 75%.

11. Mr A gave evidence before the Board to the effect that the taxpayers had fully co-operated with the Revenue. In the course of that evidence, Mr A accepted that the taxpayers were not able to adduce sufficient evidence before the Board in the November 2003 hearing, but maintained the taxpayers' stance that the income was derived from trading offshore. Mr Law interposed during the evidence to make it clear that the taxpayers have no intention of challenging the findings of the Board and accept that they are bound by them.

**The Commissioner's arguments**

12. Ms Wong argued that the investigation took a long period of time because the taxpayers and related parties had over 40 bank accounts. She contended that the taxpayers had all along failed to disclose the unreported assessable profits or income, and disagreed that the facts fall within the category of 'disclosure with full information promptly on challenge'. She emphasized that the under-reporting persisted for a number of years and the amount of assessable profits amounted to over $20,000,000 or 70% of the total assessable income. She pointed out that even though the taxpayers had not received much education, they had shown themselves to be capable of managing a sizeable business. They are sophisticated and successful businessmen. In short, she submitted that there were no mitigating circumstances discernible from the background of the taxpayers, the sophistication of the business, or the attitude of the taxpayers.

13. Ms Wong referred to D118/02, IRBRD, vol 18, 90 a decision where the Board (comprising its chairman and two deputy chairmen) reviewed the history of the provision on additional tax and surveyed the level of penalty handed down by the District Court in cases which resulted in prosecutions and convictions, as well as many of the previous decisions of the Board. The Board noted that for the year of assessment 2000/01, the level of fine under section 80(2) was around $2,500 and that of the 33 cases dealt with in Court between 1971 and 2002, the arithmetical mean of further fine imposed was 97.5% of the tax involved. The Board indicated its preference for the approach adopted in D53/88, IRBRD, vol 4, 10 and D34/88, IRBRD, vol 3, 336. In the former, the Board pointed out that penalty at 100% of the amount of tax undercharged is appropriate to those cases:

(1) where there has been no criminal intent and the taxpayer has totally failed in his or its obligations under the IRO;

(2) where the Commissioner has had to resort to investigations or preparation of assets betterment statements or has otherwise had difficulty in assessing the tax; or

(3) where the failure by the taxpayer to fulfil his or its obligations under the IRO has persisted for a number of years.

14. Of the 10 factors listed by the Board in D118/02, Ms Wong highlighted the following for the Board's consideration: (a) the amount of tax involved, (b) whether there was an intention to evade (c) whether there has been any loss of revenue, (d) the lack of education on the part of the taxpayers and (e) conduct of the taxpayers before the Board.

15. When the Commissioner issued the notices of assessment and demand for additional tax, no reason was given to the taxpayers for her decision on the amount of penalty imposed under section 82A. This is the normal practice. Ms Wong explained to the Board that in the present case, the Commissioner regarded the facts as falling within the category of 'incomplete or belated disclosure' and the nature of understatement to be group (b). She further explained that in the present case, the Commissioner took 100% of the amount of tax undercharged as the starting point and added an element of commercial restitution by taking 7% per annum compounded monthly. The period taken for reckoning this interest element was different for each taxpayer and also varies depending on the particular year of assessment in question. Ms Wong helpfully provided the Board with a table showing the different applicable periods. Those periods varied between 56 and 64 months and were reckoned from the date when the tax would have been payable if the profits have been properly stated to the date when the assessor issued an estimated assessment.

**Are the amounts of additional tax excessive in the present case?**

16. In our view, Mr Law was correct in not seeking to challenge the findings of the Board in its decision delivered in February 2004. There has been no appeal from that decision and its findings must bind the parties to that appeal. In our view, it must follow from that decision that the taxpayers had failed, during the relevant years of assessment, to make a full report on their assessable profits. It would, in these circumstances, be difficult to treat these cases as ones where the taxpayers made full disclosure promptly on challenge. In our view, the decision of this Board in D53/88 (endorsed in D118/02) is apposite and the Commissioner was justified in taking 100% of the tax undercharged as the starting point in the present case.

17. However, we accept Mr Law's submissions that the position of the taxpayers have fundamentally remained the same throughout the period of investigation. We are of the view that in the circumstances of the present case, the period of time taken for investigation and the raising of

estimated assessment was excessive. It would not be fair to visit the consequences of any delay caused as a result of the prolonged investigation on the taxpayers in the form of increasing the amount of additional tax on account of commercial restitution. Ms Wong submitted that a great deal of time was required for the investigation because the taxpayers and related parties had a large number of bank accounts. This was denied by the taxpayers. It was said that only one account had substantial deposits. In the absence of any evidence from the Commissioner, we do not feel able to accept the explanation for what appears to us to be an inordinately long period of investigation.

18. It seems to us that the adoption of a period of 56 to 64 months for the purpose of calculating the amount for commercial restitution is unjustified and excessive, especially when applied to the more recent years of assessment. We accept that this is a case where there has been persistent failure on the part of the taxpayers to perform their obligations. We would also take the view that the tax undercharged in respect of the earlier years would warrant a higher rate on account of commercial restitution. We are not, however, satisfied that a rate of 7% per annum compounded monthly should be applied in the circumstances of the present case. Indeed, we note that the Revenue has adopted a more or less uniform 50% uplift in the case of the three appellants even though the period of default for the Restaurant D covered a much earlier period of time (that is, 1990/91 to 1993/94) compared to the individual taxpayers (viz 1993/94 to 1996/97). Bearing all the circumstances in mind, we are of the opinion that the additional tax on the Restaurant D should be reduced to approximately 140% of the amount of tax undercharged and the tax on the individual taxpayers should be reduced to approximately 120% of the tax undercharged as particularised below.

**Restaurant D**

| **Year of assessment** | **Tax payable** | **Additional tax** |
|---|---|---|
| | $ | $ |
| 1990/91 | 118,550 | 165,900 |
| 1991/92 | 325,338 | 455,400 |
| 1992/93 | 504,727 | 706,600 |
| 1993/94 | 84,000 | 117,600 |
| Total | | 1,445,500 |

**Mr A**

| **Year of assessment** | **Tax payable** | **Additional tax** |
|---|---|---|
| | $ | $ |
| 1993/94 | 273,300 | 327,900 |
| 1994/95 | 589,500 | 707,400 |
| 1995/96 | 265,500 | 318,600 |
| 1996/97 | 13,500 | 16,200 |
| Total | | 1,370,100 |

**Mr B**

| **Year of assessment** | **Tax payable** | **Additional tax** |
|---|---|---|
| | $ | $ |
| 1993/94 | 216,300 | 256,500 |
| 1994/95 | 54,000 | 64,800 |
| 1995/96 | 400,500 | 480,600 |
| 1996/97 | 150,000 | 180,000 |
| Total | | 981,900 |

19. We accordingly order that these appeals be allowed to the extent of reducing the additional tax assessed on the taxpayers in the case of BR 66/04 to HK$1,445,500, in the case of BR 67/04 to HK$1,370,100 and in the case of BR 68/04 to HK$981,900.