Case No. D22/90

Penalty tax – incorrect business profits tax returns – assets betterment statement – penalties increased to double the tax undercharged – section 82A of the Inland Revenue Ordinance.

Panel: T J Gregory (chairman), John C Broadley and Charles Hui Chun Ping.

Date of hearing: 7 December 1989.
Date of decision: 13 July 1990.

The taxpayer was the sole proprietor of a business and filed tax returns on which he was duly assessed to tax. The Inland Revenue Department conducted an investigation into the tax affairs of the taxpayer and used the assets betterment procedure to assess the taxpayer with the tax undercharged. The Deputy Commissioner then assessed the taxpayer to additional tax by way of penalty in an amount slightly in excess of the profits tax undercharged. The taxpayer appealed to the Board of Review on the grounds that there was a reasonable excuse or that the penalties were excessive.

Held:

The case for the taxpayer indicated that the taxpayer had deliberately embarked on a scheme to reduce his taxable profits. In such circumstances the penalties should be increased to twice the amount of the tax which would have been undercharged if the case had gone undetected.

Appeal dismissed and assessments increased.

Cases referred to:

D34/88, IRBRD, vol 3, 336
D4/89, IRBRD, vol 4, 172
D56/88, IRBRD, vol 4, 52

Ng Wai King for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. THE NATURE OF THE APPEAL

The Taxpayer appealed against the quantum of the additional tax assessed upon him under section 82A of the Inland Revenue Ordinance ('the Ordinance') with respect to incorrect profits tax returns of his business for the years of assessment 1980/81 to 1985/86, both inclusive.

2. THE FACTS

2.1 At the material times the Taxpayer was the sole proprietor of a firm (X Company) which commenced in March 1977. At all material times X Company was engaged in importing and trading in materials for the building industry.

2.2 The relevant profits tax returns, which were all submitted through a firm of certified public accountants, having been signed by the Taxpayer, provided the following particulars:

Year of Assessment	Date of Issue of Return	Date of Receipt of Return	Profits per Return $
1980/81	1-4-1981	19-8-1981	199,523
1981/82	1-4-1982	7-10-1982	105,796
1982/83	6-4-1983	23-12-1983	329,894
1983/84	2-4-1984	28-9-1984	(79,731)
1984/85	1-4-1985	2-12-1985	(4,304)
1985/86	1-4-1986	12-11-1986	238,680

2.3 For the years of assessment 1980/81 to 1983/84, both inclusive, assessments were raised on the profits stated in the profits tax returns. For the years of assessment 1984/85 and 1985/86 the assessor made some adjustments to the returned profits, or losses, in raising the assessments and the Taxpayer took no exception thereto. A summary of the profits assessed (losses agreed) based on the tax returns is as follows:

Year of Assessment	Date of Issue	Profits Assessed $
1980/81	20-11-1981	199,523
1981/82	25-11-1982	105,796
1982/83	19-1-1984	329,894
1983/84	5-12-1984	(79,731)
1984/85	20-3-1986	(4,360)

1985/86	19-1-1987	306,866

2.4 In or about January 1987 the Revenue initiated an enquiry into the tax affairs of the Taxpayer. During an interview on 26 January 1987, he confirmed that the profits declared in the relevant profits tax returns were correct. At this interview the Taxpayer was notified of the penalty provisions with respect to incorrect returns. A note of the interview was sent to the Taxpayer for confirmation of the accuracy and was returned signed without amendment on 3 March 1987. However, when returning the note the Taxpayer sent a memorandum containing corrections to some of the detail in the note.

2.5 During the course of the Revenue's investigation 'protective' additional assessments were issued as follows:

Year of Assessment	Date of Issue	Additional Profits $
1980/81	18-2-1987	600,000
1981/82	10-3-1988	600,000
1982/83	16-3-1989	300,000

The Taxpayer lodged objections against these additional assessments within the time permitted by the Ordinance.

2.6 On 19 March 1987 the Taxpayer attended a further interview with the investigating officers and claimed that the additional assessment for the year 1980/81 was unfair. The note of the interview was confirmed as correct by the Taxpayer on 27 April 1987. Again, the Taxpayer sent a memorandum with the note when he returned it.

2.7 On 28 May 1987 the Revenue wrote to the Taxpayer seeking information and on 17 June 1987 the Taxpayer replied.

2.8 The Taxpayer was further interviewed on 4 October 1988 and 13 December 1988 and during each interview he was asked to provide further information. The information reported was provided by him by letters dated 6 October 1988 and 13 February 1989 respectively.

2.9 Under cover of a letter dated 1 March 1989 the Revenue issued an assets betterment statement ('ABS'), together with supporting schedules, covering the period from 1 April 1980 to 31 March 1986.

2.10 By letters dated 13 March 1989, 23 March 1989, and 1 April 1989, the Taxpayer submitted counterproposals as to the discrepancy disclosed by the

ABS. On 4 April 1989 the Taxpayer acknowledged a total discrepancy of $892,079 by countersigning the ABS.

2.11 On 11 May 1989 the Taxpayer attended what was to be his final interview with the Revenue. During this interview the Taxpayer agreed to the method of apportionment of the additional assessable profits over each of the relevant years of assessment and which agreement is evidenced by the Taxpayer's signature to a written memorandum recording the detail. This memorandum contained an acknowledgment by the Taxpayer that the question of penalty assessments, in an amount not exceeding three times the tax undercharged, continued outstanding.

2.12 The following is a tabulation of the assessable profits before and after the investigation, the profits understated and the amount of tax undercharged:

Year of Assessment	Profits Before Investigation	Profits After Investigation	Profits Understated	Tax Under-Charged
	$	$	$	$
1980/81	199,523	301,506	101,983	15,297
1981/82	105,796	222,997	117,201	29,115
1982/83	329,894	511,227	181,333	27,200
1983/84	(79,731)	79,246	79,246	11,886
1984/85	(4,360)	181,799	181,799	30,905
1985/86	306,866	453,292	146,426	39,188
Total	857,988	1,750,067	807,988	153,591

2.13 On 10 July 1989 the Deputy Commissioner gave notice under section 82A(4) of the Ordinance to the Taxpayer informing him of the intention to assess additional tax by way of penalty in respect of the incorrect profits tax returns filed by the Taxpayer for the years of assessment 1980/81 to 1985/86, both inclusive.

2.14 On 4 August 1989 the Taxpayer submitted his written representations.

2.15 On 12 September 1989 the Deputy Commissioner issued notices of assessment and demand for additional tax by way of penalty under section 82A as follows:

Year of Assessment	Profits Tax Undercharged	Amount of Additional Tax	Percentage of Penalty Tax
	$	$	%

1980/81	15,297	19,500	127
1981/82	29,115	37,100	127
1982/83	27,200	34,700	128
1983/84	11,886	14,700	124
1984/85	30,905	36,000	116
1985/86	39,188	42,800	109
Total	153,591	184,800	120
	======	======	

2.16 On 12 October 1989, the Taxpayer gave notice of appeal to the Board against the assessment to additional tax by way of penalty. His grounds of appeal may be summarized as follows:

2.16.1 That after a three years investigation the Revenue had failed to find any evidence that there had been any deliberate act of tax evasion.

2.16.2 That the tax paid by a corporation owned by the Taxpayer proved that he was a law-abiding merchant.

2.16.3 That the investigation by the Revenue was maliciously instigated by a third party whose own misconduct, it was stated, was under investigation by other Hong Kong authorities.

3. THE CASE FOR THE TAXPAYER

The Taxpayer appeared in person. The Board explained to him that his appeal was against the quantum of the additional tax only. His agreement to the ABS and, by operation of section 70 of the Ordinance, his payment without objection of the additional profits tax assessed as a result of the investigation precluded the Board from considering any submissions as to the inaccuracy of either the ABS or those additional assessments.

3.1 Having been duly affirmed, he made the following submissions:

3.1.1 As to the total discrepancy of $892,097: this should be reduced to $442,062 being the amount of interest paid by him in respect of borrowings incurred exclusively to enable him to operate X Company. He started X Company with a loan of $20,000. Thereafter he raised large loans and had to pay interest.

3.1.2 He had been told that the maximum penalty was three times the tax which would have been unrecovered had the case gone undetected. He had told the Revenue that the imposition of additional tax would be very unfair on him. Although he disagreed with the total discrepancy he was willing to pay the tax based on the discrepancy but he did not go along with a ‘fine’. He stated that he thought that he should not be taxed on the interest. He had borrowed from

friends: if anyone should be taxed it was the lenders but as they were his friends he did not think it was fair for them to bear the tax. He stated that the interest was disclosed in his accounts and was paid by cheques through banks. He was prepared to pay the tax on behalf of his friends and if he did that penalties should not be imposed.

3.1.3 He had suggested to the Revenue that if he paid the tax found to be due, $153,591, he would not be required to pay a penalty but this suggestion had not been agreed to by the Revenue.

3.1.4 He had cooperated fully during the investigation. None of his accounts were maintained 'falsely'. It is the obligation of a genuine business to file tax returns and pay the tax. A limited company of which he was a shareholder paid a lot of tax. The imposition of penalties was very unfair. The investigation covered several years and many things had been forgotten. Was everything truly reflected in the assessments?

3.1.5 He knew no English and had to have documents translated. He knew no tax law. He had trusted the certified public accountants who had prepared the accounts of X Company. If there was any responsibility it was theirs.

3.2 The Taxpayer was then cross-examined by the representative of the Revenue. In reply to questioning the Taxpayer stated:

3.2.1 Schedule 5 to the ABS, loans and advances, was not correct. When pressed he stated that the amount was not correct.

3.2.2 The interest on the loans had been paid by cheques issued by X Company. The cheque stubs had already been sent to the Revenue.

3.2.3 To avoid those who had made the loans having to pay tax on the interest he had paid the interest and the amount paid was spread across several accounts.

3.2.4 The representative of the Revenue queried several of the payments recorded in the accounts of the cash books of 1981 to 1986. The Taxpayer stated that all were interest paid to the lenders of the loans. He also confirmed that the amounts coincided with what he had told the Revenue at his interview on 26 January 1987. The Taxpayer added that he wanted these lenders not to pay tax so it was charged to X Company. When pressed as to the accounts to which the amounts were debited he said this was 'transportation account'.

3.3 The accountant of X Company, Ms A, having been duly affirmed, was questioned by the representative of the Revenue as to the Taxpayer's evidence recorded in paragraph 3.2.4 above. She explained that the accounting treatment involved was in two stages. This treatment was demonstrated by reference to

the cash book of X Company, particularly that for the period 1 April 1982 to 31 March 1983, and X Company's ledger containing the 'transportation account' which was in the possession of the Revenue and which was shown to her. Her evidence was that the first stage of this accounting treatment was exemplified by three debits at page 118 of the cash book, a debit of $1,000 on 22 November 1982 and debits of $600 and $1,200 on 23 November, described as interest payments to two named individuals. The balancing entry was a credit of $2,800 to the 'director's account' made on 14 December 1982 which is at page 119 of the cash book. The second stage of the accounting treatment was to enter into the transportation account a payment to a contractor supplemented by an amount equal to the credit to the 'director's account'. The witness identified the entry in the transportation account for the first stage transactions set out above. She confirmed that this accounting treatment was common to all interest payments.

4. SUBMISSION ON BEHALF OF THE REVENUE

The Revenue submission was in writing and may be summarized as follows:

4.1 Having identified the nature of the appeal the Revenue submitted that as the Taxpayer had made incorrect returns by understating his profits and overclaiming his losses without reasonable excuse and as no prosecution under section 80(2) or section 82(1) of the Ordinance had been instituted he was liable to be assessed to additional tax under section 82A of the Ordinance.

4.2 The submissions on the specific grounds of appeal may be summarized as follows:

4.2.1 Ground 1, namely:

4.2.1.1 that there was no deliberate act of tax evasion nor malpractices found by the Revenue;

4.2.1.2 that an amount of $442,060, out of the total additional assessable profits ($892,079) for the relevant years, was attributable to interest paid for the Taxpayer's personal loans which should be considered as business expenses;

4.2.1.3 that the accounts staff of the Taxpayer was not familiar with tax laws and one has to take into account the possibility of certain omissions due to negligence; and

4.2.1.4 that the acceptance by the Taxpayer of the additional assessments made with tax thereon ($159,300) paid is already a punishment to the omission of income.

4.2.2 The submission:

4.2.2.1 Section 82A of the Ordinance does not require the Revenue to prove that the taxpayer had wilfully evaded tax before it may be invoked. The relevant provisions were then quoted and it was submitted that in the present case the Taxpayer had admitted he had understated the assessable profits for the relevant years. The onus of proof was on the Taxpayer to show that he had committed the offence with reasonable excuse. A lack of criminal intent is not a factor. The Board was referred to D34/88, IRBRD, vol 3, 336 at page 344.

4.2.2.2 The inclusion, as claimed by the Taxpayer, of interest paid in respect of personal loans does not constitute a reasonable excuse. That was merely incidental and forms no part of a reasonable excuse for committing the offence. Whether or not the payments were a business expense, as alleged by the Taxpayer, was a matter of fact and the onus of proof rested upon the Taxpayer. During the investigation the Taxpayer did not satisfy the Revenue that the loans were made for business purposes whereby the interest could not be counted as a business expense. The Board's attention was drawn to the fact that had the interest in question been paid for business purposes it would have been separately itemized in the yearly accounts prepared for X Company and claimed as a deductible expense. The Board was referred to the computation annexed to the accounts for the business for the year ended 31 March 1980 which disclosed no claim for interest. The computations for the other years were the same.

4.2.2.3 There was no excuse for the Taxpayer to say that he did not understand tax laws or that the staff he employed were not competent. It was his responsibility to ensure that competent staff were employed, refer D34/88, IRBRD, vol 3, at page 344 and D4/89, IRBRD, vol 4, 172 at page 176.

4.2.2.4 The argument that paying the tax charged on the additional assessments made by the Revenue was already a sufficient punishment was unfounded. It should be borne in mind that by paying the tax previously undercharged the Taxpayer did no more than fulfilling his statutory obligation but that such fulfilment was only after pressure had been put on him by the Revenue through its investigation.

4.2.3 Ground 2 and Ground 3:

4.2.3.1 Ground 2:

That the Taxpayer is a law-abiding merchant as evidenced by the quantum of tax paid by his other incorporated business.

4.2.3.2 Ground 3:

That the investigation in question was caused by the defamation made by a Hong Kong posted Chinese cadre. This person was subsequently deprived of all his official duties and fled away after the Taxpayer had successfully counteracted him.

4.2.4 The submission:

Neither ground was a reasonable excuse for committing the offence. Full disclosure of assessable profits in one business does not imply that full disclosure is being made for another and each individual case has to be examined on its own merits. The fact of the matter was that the Taxpayer had agreed to the assets betterment statement, had admitted that the profits tax returns previously submitted were incorrect and it matters not that the offence had been exposed by a third party.

4.3 The representative then referred the Board to D56/88, IRBRD, vol 4, 25 at pages 32-34. He submitted that the facts established that the Taxpayer was a sophisticated person running a sophisticated business.

4.4 Finally, the Board's attention was then drawn to the quantum of the penalty and it was pointed out that the penalty amounted to 40% of the maximum. The Deputy Commissioner had taken into account all relevant facts before he assessed the penalty and whilst the amount was higher than the starting point for penalties as upheld by previous Board cases, when considering all the facts, including the time required to complete the investigation, it was submitted that the penalties were not excessive.

5. REPLY OF THE TAXPAYER

5.1 The Taxpayer acknowledged that he was a sophisticated person but he had not applied himself to tax affairs. He submitted that he had receipts for all interest payments made and these were tendered to the Board. However, the Board declined to accept these receipts as this question was relevant to the ABS and not to the matter under appeal.

5.2 The Taxpayer stated that the interest of $442,600 had been paid and that he, personally, had not pocketed one cent of the interest and the amount should be deducted.

5.3 In conclusion the Taxpayer requested that the amount of the interest be taken into account and if there had to be a penalty it be set at the minimum.

6. REASONS FOR THE DECISION

6.1 On 4 April 1989 the Taxpayer acknowledged a total discrepancy of $892,079 by countersigning the ABS, refer paragraph 2.10 above. Additionally, on 11 May 1989 the Taxpayer agreed to the method of apportionment of the additional assessable profits over each of the relevant years of assessment, refer paragraph 2.11 above. Additional assessments were thereafter raised and the tax paid. No objection was taken to these additional assessments and, accordingly, section 70 of the Ordinance has application and those assessments are not the subject matter of this appeal.

6.2 This appeal is concerned with the penalties imposed under section 82A and the onus was on the Taxpayer to satisfy the Board that:

6.2.1 he had a reasonable excuse for submitting incorrect tax returns; and/or

6.2.2 the penalties were excessive.

6.3 The Taxpayer drew nothing to the attention of the Board which could be described as an excuse, whether reasonable or otherwise, for the filing of the incorrect returns. Factually, what was established to the satisfaction of the Board may be summarized as follows:

6.3.1 None of the accounts of X Company, prepared by certified public accountants employed by the Taxpayer, disclosed interest payments to third parties other than well known banking institutions. The failure to claim this interest as a deduction from profits in each of the relevant years of assessment, something which would have been a legitimate deduction, militates against the allegation made during the Revenue's investigation, which commenced after the relevant documents had been filed with the tax returns, that the loans were made for the purpose of financing X Company. Accordingly, the Taxpayer has failed to satisfy the Board that, and notwithstanding his prior agreement to the ABS, the borrowings were made for the purposes of the business of X Company.

6.3.2 There was a series of deliberate actions taken with a view to evade tax namely for the debit in respect of the gross interest payments to be counterbalanced by a credit from X Company's directors and for that credit to be recovered by an equivalent amount being added to an expense, refer the evidence of the accountant at paragraph 3.3 above. The effect of these actions has been that:

6.3.2.1 the lenders received interest without deduction of interest tax and an amount equivalent to the tax was not volunteered by the Taxpayer, refer paragraphs 3.1.2 and 3.2.3 above; and

6.3.2.2 the interest paid was recovered by being added to an expense account;

6.3.2.3 whereby the Revenue may have lost the tax on the interest paid on the borrowings (there was no evidence that the Revenue had received the interest tax from the recipients as a consequence of the investigation) but X Company's taxable profits had been reduced by an amount equal to the gross interest paid.

6.4 Section 68(8)(a) of the Ordinance provides that:

> 'after hearing the appeal the Board shall confirm, reduce, increase or annul the assessment appealed against or may remit the case to the Commissioner with the opinion of the Board thereon.'

6.5 On the evidence before the Board at the appeal it is perfectly clear that the Taxpayer was fully aware of the provisions of the Ordinance and in addition to generally understating his profits embarked on a scheme to procure the payment of interest on loans without accounting for the tax on the interest paid whilst, at the same time, recovering this interest by disguising it as a business expense.

6.6 The Board considered remitting the case to the Commissioner with a view to consideration being given to a prosecution. However, it is necessary for the Board to bear in mind that all of the documentation which would be required to establish beyond reasonable doubt that each of the interest payments was treated as described by the accountant of X Company may no longer be available or, assuming it is still available, that the time required to establish the facts to the necessary standard could well be disproportionate to the benefit to be obtained. Accordingly, the Board has reluctantly decided that that is not an appropriate course to adopt and, in lieu thereof, the Board considers that the appropriate penalty is two-thirds of the maximum permitted by the Ordinance.

7. DECISION

For the reasons stated the Board dismisses this appeal and in exercise of section 68(8) of the Ordinance orders that the additional tax to be paid by the Taxpayer is to be an amount equal to twice the profits tax which would have been undercharged had the case gone undetected whereby in lieu of the amounts assessed by the Deputy Commissioner the amount of additional tax in each of the relevant year of assessment shall be amended as follows:

Year of Assessment	Profits Tax Undercharged	Amount of Additional Tax	Percentage of Penalty Tax
	$	$	%
1980/81	15,297	30,594	200
1981/82	29,115	58,230	200
1982/83	27,200	54,400	200

1983/84	11,886	23,772	200
1984/85	30,905	61,810	200
1985/86	39,188	78,376	200
Total	153,591	307,182	200
	======	======	