

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D27/90

Penalty tax – business profits – assets betterment statement – quantum of penalties – section 82A of the Inland Revenue Ordinance.

Panel: Henry Litton QC (chairman), Geoffrey Hui and Edwin Wong.

Date of hearing: 24 July 1990.

Date of decision: 21 August 1990.

The taxpayer was carrying on business and following an assets betterment procedure, the taxpayer was assessed to tax on the understated profits revealed by the assets betterment statement. The Commissioner imposed penalties on the taxpayer under section 82A of the Inland Revenue Ordinance which were in total approximately equal to the tax undercharged but which were in different percentage amounts for the eight years in question. The amount varied from 116% to 22.5% of the amount of tax undercharged. It was explained that the Commissioner had taken into account that there were certain 'contentious elements' in the assets betterment statement.

Held:

The penalties were not excessive. The Commissioner had correctly taken into account that there were disputed amounts and that the quantum of the penalties should be reduced in respect of certain years.

Appeal dismissed.

Tse Woon Ping for the Commissioner of Inland Revenue.

Taxpayer represented by a chartered secretary.

Decision:

Introduction

1. This is an appeal against the imposition of additional tax by the Commissioner by way of penalty under the provisions of section 82A of the Inland Revenue Ordinance.

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2. The Taxpayer is the sole proprietor of A Company which commenced business in the year 1968 as a wholesaler, importer and exporter of drawnworks and embroidery made in China.

3. At the hearing of the appeal the Taxpayer appeared with two representatives, a Mr X (who had accompanied the Taxpayer at an interview with the assessors in December 1989) and Miss Y, a chartered secretary employed by B Limited. This company apparently provides secretarial services to the Taxpayer. At the commencement of the hearing we asked the Taxpayer to elect which of these two persons he wished to represent him at the hearing, and he chose Miss Y. The representations on this appeal were accordingly made on the Taxpayer's behalf by Miss Y.

4. It appears to us that Miss Y is not fully conversant with the provisions of section 82B of the Inland Revenue Ordinance under which we, as the Board of Review, exercise our jurisdiction. It would, we think, be helpful if we outline in this decision the statutory framework for imposing penalties so that the powers and functions of a Board of Review under a section 82B appeal might be better understood.

- (1) The appeal is against an assessment to additional tax made by the Commissioner or his Deputy personally.
- (2) The penalty provisions under section 82A appear in part XIV of the Inland Revenue Ordinance. This is something quite separate from the powers of assessment exercisable by the assessor under part X of the Ordinance.
- (3) What happened in this case was that the profits tax returns previously made by the Taxpayer were found to be incorrect by the assessor. In accordance with usual practice the assessor then made estimated assessments on the Taxpayer, estimating the profits he had made over the years of assessment in question. This was done by means of what is called an assets betterment statement, the assessor exercising his best judgment upon the material and information available to him.
- (4) An assessment in respect of business profits made by an assessor is open to objection by a taxpayer. Whilst an estimated profits tax assessment is under objection or appeal, the Commissioner does not exercise his powers to impose a penalty under section 82A. The reason is obvious. The maximum penalty under section 82A is treble the amount of tax undercharged. The Commissioner would not know what that might be until the assessment regarding profits tax has been finalised.
- (5) Once a profits tax assessment has been made and the period for objections has expired, then under the provisions of section 70 of the Ordinance the assessment 'shall be final and conclusive for all purposes of this Ordinance as regards the amount of such assessable ... profits'.

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- (6) The legal foundation for the exercise of the Commissioner's powers under section 82A of the Ordinance lies upon this fact: namely, that a person has without reasonable excuse made an incorrect return: see section 82A(1)(a). Thus, upon an appeal under section 82B to the Board of Review, if a taxpayer is able to satisfy a Board of Review, on the evidence adduced before it that the circumstances for the exercise of the Commissioner's powers under section 82A(1)(a) have not been satisfied, the Board of Review will discharge the penalty assessment altogether. There may be other circumstances under which the taxpayer can legitimately assert that he is 'not liable to additional tax' – see section 82B(2)(a) – but, generally speaking, if the 'reasonable excuse' argument is not tenable, then the taxpayer is, on the appeal, confined to the provisions of section 82B(2)(c) of the Ordinance: namely that the amount of additional tax is 'excessive having regard to the circumstances'.
- (7) The expression 'excessive having regard to the circumstances' is very broad, but one of the circumstances which the Board of Review is bound to bear in mind is that, at the stage of the section 82B appeal before the Board, the profits tax assessment has already been finalised and is, under the provisions of section 70, 'final and conclusive for all purposes'. Obviously, if there was some fundamental flaw in the process of assessment, and the provisions of part X of the Ordinance have not been duly observed, then the Board of Review can look behind the assessment. But, generally speaking, an appeal under section 82B(2)(c) of the Ordinance cannot be taken as an occasion for objecting to the profits tax assessments made by the assessor.

History

5. It was in February 1987 that the assessor in this case raised an additional assessment to profits tax in respect of the year of assessment 1980/81. At about the same time, an investigation was commenced and on 13 May 1987 the Taxpayer was first interviewed by officers of the investigation unit. Over two years later an assets betterment statement was issued. This covered not only the six years of assessment prior to the commencement of the tax investigation, but the two years thereafter. This was because, in the opinion of the assessor, the returns lodged after the investigation had commenced were also incorrect.

6. The assets betterment statement issued on 24 October 1989 covered the period 1 July 1979 to 30 June 1987 and showed total shortfalls of assessable profits in the sum of \$13,749,473.

7. Following this, there were further interviews with the Taxpayer and his representative and eventually, in December 1989, the Taxpayer signed a schedule of adjustments to the assets betterment statement showing total discrepancies amounting to

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\$730,000. In signing the schedule, the Taxpayer also made an acknowledgements in these terms:

‘I understand that my acceptance of the above does not conclude the whole matter, and that upon finalisation of the assessments, the case will be put up to the Commissioner or his Deputy for consideration of penalty action as provided under part XIV of the Inland Revenue Ordinance.’

8. The following is a comparative table of assessable profits as per the Taxpayer’s returns and assessable profits accepted by him in consequence of the investigation:

<u>Year of Assessment</u>	<u>Profits (Loss) Returned</u> \$	<u>Estimated Profits as assessed</u> \$	<u>Profits Understated</u> \$	<u>Profits Tax Undercharged</u> \$
1980/81	49,190	630,541	581,351	94,712
1981/82	65,992	586,399	520,407	87,916
1982/83	(86,480)	710,293	710,293	106,543
1983/84	6,032	975,915	969,883	146,387
1984/85	102,409	2,056,549	1,954,140	349,613
1985/86	106,811	1,400,543	1,293,732	233,530
1986/87	186,967	753,324	566,357	96,960
1987/88	<u>609,234</u>	<u>1,226,591</u>	<u>617,357</u>	<u>101,864</u>
 Total	 1,040,155 =====	 8,340,155 =====	 7,213,520 =====	 1,217,525 =====

Section 82A assessment

9. On 16 February 1990 the Commissioner gave notice to the Taxpayer that he was of the opinion that the Taxpayer had, without reasonable excuse, made incorrect profits tax returns for the years of assessment 1980/81 to 1987/88. In response to the notice, the Taxpayer submitted written representations to the Commissioner to the following effect:

- (1) Payments made in the years ending 30 June 1986 and 30 June 1987 to a Mr Z were, in truth, repayments of loans made by Mr Z when the Taxpayer’s business was in financial difficulties. The net sums constituting payments to Mr Z, after taking into account payments from the same person, had gone into the assets betterment statement to increase the assessable profits for the last two years of assessment.
- (2) The sums recorded in the books as ‘proprietors withdrawals’ were not withdrawals as such but were payments made to suppliers of goods and used for cash purposes.

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- (3) There was, in reality, no material increase in the Taxpayer's assets over the eight years of assessment in question as all the assets were pledged to banks for overdraft facilities.
 - (4) There is no evidence of any increase in bank balances (such as overseas bank deposits) to justify the inference of an enormous omission of tax.
 - (5) If the understated profits were as alleged, then the turnover of the business would have been very much greater; but A Company was only a small business in its field.
 - (6) The Taxpayer had already undertaken a great burden in discharging the tax assessment amounting to a total \$1,179,556.
 - (7) The Taxpayer had demonstrated his co-operation with the Inland Revenue Department by paying the additional tax as assessed.
 - (8) The Taxpayer's former accountant was unqualified and omitted to make deductions for obsolete stock. (In the business assets schedule attached to the assets betterment statement, the stock increased from about \$2,000,000 in 1982 to about \$9,000,000 in 1987).
 - (9) The tax investigation had adversely affected the Taxpayer's health and business and he had agreed with the suggested discrepancies in business profits in order to finalise the investigation. He had therefore not insisted upon claiming deductions for the 'loan repayments' to Mr Y and for obsolete stock.
10. Following the Taxpayer's representations, the Commissioner on 4 April 1990 assessed the Taxpayer to additional tax under section 82A as follows:

<u>Year of Assessment</u>	<u>Tax Undercharged</u> \$	<u>Section 82A Additional Tax</u> \$	<u>Percentage of Penalty Tax</u> %
1980/81	94,712	113,000	119
1981/82	87,916	105,000	119
1982/83	106,543	127,000	119
1983/84	146,387	175,000	119.5
1984/85	349,613	400,000	114
1985/86	233,530	250,000	107
1986/87	96,960	36,000	37
1987/88	<u>101,864</u>	<u>23,000</u>	<u>22.5</u>

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Total	1,217,525	1,229,000	101
	=====	=====	

11. The approach of the Commissioner in exercising his powers under section 82A, as we were informed by his representative at the hearing, was this: for the first six years of assessment, that is 1980/81 to 1985/86, the penalty worked out as 116% of the tax undercharged. However, for the last two years of assessment (where the returns were lodged after the investigation had commenced) because there were some 'contentious elements' included in arriving at the estimated profits, the penalty was far less: for 1986/87, it was 37% of the tax undercharged and for 1987/88 it was 22.5%. The contentious elements were in payments made to Mr X and the claimed obsolescence in the stock.

The Appeal

12. At the hearing of the appeal before us, the Taxpayer did not give evidence nor was any evidence adduced before us beyond (i) a letter from Mr Z and (ii) a bank statement from a bank for A Company for the months of May and June 1990 showing an overdrawn position.

13. The Taxpayer's representative, Miss Y, made representations to us which, essentially, covered the same points as outlined in paragraph 9 above. One of the points made by Miss Y was that many of the unidentified withdrawals from the bank accounts which went towards increasing the estimated profits were 'believed' to have been cash purchases and monthly salary payments. This expression of belief, as we understand it, was the belief of the company rendering secretarial services to the Taxpayer, as referred to in paragraph 3 above. We do not regard this as carrying any weight whatsoever, apart from the fact that in essence the submission amounted to nothing more than an attempt to persuade us that the estimated assessment based upon the assets betterment statement were excessive: assessments which, pursuant to section 70 of the Inland Revenue Ordinance were final and conclusive for all purposes.

14. It is clear to us that the assessors have made the assessments in this case after exercising great care and that, where withdrawals from bank accounts might arguably have been referable to the company's business purposes, the benefit of the doubt was given to the Taxpayer.

15. It is clear from the assets betterment statement, accepted by the Taxpayer, that apart from the contentious elements (namely, unidentified withdrawals and obsolete stock, and the question of payment to Mr Z), there was an increase in assets disproportionate to the business profits as disclosed.

16. It is quite possible that the final estimated assessments, as agreed to by the Taxpayer, resulted in higher profits than were actually the case. This possibility has, however, been largely taken into account by the Commissioner in imposing very low penalties in the last two years, since it was in the last two years of assessment that the bulk of

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the 'contentious elements' appeared. We bear in mind the fact that the root cause of the Taxpayer's problems is his failure to keep accurate business records; he had allowed returns which he must have known were inaccurate to be lodged on his behalf.

17. We are satisfied that the investigation was conducted as thoroughly and fairly as the circumstance allowed. Once it was accepted that the returns were incorrect, as was plainly the case, and in the absence of accurate books and records being produced by the Taxpayer, estimated assessments based upon the assets betterment method became inevitable. As to this, the Taxpayer has only himself to blame.

18. In our view, having regard to all the relevant circumstances of this case, the additional tax imposed by the Commissioner was not excessive and this appeal is dismissed.