INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D2/88

Appeals – penalty assessment – whether Board of Review on appeal can increase penalties – ss 68(8)(a) and 82B(3) of the Inland Revenue Ordinance.

Penalty assessment – whether Board of Review on appeal can increase penalties – s 82B of the Inland Revenue Ordinance.

Penalty assessment – whether penalties can be imposed on taxpayers who fail duly to lodge returns but subsequently submit correct returns – s 82A(1)(ii) of the Inland Revenue Ordinance.

Penalty assessment – whether penalties excessive – general yardstick for calculation of penalties – s 82A of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), John A Cheetham and Geoffrey Hui.

Date of hearing: 6 January 1988.
Date of decision: 7 April 1988.

This case involved two taxpayer companies. The taxpayers did not notify the Commissioner of their liability to tax, and thus delayed paying tax for up to seven years. They were slow in responding to subsequent demands to submit returns. Their general behaviour showed total disregard of their obligations under the Inland Revenue Ordinance. The assessor ultimately resorted to issuing estimated assessments in order to provoke submission of returns, and these returns were accepted without adjustment.

The Commissioner imposed penalties with respect to a number of years of assessment ranging between 11.6% and 20% of the maxima permitted (averaging 13% and 14.2% for each taxpayer).

The taxpayers appealed. They claimed that penalties under s 82A could not be levied upon a taxpayer who fails to submit returns, or who fails to notify the Commissioner of his liability to tax, but who ultimately submits correct returns and pays his full tax liability. Their argument was that, in such a case, no tax has been 'undercharged' within the meaning of s 82A. Alternatively, the taxpayers argued that the penalties were excessive.

Held:

(a) Penalties can be levied under section 82A on taxpayers who fail to lodge returns or fail to notify the Commissioner of their liability to pay tax, even where they subsequently file correct returns and pay their tax liability.

(b) The low tax rates in Hong Kong depend on compliance by taxpayers with the provisions of the Inland Revenue Ordinance. Penalties are therefore substantial. As a general yardstick, the starting point for calculation of penalties is the amount of tax undercharged (that is, 33.3% of the maximum permitted).

(c) Some discount should be allowed for a taxpayer's cooperation and voluntary disclosure. Here, the full disclosure by the taxpayers of their profits avoided further investigation. Even taking these factors into account, however, the penalties imposed in this case were too low.

(d) The Board of Review has power to increase penalties in cases of unsuccessful appeals against s 82A assessments. A warning is given that, in future cases, the Board might exercise this power.

Appeal dismissed.

Case referred to:

CIR v Kwok Siu Tong (1977) 1 HKTC 1012

G S Chadha for the Commissioner of Inland Revenue.
Benjamin Chain instructed by Sit, Fung, Kwong and Shum for the taxpayer.

Decision:

In this appeal two separate appeals were heard simultaneously at the request and with the consent of all parties and it was agreed that the material facts of both cases were the same.

The two appeals are against penalty tax assessments issued under section 82A of the Inland Revenue Ordinance.

Though the parties agreed that the material facts of the two appeals were the same, it is convenient to set them out separately as a number of dates and other features were different.

First appeal

The relevant facts of the first appeal were as follows:

1. The Taxpayer was a limited company incorporated in June 1977. In a Provisional Profits Tax Return for the year of assessment 1977/78 lodged on 17 April 1978, the Taxpayer informed the Commissioner that the Taxpayer had not yet commenced business. By letter dated 17 August 1978, the assessor informed the Taxpayer that, should it commence business or earn income that was chargeable to Hong Kong Profits Tax, it was required to so inform the Commissioner.

2. In response to an assessor's notice of 5 November 1982 asking for information as to whether business had commenced, the Taxpayer informed the Commissioner on 22 November 1982 that the Taxpayer had commenced its business of importing and exporting knitter garments on 22 May 1978.

3. A Profits Tax Return for the year of assessment 1981/82 was issued to the Taxpayer for completion on 29 October 1982. In default of its return, on 20 December 1982 the Inland Revenue Department issued a final notice and the Taxpayer applied on 3 January 1983 for an extension of time to 31 January 1983 within which to submit the Tax Return. By letter dated 18 February 1983, the assessor refused this request for extension. As the return in question had not been submitted within the period of 14 days specified in the final notice of 20 December 1982, the Assistant Commissioner was of the opinion that an apparent offence had been committed and by letter dated 6 May 1983 offered to compound the offence committed provided that the Taxpayer paid the sum of $600 and lodged the return within 14 days from 6 May 1983. However, despite this offer to compound, the Profits Tax Return for 1981/82 was not submitted until 7 November 1983.

4. On 1 November 1983 the Taxpayer submitted to the Inland Revenue Department accounts for each of the financial periods from 12 May 1978 to 31 December 1982, and on 28 March 1984 lodged with the Inland Revenue Department Profits Tax Returns for each of the years of assessment 1978/79, 1979/80 and 1980/81.

5. A Profits Tax Return for the year of assessment 1983/84 was issued on 2 April 1984. On 28 August 1984 the Taxpayer applied for an extension of time to file the return by the end of September 1984 but this request for extension was refused. In default of receiving the return, an estimated assessment in the amount of $11,000,000 was issued on 4 March 1985. On 26 March 1985, a notice of objection to this estimated assessment was lodged but it was not until 19 April 1985 that the return for 1983/84 was submitted to validate this objection to the estimated assessment. On 17 May 1985, the estimated assessment was reduced from assessable profits of $11,000,000 to assessable profits of $9,860,209.

6. The Commissioner after giving due notice to the Taxpayer and having received submissions from the Taxpayer decided to impose penalty tax assessments under section 82A. For convenience we set out in tabular form the years of assessment, tax assessed on profits, and the section 82A penalty assessments as follows:

Year of Assessment	Tax assessed on profits	Section 82A Additional tax by way of penalty
1978/79	$ 277	$ 100
1979/80	$ 67,804	$ 40,600
1980/81	$ 41,555	$ 22,100
1981/82	$ 419,495	$182,400
1983/84	$1,626,934	$598,000
	$2,156,065	$843,200

Second appeal

The relevant facts of the second appeal were as follows:

1. The Taxpayer commenced business on 3 November 1976 as importers and exporters of garments. On 6 April 1983, a Profits Tax Return for the year of assessment 1982/83 was issued to the Taxpayer.

2. On 29 October 1983, the Taxpayer submitted financial statements to the Inland Revenue Department for the period from 3 November 1976 to 31 December 1977 and for the years ended 31 December 1978, 31 December 1979, 31 December 1980, 31 December 1981 and 31 December 1982. At the same time the Taxpayer requested Profits Tax Returns for the years of assessment 1977/78, 1978/79, 1979/80, 1980/81, 1981/82 and 1982/83 to be issued to it for completion and return to the Inland Revenue Department.

3. On 6 December 1983, Profits Tax Returns for the years of assessment 1977/78 through to and including 1981/82 were issued to the Taxpayer and these returns plus the return for 1982/83 were submitted to the Inland Revenue Department on 9 February 1984. On 24 February 1984, the assessor accepted the returns and issued Profits Tax Assessments based thereon for the years in question.

4. On 2 April 1984, a Profits Tax Return for the year of assessment 1983/84 was issued to the Taxpayer. On 8 November 1984, in default of the Profits Tax Return having been submitted, the assessor raised an estimated assessment on the Taxpayer for the year of assessment 1983/84 in the amount of $600,000. No objection was lodged by the Taxpayer against this assessment.

5. On 26 February 1985, the assessor raised an additional estimated assessment for the year of assessment 1983/84 in the further amount of $400 and again no objection was lodged by the Taxpayer against this additional estimated assessment.

6. On 26 April 1985, the assessor raised a further third additional estimated assessment for the year of assessment 1983/84 in the amount of $1,000,000. On 13 May

1985, the Taxpayer lodged objection against this third estimated assessment and in support of the objection the Taxpayer submitted a Profits Tax Return for the year of assessment 1983/84 which showed assessable profits of $1,580,406. On 14 June 1985, the Taxpayer's objection was allowed and a revised assessment for the year of assessment 1983/84 was issued showing assessable profits of $1,580,406.

7. On 1 April 1985, a Profits Tax Return for the year of assessment 1984/85 was issued to the Taxpayer. On 24 October 1985, in default of the return having been lodged, the assessor raised an estimated assessment for the year of assessment 1984/85 in the amount of $2,000,000. On 7 November 1985, the Taxpayer submitted its Profits Tax Return for the year of assessment 1984/85 showing assessable profits of $3,250,229. On 29 November 1985, the assessor raised on the Taxpayer an additional assessment for the year of assessment 1984/85 in the amount of additional assessable profits of $1,250,229 based on the return submitted by the Taxpayer.

8. The Commissioner after giving due notice to the Taxpayer and having received submissions from the Taxpayer decided to impose penalty tax assessments under section 82A. For convenience we set out in tabular form the years of assessment, tax assessed on profits, and the section 82A penalty assessments as follows:

Year of Assessment	Tax assessed on profits	Section 82A Additional tax by way of penalty
1977/78	$ 19,167	$ 11,000
1978/79	$ 112,563	$ 67,500
1979/80	$ 237,170	$141,600
1980/81	$ 34,368	$ 18,200
1981/82	$ 104,669	$ 45,800
1982/83	$ 82,666	$ 29,900
1983/84	$ 260,766	$ 95,900
1984/85	$ 601,292	$210,400
	$1,452,661	$620,300

Arguments for Taxpayers

At the hearing of the appeal, the Taxpayer was represented by Mr Benjamin Chain of Counsel. He did not seek to dispute the facts other than to point out and to have confirmed by the Commissioner's representative that the two Taxpayers had been eventually assessed to tax on the basis of the tax returns and accounts which they had submitted and that tax had been paid on this basis.

Counsel submitted that his clients were not liable to any section 82A additional tax or in the alternative that the additional tax assessed was excessive. In his submission, he

concentrated on the first of the two appeals but pointed out and it was agreed that the submissions he made on that appeal were equally valid on the other appeal.

Were Taxpayers liable under s 82A?

He referred the Board to section 82A and drew our attention to the fact that, if returns had been filed which were incorrect, then he would have no argument because there was High Court authority in the decision of CIR v Kwok Siu Tong (1977) 1 HKTC 1012. That case decided that the wording in section 82A, 'the amount of tax which ... has been undercharged in consequence of [the] incorrect return' means the difference between the tax on the ultimate assessment and tax on the original incorrect return if it had been accepted. He pointed out that, in the present appeal, we were dealing with a different type of case where no tax returns had been filed and that accordingly different considerations applied. He argued that no tax had been undercharged in consequence of the failure of either of the Taxpayers to comply with the notices requiring them to file tax returns by a specified date, and that no tax had been undercharged because of a failure to detect the fact that the returns had not been filed by the dates specified, because the two Taxpayers had ultimately filed their tax returns and the tax returns had been accepted and tax had been assessed on the basis of the returns as they were ultimately filed.

Counsel submitted that the only circumstances in which section 82A(1)(ii) can apply would be in the rare situation where a taxpayer has failed to file a tax return within the limitation period specified by the Inland Revenue Ordinance so that, as a result of the failure to file the tax return, the Commissioner is, because of the limitation period, unable to collect the tax.

We are unable to agree with the submission made by Counsel on behalf of the two Taxpayers. The meaning of section 82A in relation to those persons who fail to comply with the obligations to file tax returns under either section 51(1) or section 51(2) is quite clear. Under section 51(1) a taxpayer is required to furnish a tax return to the Commissioner if he receives a notice from an assessor. Under section 51(2) every person chargeable to tax shall inform the Commissioner that he is so chargeable in accordance with the provisions of that sub-section. Section 82A clearly states that any person who without reasonable excuse fails in his obligations under either section 51(1) or section 51(2) is liable to be assessed to a penalty of triple the amount of tax which 'would have been undercharged if such failure had not been detected'. Section 82A specifically covers the situation where the failure to comply has in fact been detected. It creates a hypothetical set of circumstances in which it is to be assumed that the failure has gone undetected. If a person either fails to submit a tax return when so required or fails to inform the Commissioner of his liability to be assessed and such failures go undetected, it is clear that the taxpayer would altogether avoid paying any tax. Accordingly the amount of tax which would have been undercharged if such failure had not been detected is 100% of the tax liability of the taxpayer. Accordingly we find no substance in this part of Counsel's submission and find in favour of the Commissioner.

Were the penalties excessive?

The second part of the case argued before us on behalf of the two Taxpayers was that the amounts in question were excessive. On the other hand the representative for the Commissioner submitted that the amounts of the section 82A penalty assessments were in fact too low and should be increased.

Counsel for the two Taxpayers did not make any submissions on the facts before us or adduce any evidence or lay any additional facts before us which would explain or in any way excuse the conduct of the two Taxpayers. It is apparent that, placing the best possible explanation on the facts in their favour, they simply totally disregarded their obligations to file their tax returns and to inform the Commissioner that they were taxable, and failed to take any other steps to fulfill their obligations under the Inland Revenue Ordinance. These are not cases of unsophisticated taxpayers who do not understand their obligations and they are not cases of people making small profits. The two Taxpayers commenced business and rapidly earned substantial taxable profits. In both cases it was necessary for an assessor to issue substantial estimated assessments before the respective Taxpayers were prepared to honour their obligations under the Inland Revenue Ordinance. The only mitigating circumstance is that the Taxpayers did eventually file tax returns and accounts which were accepted by the Commissioner and formed the basis on which they were assessed to tax. It is relevant in such cases to take into account the co-operation which a taxpayer gives when the taxpayer has been found to be in default of his obligations under the Inland Revenue Ordinance. It is also relevant to take into account whether or not the taxpayer has made full 'voluntary' disclosure of its taxable income. However it is also relevant to bear in mind that the full disclosure by the two Taxpayers in this case was only after extreme steps had been taken by the Inland Revenue Department who had been forced to go to the length of issuing substantial estimated assessments on a number of occasions.

In our opinion, the Commissioner in levying tax under section 82A has erred in being too lenient. A yardstick for cases of this nature should be a starting point of penalties equal to the amount of tax under-charged. Our tax rates in Hong Kong are comparatively low by world standards and can only remain low if all those liable to pay tax fully co-operate in the disclosure of their taxable income in accordance with the provisions of the Inland Revenue Ordinance. Indeed, if in the present cases the Taxpayers had overtraded and failed before they actually paid any tax, the Revenue would have collected nothing at all from them. If a significant number of taxpayers were to behave, as the two Taxpayers in the cases before us have behaved, the entire system of Inland Revenue in Hong Kong could collapse. The legislature has provided very substantial penalties under section 82A for good reasons.

Bearing in mind that the two Taxpayers did in fact eventually make full disclosure of their assessable profits and that it was not necessary for the Inland Revenue Department to investigate further the affairs of the two Taxpayers, it is appropriate that penalties of less than the amount of the tax undercharged should be imposed but we feel that the Commissioner has been very lenient in the present cases.

<u>Increase of penalties by the Board</u>

We feel it appropriate to point out that section 82B(3) provides that the Board when hearing section 82A appeals will have all of the powers conferred upon the Board by section 68 of the Inland Revenue Ordinance. Sub-section 8(a) of that section specifically empowers this Board to increase the assessment appealed against. In this case, the Board has given careful consideration to the submission by the representative of the Commissioner that the penalties should be increased. However, as this is the first case which to the knowledge of this Board has come before a Board of Review, at least in recent years, where it has been suggested that the penalties should be increased, we feel it inappropriate to do so but draw attention in our decision that future Boards may not be so lenient.

For the reasons given we find that the Commissioner was correct in his assessments and that the same were in no way excessive.