Case No. D2/92

Penalty tax – failure to file profits tax return within specified time limit – reasonable excuse and quantum of penalty – section 82A of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Victor Hui Chun Fui and Vincent Liang Wan Sang.

Date of hearing: 26 February 1992.
Date of decision: 6 April 1992.

The taxpayer was a company which failed to file its profits tax return within the time specified. The taxpayer submitted that the delay was caused because of the acquisition of a computer. It was submitted that the problems caused by the acquisition of the computer gave the taxpayer a reasonable excuse or made the penalty excessive in the circumstances.

Held:

The acquisition of a computer was not a reasonable excuse. With regard to the quantum of the penalty, a penalty of approximately 10% of the total amount of the tax involved is not excessive.

Appeal dismissed.

[Editor's note: This decision can be usefully read with D5/92.]

Cases referred to:

CIR v KWOK Siu-tong 1 HKTC 1012
Dodge Knitting Company Limited and Dodge Trading Limited v CIR 2 HKTC 597
D58/87, IRBRD, vol 3, 11
D74/89, IRBRD, vol 6, 169
D1/82, IRBRD, vol 1, 407
D45/88, IRBRD, vol 3, 410

Yue Chu Ching Yee for the Commissioner of Inland Revenue.
Robert Lew of Messrs James Lew & Co for the taxpayer.

Decision:

This is an appeal by a limited company against an additional penalty tax assessment made upon it under section 82A of the Inland Revenue Ordinance. The facts are as follows:

1. The Taxpayer was incorporated in mid-1986 and commenced business in mid-1987. It described its principal activities as importing, exporting and investment.

2. The Taxpayer closed its accounts on 31 March each year.

3. On 2 April 1990 a profits tax return for the year of assessment 1989/90 was issued to the Taxpayer. An extension of time was obtained for the submission of the profits tax return up to 15 November 1990. No further extension of time was requested and no further extension was granted.

4. In the absence of a profits tax return for the year of assessment 1989/90 an estimated assessment was issued on 30 November 1990 in estimated assessable profits of $370,000.

5. On 18 March 1991 the Taxpayer filed its profits tax return for the year of assessment 1989/90 showing assessable profits of $2,133,007.

6. On 14 June 1991, an additional assessment for 1989/90 was issued to the Taxpayer in the sum of $1,763,007.

7. On 27 August 1991 the Commissioner gave notice that he proposed to assess on the Taxpayer additional tax by way of penalty in respect of the failure of the Taxpayer to file its tax return within the time stipulated.

8. By a letter dated 3 September 1991 the tax representative of the Taxpayer made representations to the Commissioner. By letter dated 30 September 1991 the tax representative made further representations on behalf of the Taxpayer.

9. On 10 October 1991 the Commissioner after taking into account the representations, issued a notice of assessment for additional tax for the year of assessment 1989/90 in the amount of $35,000.

10. On 6 November 1991 notice of appeal was duly given to the Board of Review by the Taxpayer.

At the hearing of the appeal the Taxpayer was represented by its tax representative and two witnesses were called to give evidence on behalf of the Taxpayer. One was the accounting manager of the Taxpayer and the other was the tax representative himself.

The evidence given, which we accept, was to the effect that the Taxpayer purchased a small mainframe computer in 1987 and software for the computer in 1988. Difficulties were encountered in operating the software and the computer and the production of the accounts of the Taxpayer for the years ended 31 March 1989 and 31 March 1990 was delayed. The accounts of the Taxpayer for the year ended 31 March 1990, which formed the basis of the tax return for the year of assessment 1989/90 were not ready for audit until November 1990 and the auditors were not able to complete their audit work until early in March 1991. When the accounts were audited the auditors made a qualification because the Taxpayer had not been able to produce consolidated accounts. There were problems with the computer producing the accounts for a trading subsidiary which meant that the auditors could not complete their audit of the accounts of the Taxpayer.

At the hearing the representative for the Taxpayer laid before the Board the complete computerized ledger accounts of the Taxpayer for the year in question. It appeared from these accounts that the company had not closed its accounts each month as one would expect of an active trading company but had closed its accounts for the entire year at some date after the close of that year. It also appeared from the ledger accounts that there was nothing unduly complex about the accounts of the Taxpayer. In answer to a question from the Board the representative of the Taxpayer indicated that the computer and the software was more complex than necessary for such a business. There was a suggestion at the time when the computer system was acquired that it was the intention of the Taxpayer to operate a more complex retail type of business.

The representative for the Taxpayer submitted that the Taxpayer had a reasonable excuse for its delay in filing its profits tax return and that even if it did not have a reasonable excuse, the penalty was excessive in the circumstances.

The representative said that the Taxpayer was not able to file its profits tax return on time because the computerized accounts were not ready for audit. He said that there had been no attempt to evade or to delay the filing of the return. He said that section 82A of the Inland Revenue Ordinance does not impose an automatic penalty but is a power given to the Commissioner who can only impose a penalty where he comes to the conclusion that there is no reasonable excuse.

With due respect to the representative we are unable to accept his submission that there was a reasonable excuse. The Inland Revenue Ordinance imposes an obligation upon all taxpayers to file their tax returns on time. In this case the Taxpayer was able to carry on its business, paying its bills and collecting its accounts receivable from its customers. It is well-known that problems can arise when accounts are changed from a manual system to a computer system. The Taxpayer chose to computerize its accounts and chose the computer and the software. We have no doubt that if the Taxpayer had really wanted to fulfil its obligations under the Inland Revenue Ordinance it could have done so. It would not have been difficult for the Taxpayer to have maintained a handwritten accounting system. The ledger accounts tabled before us were quite simple with a

comparatively small number of entries. No explanation was given why the Taxpayer did not close and balance its accounts each month as most active trading companies would do. The accounting manager when giving evidence said that she maintained handwritten accounts for the purpose of operating and presumably reconciling the bank accounts of the Taxpayer. It also appeared that she maintained some manual system of recording accounts receivable and accounts payable.

In view of the foregoing we cannot accept that the company had a reasonable excuse for failing to comply with its obligations under the Inland Revenue Ordinance.

The representative for the Taxpayer then submitted that the quantum of the penalty was excessive because the Taxpayer did of its own volition file its tax return, albeit late. In addition the Hong Kong government had lost little because the delay in payment of tax was short and there was no cause to punish the Taxpayer. The representative referred us to the cases of CIR v Kwok Siu-tong 1 HKTC 1012, Dodge Knitting Company Limited and Dodge Trading Limited v CIR 2 HKTC 597, and Board of Review Decisions D58/87, IRBRD, vol 3, 11 and D74/89, IRBRD, vol 6, 169.

The representative of the Commissioner submitted that the penalty was not excessive in the circumstances and cited to us Board of Review Decisions D1/82, IRBRD, vol 1, 407 and D45/88, IRBRD, vol 3, 410.

The representative for the Taxpayer submitted that the Taxpayer had voluntarily filed its profits tax return and the Inland Revenue Department had not been required to make any special effort or carry out any investigation work. He drew our attention to the wording of section 82A of the Inland Revenue Ordinance and pointed out that the Inland Revenue Department had not detected anything and that there had been no undercharge to tax. He submitted that this was no more than a case involving the late payment of tax and that a 5% penalty should be computed on $290,896.

It appeared to us that when assessing the penalty in this case the Commissioner had already taken a lenient view. The penalty which he had imposed is $35,000 which is approximately 10% of the total amount of the tax involved which is $351,946. It is not suggested that the Taxpayer had tried to evade tax. As requested by the representative for the Taxpayer we place on record that there is no suggestion whatsoever that the directors of the Taxpayer have in any way been fraudulent. Section 82A of the Inland Revenue Ordinance refers to the word 'detect' in a hypothetical manner. What section 82A is trying to say is that the amount of the penalty calculated by reference to the amount of tax which is involved and which not have been paid if the Taxpayer had never filed a tax return and if the Inland Revenue Department had never taken any action. This is purely hypothetical and a method of calculating the maximum penalty. In this case the Inland Revenue did take action and the Taxpayer did file a tax return. However the Taxpayer was late in filing its tax return. The question to be answered is pure and simple. Is a penalty of approximately 10% of the amount of the tax involved or approximately 3.3% of the maximum penalty excessive in the circumstances?

We find that penalty imposed by the Commissioner of $35,000 is not excessive. The representative for the Taxpayer had suggested that a penalty of 5% of the tax involved after deducting the amount of the estimated assessment is appropriate. With this we cannot agree. First of all there is no legal ground for deducting the amount of the estimated tax. The Dodge case makes it clear that estimated assessments do not affect the liability of a taxpayer to penalties under section 82A. Likewise, estimated assessments do not affect the quantum of a penalty to be imposed under section 82A. The penalty is imposed because the Taxpayer failed to comply with its obligations under the Inland Revenue Ordinance and the Commissioner had decided to exercise the discretion granted to him under section 82A of the Inland Revenue Ordinance. In this case the failure by the Taxpayer is to file its tax return within the stipulated time which in this case expired on 15 November 1990. It is the obligation of the Commissioner to protect the public revenue. A power is given by the Inland Revenue Ordinance to assessors to raise estimated assessments when a person fails to file a tax return. Estimated assessments are by their nature imprecise and often conservative. In this case the estimated assessments were very conservative. The issuing of estimated assessments should not be a routine matter but a power which the Commissioner through his assessors need rarely invoke. Our system of taxation is both low and simple. It relies upon taxpayers fulfilling their obligations under the Inland Revenue Ordinance.

The representative for the Taxpayer had pointed out to us that if his client had duly complied with all of its obligations under the Inland Revenue Ordinance but had merely failed to pay the tax assessed on the due date there would be a surcharge or penalty of 5% of the amount of the tax. It is clear that failure to file a tax return is more serious than the omission to pay duly assessed tax on the due date. In the present case the Taxpayer was some four months late in filing its return after having been granted an extension of time of some six months from the original due date of 3 May 1990. A penalty of approximately 10% of the tax involved or double the penalty for being late in making payment of duly assessed tax is not, in our opinion, excessive.

For the reasons given we dismiss this appeal.