Case No. D29/96

Penalty tax – failure by director and employee of company to report chargeability to salaries tax – relevance of commercial restitution in assessing penalty tax – whether penalty tax of 50% excessive in the circumstances – Inland Revenue Ordinance sections 82A and 82B.

Panel: Andrew Halkyard (chairman), Daniel Cheung Kwok Chun and Benjamin Kwok Chi Bun.

Date of hearing: 2 July 1996.
Date of decision: 19 July 1996.

The taxpayer was a partner of a firm of solicitors which had a consultation and services agreement with an associated service company ('the Company'). The taxpayer received a commission of $1,339,195 from the Company in the year of assessment 1991/92. He did not notify the Inland Revenue Department of his chargeability to salaries tax within four months after the end of the year of assessment as required by section 51(2) of the Inland Revenue Ordinance. The Company's employer's return of remuneration and pensions for the year of assessment, which was filed by the Company and signed by the taxpayer as a director of the Company, also failed to include the commission. As a result of enquiries raised during the period December 1994 to March 1995, the taxpayer disclosed the commission income. Penalty tax was raised on the taxpayer in the amount of approximately 50% of the tax which would have been undercharged if the taxpayer's failure to notify his chargeability had not been detected.

Held:

The taxpayer had no reasonable excuse of failing to notify the Department of his chargeability to salaries tax in the year of assessment 1991/92. The taxpayer, being both director of the Company who signed the employer's return as well as the individual taxpayer in this case, was in a special position of trust in regard to various compliance obligations imposed by the Inland Revenue Ordinance. Failure by the taxpayer to notify chargeability was not discovered by the Department until nearly three years after the end of the relevant year of assessment and, if undetected, would have meant that the taxpayer simply slipped through the salaries tax net. In the circumstances, including the fact that the taxpayer had the use of the tax ultimately paid for a lengthy period, the penalty tax assessed was not excessive.

Appeal dismissed.

Case referred to:

D54/93, IRBRD, vol 8, 391

Kung Chun Fai for the Commissioner of Inland Revenue.
K P Cheng of Messrs K P Cheng & Co for the taxpayer.

Decision:

This is an appeal against the amount of additional or penalty tax imposed by the Commissioner under section 82A of the Inland Revenue Ordinance ('IRO').

The facts

1. At all relevant times the Taxpayer was the partner of a firm of solicitors ('the Firm') which had a consultation and services agreement with a company ('the Company').

2. At all relevant times the Taxpayer was a director of the Company.

3. During the period 1 April to 31 December 1991, the Company paid emoluments to or in respect of the Taxpayer as follows:

Directors' remuneration:

Commission	$1,339,195
Overseas travelling	152,908
	$1,492,103

The Company's accounts, which disclosed particulars of directors' remuneration for the period ended 31 December 1991, were approved by the board of directors and signed by the Taxpayer as director on 14 July 1993.

4. The payments referred to at fact 3 were not included in the Company's employer's return of remuneration and pensions for the year of assessment 1991/92. The employer's return, filed by the Company with the Inland Revenue Department ('IRD'), was dated 6 May 1992. It was signed by the Taxpayer as director of the Company.

5. In the course of examining the Company's accounts for the period ended 31 December 1991, the assessor raised various enquiries on the Company. The enquiries, which were raised during the period December 1994 to March 1995, related to the directors' remuneration charged in the Company's accounts.

6. After receiving various answers from the Company to the enquiries, including the information disclosed at facts 3 and 4, the assessor issued a salaries tax return to the Taxpayer on 18 April 1995 for the year of assessment 1991/92.

7. The salaries tax return was completed by the Taxpayer on 15 May 1995. It contained the following particulars:

Name of employer:	the Company
Capacity in which employed:	Director
Particulars of income:	Commission
Period covered:	1-4-91 to 31-12-91
Amount:	$1,339,195

8. On 14 July 1995 the assessor raised a salaries tax assessment for the year of assessment 1991/92 on the Taxpayer taxing the income disclosed at fact 7.

9. No objection was lodged against this assessment.

10. In contravention of section 51(2) of the IRO the Taxpayer did not notify the IRD of his chargeability to salaries tax within four months after the end of the year of assessment 1991/92.

11. The Commissioner was of the opinion that the Taxpayer had, without reasonable excuse, failed to inform the Commissioner in writing that he was chargeable to salaries tax for the year of assessment 1991/92 within the terms prescribed by section 51(2). On 22 November 1995, the Commissioner gave a notice to the Taxpayer under section 82A(4) that he proposed to assess the Taxpayer to additional tax by way of penalty in respect of the year of assessment 1991/92.

12. On 15 December 1995, the Taxpayer, through Messrs K P Cheng & Co, Certified Public Accountants ('the Representative'), submitted to the Commissioner representations in response to the notice issued on 22 November 1995. The Representative stated that:

> ' … The outgoing accountant who was solely responsible for tax reporting has mistakenly omitted to report [the directors' remuneration] in the relevant employer's return.
>
> Our clients have no intention to omit the reporting of income as all their income has been properly accounted for and reported under the

tax file of [the Firm] throughout all years of assessment except the year 1991/92.

Further, the completion of the relevant salaries tax return promptly upon receipt … indicated that our client has **never** intended to fail to inform the Commissioner his chargeable income in respect of all years of assessment.'

13. On 15 February 1996, the Commissioner, having considered and taken into account the Taxpayer's representations, issued an assessment for additional tax in respect of the year of assessment 1991/92 in the sum of $100,000. This amount is 49.7% of the tax which would have been undercharged if the Taxpayer's failure to notify his chargeability to salaries tax for the year of assessment 1991/92 had not been detected.

14. On 13 March 1996, the Taxpayer appealed to this Board against the assessment of additional tax on the grounds that the penalty imposed was excessive. The grounds of appeal stated:

'(a) Our client has been employing fulltime accountant to cope with [the Firm's] accounting functions as well as personal tax since 1987.

(b) In the year of 1992, the Firm's accountant has been laid off because of his poor performance and his duty was assumed by the replacement accountant. In early 1993, the Firm changed the auditors to us [the Representative] who is responsible for the Firm's and [the Taxpayer's] tax matters since the year of assessment 1992/93.

(c) [The Taxpayer] persistently trusts that all his business income derived from his legal practice has been reported under profits tax of his Firm and which should be done by the accountant.

(d) Until 16 December 1994, the day on which the IRD requested additional information relating to [the Company] in respect of profits tax for the year of assessment 1991/92, [the Taxpayer] and us found that $1,339,195 has been included as directors' emoluments payable to [the Taxpayer by the Company].

(e) On 17 May 1995, shortly after the first query raised by the IRD on 16 December 1994, we completed the salaries tax return reporting such income and filed with the IRD.

(f) The fact that we reported the income without delay shortly after agreement of chargeable income indicates [the Taxpayer] has never intended to fail to inform the IRD his income. Coupled with the fact that [the Taxpayer] properly and punctually reported all his business

income to the IRD in the years of assessment 1992/93, 1993/94 and 1994/95 … there is no reason why [the Taxpayer] had intention not to report his income in the year of assessment 1991/92 as alleged by the Commissioner.

(g) In addition, the Commissioner has not taken into account the above facts that [the Taxpayer] is fully co-operative in furnishing information to the IRD and there did not exist a history of failing to submit returns and assessed an additional tax amounting to $100,000 which represents 49.7% of the tax undercharged. We consider that the additional tax would **not** be excessive only when [the Taxpayer] consistently failed to inform the Commissioner his assessable income for few years.'

Proceedings before the Board

The Taxpayer was represented by Mr K P Cheng of the Representative. Mr Cheng called no witness and adduced no further documentary evidence during the Board hearing.

Contentions for the Taxpayer

Apart from reiterating the grounds of appeal (fact 14 refers), Mr Cheng made the following submissions as to why, in terms of section 82B, the penalty tax in dispute was excessive in the circumstances:

(1) The Taxpayer had no intention to evade tax. The default was only in relation to one year of assessment. Therefore, a lower penalty than that assessed, say 10% of the amount that would have been undercharged or a reduced lump sum, was appropriate.

(2) The hearing of the appeal had been adjourned and the Taxpayer had incurred professional fees in connection therewith.

(3) Penalty tax should be based upon culpability; it should not be based upon the amount of income for which the Taxpayer failed to notify chargeability.

Contentions for the Commissioner

The Commissioner was represented by Mr Kung Chun-fai. It is not necessary for us to set out in detail Mr Kung's submissions. In summary, he argued first, that the Taxpayer had no reasonable excuse for failure to report chargeability (this was not in dispute); second, that tax compliance in Hong Kong relies to a great extent upon individual taxpayers taking full responsibility for their taxation affairs and reasonable penalties are a key component for operating this system effectively; and third, that the penalty tax in dispute was not excessive in the circumstances because, when all the facts are examined, not only was the Taxpayer responsible for satisfying the compliance obligations of both the

Company (as its director) and of himself (as an individual liable to salaries tax) but he was also responsible for the flow of all relevant information to the IRD.

Reasons for our decision

Clearly the Taxpayer had no reasonable excuse for failing to notify the IRD of his chargeability to salaries tax in the year of assessment 1991/92. This was not contested by the Representative. The sole issue before us, therefore, is whether the penalty tax was, in terms of section 82B(2), excessive having regard to the circumstances.

In accordance with section 68(4) the onus is on the Taxpayer to prove that the assessment appealed against is excessive. In this regard, Mr Cheng chose not to call any oral evidence or adduce further documentary evidence. That was by no means fatal to the Taxpayer's case, but it did mean that we can only proceed upon the admitted facts before us. The key facts are clear: the Taxpayer, the director who signed the Company's employer's return which omitted details of the director's emoluments paid to him (fact 4) and who signed the Company's accounts showing payment of a significant amount of directors' remuneration (fact 3), did not inform the IRD that he was liable to salaries tax within the time limit specified by section 51(2). This failure to notify was not discovered by the IRD until nearly three years after the end of the year of assessment 1991/92.

We turn now to the arguments and mitigating factors advanced by Mr Cheng. None of these persuaded us that the penalty tax in dispute was excessive. We note that some of the arguments and contentions, especially to the extent that they reiterated the matters contained in the grounds of appeal, were unsupported by oral or other documentary evidence. But even assuming the truth of every contention made by Mr Cheng, we would require much more to find for the Taxpayer. Turning specifically to those arguments: (1) a good compliance record and absence of intention to evade tax are *not* mitigating factors, but their absence can be aggravating ones (compare D54/93, IRBRD, vol 8, 391 at 393); (2) we cannot see the relevance of the contention that the penalty tax should be reduced because the Taxpayer has incurred additional professional fees in relation to this appeal; and (3) we were not referred to any authority indicating that the penalty tax was excessive when compared with other cases involving failure to notify chargeability.

Before considering Mr Cheng's remaining submissions that the penalty tax was excessive, it is appropriate at this juncture to state that we were attracted by Mr Kung's more broadly-based argument for the Commissioner. We would develop this in the following manner:

(1) Generally. The tax system in Hong Kong as embodied in the IRO is based upon a simple, low rate structure with straightforward and easily understood compliance obligations placed upon those persons subject to tax.

(2) In many ways this system operates very much upon goodwill and trust. Accordingly, it is pivotal to our present system of low taxation and simple procedures (for example, there is no general PAYE system or other general

withholding tax regime) that proper compliance with the taxation obligations imposed by the IRO is assured.

(3) It is unfortunate, but doubtless true, that encouragement to comply with the IRO is necessary through the use of sanctions such as penalty tax imposed under section 82A.

(4) To be effective, these sanctions must be a sufficient deterrent against non-compliance, without in any individual case being abusive or being not commensurate with the offence under consideration.

(5) Specifically. The Taxpayer, being both director of the Company who signed the employer's return as well as the individual taxpayer in this case, was in a special position of trust. In the circumstances of this case, failure by the Taxpayer to report chargeability, if undetected, would have meant that the Taxpayer simply slipped through the salaries tax net. Finally, in this regard it is relevant to note that the IRO contains reporting obligations for both employers and individuals subject to salaries tax.

We appreciate that the above comments are general in nature. But they do, in our view, help set the scene against which the appropriate level of penalties in individual cases could be considered.

Before concluding, we must make clear that we accept Mr Cheng's submission that the Taxpayer had no intention to evade tax. On this basis, we then seriously considered Mr Cheng's argument that penalty tax imposed under section 82A should be based upon culpability and that in all the circumstances a lower level of penalty would be appropriate in this case. However, the fact remains that, contrary to section 51(2), the Taxpayer did not notify the IRD of his chargeability to salaries tax in the year of assessment 1991/92 within the time prescribed and, as a result, the Taxpayer's liability to salaries tax was not discovered until nearly three years after the end of the year of assessment. If commercial restitution should play a part in assessing penalties, and in our view it should, interest-free use by the Taxpayer of the amount ultimately paid in tax would represent a considerable portion of the penalty tax assessed in this case. When this is considered together with the pivotal position occupied by the Taxpayer in ensuring that the various taxation compliance provisions pertaining to this case were satisfied as well as the more general concerns expressed above, we can only conclude that Mr Cheng has not overcome the burden of showing that the penalty tax assessed in this case was excessive in the circumstances.

For all the above reasons we hereby dismiss the appeal.