Case No. D34/07

Penalty tax – reasonable excuse for additional tax – sections 51(2) and 82A(1)(e) of the Inland Revenue Ordinance ('IRO') – whether or not the appellant's failure to comply with section 51(2) was detected – factors affect the level of penalty

Panel: Kenneth Kwok Hing Wai SC (chairman), John Charles Maisano and Mark R C Sutherland.

Date of hearing: 14 September 2007.
Date of decision: 27 November 2007.

The appellant was a private limited company. The appellant declared in return that it had not commenced business during the period from 1 January 2004 to 31 December 2004. On 24 April 2006, Inland Revenue excused the appellant to submit annual tax return and to remind the appellant under section 51(2) of the IRO to notify the Commissioner in writing within four months after the end of the accounting period for that year of assessment if the appellant commenced to earn assessable profits.

By a letter dated 27 July 2006, the appellant notified the Inland Revenue pursuant to section 51(2) of the IRO. The appellant was chargeable to tax for the 2005/06 year of assessment and the basis period ended on 31 December 2005. Section 51(2) imposed a duty on the appellant to inform the Commissioner in writing by 30 April 2006 that it was chargeable to tax. The length of delay to notify in writing of its chargeability was 2 months and 27 days (i.e. from 1-5-2006 to 27-7-2006). The Commissioner assessed the appellant to additional tax under section 82A of the IRO.

The appellant appealed on the grounds that the delay was caused by change of finance manager. The appellant has taken the initiative to inform the Inland Revenue and the profits tax computation with audit accounts were submitted to Inland Revenue before issuance of profit tax return. Lastly the appellant further argued that the assessment was excessive.

Held:

1. Neither change of financial manager nor breakdown in internal communication is a reasonable excuse. Even if the appellant was ignorant of the duty, ignorance of law is no excuse. The appellant has no reasonable excuse and is liable for additional tax.

2. Detection includes discovery based on information supplied by the appellant. According to the Concise Oxford Dictionary, to 'detect' is to 'discover or identity the presence or existence of', or to 'discover or investigate (a crime or its perpetrators)', or to 'discern (something intangible or barely perceptible)'. In this case, the appellant's failure to comply with section 51(2) was 'detected' or discovered or identified by the Revenue by information supplied by the appellant. Thus, the appellant's failure to comply with section 51(2) has in fact been detected. The additional tax assessed does not exceed the maximum amount under section 82A(1)(e) (Dodge Knitting co Ltd and dodge Trading Ltd v CIR 2 HKTC 597 considered).

3. Having considered all the circumstances in this case, including the factors listed in D118/02, the assessment, although low, is nevertheless excessive in the circumstances of the case and should be reduced by half (D118/02, IRBRD, vol 18, 90 followed; D53/88, IRBRD, vol 4, 10; D34/88, IRBRD, vol 3, 336; D53/93, IRBRD, vol 8, 383; D2/90, IRBRD, vol 5, 77 and D62/96, IRBRD, vol 11, 633 considered).

Appeal allowed in part.

Cases referred to:

Dodge Knitting Co Ltd and Dodge Trading Ltd v CIR 2 HKTC 597
D118/02, IRBRD, vol 18, 90
D53/88, IRBRD, vol 4, 10
D34/88, IRBRD, vol 3, 336
D53/93, IRBRD, vol 8, 383
D2/90, IRBRD, vol 5, 77
D62/96, IRBRD, vol 11, 633

Taxpayer represented by its finance manager.
Yeung Ka Sing and Tse Yuen Ling for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the assessment ('the Assessment') dated 13 June 2007 by the Commissioner of Inland Revenue assessing the appellant to additional tax under section 82A of the Inland Revenue Ordinance, Chapter 112, ('the Ordinance') in the following sum:

Year of assessment	**Additional tax**	**Charge no**

2005/2006	$40,000	1-1122325-06-A

The agreed facts

2. Based on the agreed Statement of Facts, we make the following findings of fact.

3. The appellant has appealed against the assessment to additional tax raised on it under section 82A of the Ordinance. The additional tax was imposed because of the appellant's failure to inform the Commissioner in writing within the period prescribed under section 51(2) of the Ordinance that it was chargeable to profits tax for the year of assessment 2005/06.

4. The appellant was incorporated as a private limited company in Hong Kong on 25 March 2004 and commenced business on 1 January 2005. At all relevant times, the principal business activity of the appellant was trading of electronic components.

5. The appellant closed its accounts on 31 December 2005 for the year of assessment 2005/06.

6. On 7 October 2005, a profits tax return for the year of assessment 2004/05 was issued to the appellant. The appellant declared in the return that it had not commenced business during the period from 1 January 2004 to 31 December 2004.

7. On 24 April 2006, the Inland Revenue Department ('the Department') issued a letter (IRC 1812) to the appellant, excusing the appellant from submitting annual tax return. In line with the requirement of section 51(2) of the Ordinance the appellant was reminded to notify the Commissioner if the company commenced to earn assessable profits in the following terms:

> '... However, it is IMPORTANT that your company should note-
>
> if your company commences or recommences to earn assessable profits (before the set-off of any losses brought forward), then your company must inform the Commissioner of Inland Revenue in writing within 4 months after the end of the basis period (the accounting period) for that year of assessment . Failure to do so is an offence which may render your company liable to be fined. If your company is in doubt as to what constitutes "assessable profits", please consult our Department or your tax representative ...'

8. By a letter dated 27 July 2006 Company A ('the Representative') informed the Department that it had been appointed as the tax representative of the appellant and that the letter served as a notification pursuant to section 51(2) of the Ordinance.

9. By a letter dated 29 August 2006, the Representative requested the issue of profits tax return for the year of assessment 2005/06. Profits tax computation with supporting schedules and audited accounts showing assessable profits of $5,936,408 and tax payable of $1,038,871 for the year ended 31 December 2005 were submitted with the letter.

10. The Auditor's Report for the year ended 31 December 2005 was signed by Company A on 25 April 2006 and the Director's Report was signed by the Chairman of the Board of Directors of the appellant on the same date.

11. On 9 October 2006, the Assistant Commissioner of the Inland Revenue issued profits tax return for the year of assessment 2005/06 ('the Return') to the appellant. The deadline for submission was on 9 November 2006.

12. By a letter dated 6 December 2006 the Assistant Commissioner informed the appellant that it had failed to file the Return for the year of assessment 2005/06 within the time allowed and advised that prosecution would not be instituted subject to the [appellant] paying a sum of $3,000 and filing the completed Return within 14 days from the date of issue of the letter. The letter was computer-generated and no hard copy was kept.

13. On 20 December 2006, the appellant's Representative submitted the completed duplicate Return issued to the appellant on 12 December 2006. Together with the Return, the Representative submitted a letter applying on behalf of the appellant for the waiver of the penalty for the late submission of the Return. On 10 January 2007, the assessor informed the Representative that no further action would be taken against the appellant on that occasion.

14. The following dates are relevant to the matter under appeal:

Failure to notify chargeability by #	**Date of notification of chargeability**	**Date of issue of return**	**Date of signing audited accounts**	**Date of return (duplicate) received**	**Returned profits ($)**	**Tax under-charged per notice under section 82A ($)**	**Length of delay to notify chargeability**
30-4-2006	27-7-2006	9-10-2006	25-4-2006	20-12-2006	5,936,408	1,038,871	2 months and 27 days (i.e. from 1-5-2006 to 27-7-2006)

The basis period for the 2005/06 year of assessment ended on 31 December 2005. 30 April 2006 was four months after the expiry of the basis period.

15. No prosecution under section 80(2) or section 82(1) has been instituted in respect of the same facts.

16. On 5 January 2007, the assessor raised profits tax assessment for the year of assessment 2005/06 on the appellant as follows:

	$
Profits per return	5,936,408
Tax payable @17.5%	1,038,871

17. The appellant and the Representative did not lodge any objection against the assessment.

18. On 8 March 2007, the Commissioner gave a notice to the appellant under section 82A of the Ordinance. It was stated in the notice that the law allowed her to impose a penalty known as additional tax on the appellant for the year of assessment 2005/06 in respect of its failure to inform the Commissioner in writing of its chargeability within four months after the end of the basis period for the year of assessment if the appellant did not have a reasonable excuse for such a failure. This penalty may be up to three times the amount of tax that would have been undercharged. If the Department had not detected the failure, tax would have been undercharged in the amount of $1,038,871. Further, it was stated that the appellant had the right to submit written representations.

19. By a letter dated 29 March 2007, the appellant submitted written representations in response to the Commissioner' s notice of 8 March 2007.

20. Having considered and taken into account the appellant' s representations, the Commissioner, on 13 June 2007, assessed the appellant to additional tax under section 82A of the Ordinance in the amount as follows:

Year of assessment	**Amount of additional tax ($)**	**Percentage of additional tax on tax undercharged**
2005/06	40,000	3.85%

21. By a letter dated 11 July 2007, the appellant gave a notice of appeal against the Assessment.

Grounds of appeal

22. The appellant appealed on the following grounds (written exactly as in the original):

> 'The failure to comply with IRO section 51(2) for the requirement of informing the commissioner in writing that we have chargeable profit not later than 4 months after the end of the basis period for that year of assessment (i.e. 31st December 2005) was caused by change of finance manager.
>
> The subsequent notice was duly given by our newly appointed tax representative on 27 July, 2006. Instead of being detected, we have taken initiative actions to inform IRD the chargeability of profits tax. The profits tax computation with audit accounts were submitted to IRD on 29 August 2006 which is before issuance of profit tax return.
>
> As per our tax computation the notice of assessment for 2005/06 was issued to us in January 2007. So, we had not been "undercharged" as provided in section 82A(ii) and therefore not liable to be assessed to additional tax.'

23. At the hearing of the appeal, the appellant sought our consent under section 66(3) to rely on an additional ground that the Assessment was excessive. Mr Yeung Ka-sing had no objection and we gave our consent.

Some relevant statutory provisions on additional tax for failure to inform chargeability

24. Section 68(4) provides that the onus of proving that the assessment appealed against is excessive or incorrect shall lie on the appellant.

25. Section 51(2) provides that:

> *'Every person chargeable to tax for any year of assessment shall inform the Commissioner in writing that he is so chargeable not later than 4 months after the end of the basis period for that year of assessment unless he has already been required to furnish a return under the provisions of subsection (1).'*

26. Section 82A(1)(e), so far as relevant, provides that:

> *'Any person who without reasonable excuse ... fails to comply with section 51(2), shall, if no prosecution under section 80(2) or 82(1) has been instituted in respect of the same facts, be liable to be assessed under this section to additional tax of an amount not exceeding treble the amount of tax which ... has been undercharged in consequence of ... a failure to comply with section 51(2), or which would have been undercharged if such failure had not been detected.'*

27. Section 82B(2) provides that:

> *'(2) On an be appeal against assessment to additional tax, it shall be open to the appellant to argue that-*
>
> *(a) he is not liable to additional tax;*
>
> *(b) the amount of additional tax assessed on him exceeds the amount for which he is liable under section 82A;*
>
> *(c) the amount of additional tax, although not in excess of that for which he is liable under section 82A, is excessive having regard to the circumstances.'*

28. Section 82B(3) provides that sections 66(2) and (3), 68, 69 and 70 shall, so far as they are applicable, have effect with respect to appeals against additional tax as if such appeals were against assessments to tax other than additional tax. The Board's power under section 68(8)(a) includes the power to increase the assessment appealed against.

29. Section 68(9) provides that:

> *'Where under subsection (8), the Board does not reduce or annul such assessment, the Board may order the appellant to pay as costs of the Board a sum not exceeding the amount specified in Part I of Schedule 5, which shall be added to the tax charged and recovered therewith.'*
>
> *The amount specified in Part I of Schedule 5 is $5,000.'*

Decision on the liability point

30. The appellant did not dispute that it was chargeable to tax for the 2005/06 year of assessment.

31. The basis period ended on 31 December 2005.

32. No profits tax return for 2005/06 had been issued to the appellant by 30 April 2006.

33. Section 51(2) imposed a duty on the appellant to inform the Commissioner in writing by 30 April 2006 that it was chargeable to tax.

34. The appellant failed to do so. Thus the appellant failed to comply with section 51(2).

35. No prosecution under section 80(2) or 82(1) has been instituted in respect of the same facts.

36. In the absence of any 'reasonable excuse', the appellant would be liable to be assessed under section 82A to additional tax.

37. It alleged in its letter dated 29 March 2007 that its 'responsible' manager had not informed the appellant of the letter dated 24 April 2006 issued by the Department. There is no evidence on this assertion. The appellant has failed to prove the factual basis of the excuse put forward and the appellant's contention of reasonable excuse fails.

38. Further and in any event, neither change of financial manager nor breakdown in internal communication is, in our decision, a reasonable excuse.

39. Furthermore, the appellant made no allegation that it was not aware of the duty to inform chargeability. The auditors' report in the appellant's audited financial statements for 2005/06 was signed by Company A and dated 25 April 2006. The appellant made no allegation that Company A and the Representative were not aware of and did not advise the appellant on the duty.

40. The appellant had no reasonable excuse if it had known, or been advised, of the duty. The onus of proving that the assessment appealed against is incorrect is on the appellant.

41. Even if the appellant was ignorant of the duty (and there is no allegation of and no evidence on ignorance), ignorance of law is no excuse.

42. The appellant has no reasonable excuse and is liable for additional tax.

Maximum amount of additional tax

43. Section 82A(1)(e) provides that the maximum amount is treble the amount of tax 'which ... has been undercharged in consequence of ... a failure to comply with section 51(2), or which would have been undercharged if such failure had not been detected'.

44. The appellant did not object against the assessment made by the assessor on 5 January 2007 ('the Profits Tax assessment'). The Profits Tax assessment shows assessable profits and net assessable profits of $5,936,408.

45. The amount of tax assessed is thus final and conclusive against the appellant by virtue of section 70 which, so far as relevant, provides as follows:

> *'Where no valid objection ... has been lodged within the time limited by this Part against an assessment as regards the amount of the assessable ... profits ... the*

> *assessment as made ... shall be final and conclusive for all purposes of this Ordinance as regards the amount of such assessable ... profits ...'*

46. By section 2, 'assessable profits' simply means the profits in respect of which a person is chargeable to tax for the basis period for any year of assessment, calculated in accordance with the provisions of Part IV. Part IV is the section on profits tax. The charging section is section 14 which provides that:

> *'Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.'*

47. As 'assessable profits' simply means the profits in respect of which a person is chargeable to tax for the basis period for any year of assessment, calculated in accordance with the provisions of Part IV, the Profits Tax assessment is final and conclusive against the appellant on the amount of chargeable profits, that is, $5,936,408.

48. If the appellant's failure to comply with section 51(2) had not been detected, the tax which would have been undercharged would have been $5,936,408 x 17.5%, that is $1,038,871. Treble that is $3,116,613.

49. The second limb in section 82A(1)(e) , that is 'if such failure had not been detected', is concerned with an *hypothetical* situation. If the failure has never been detected, the situation under the second limb will never arise and the second limb may be otiose. Liu J said in 1989 in Dodge Knitting Co Ltd and Dodge Trading Ltd v CIR, 2 HKTC 597 at page 611 that 'the second limb deals with a hypothetical undercharge if such failure "had not been detected" in a case where failure was in fact detected'.

50. In our decision, detection includes discovery based on information supplied by the taxpayer.

51. According to the Concise Oxford Dictionary, to 'detect' is to 'discover or identify the presence or existence of', or to 'discover or investigate (a crime or its perpetrators)', or to 'discern (something intangible or barely perceptible)'. In this case, the appellant's failure to comply with section 51(2) was 'detected' or discovered or identified by the Revenue by information supplied by the Representative.

52. Thus, the appellant's failure to comply with section 51(2) has in fact been detected. The hypothetical undercharge if such failure 'had not been detected' is $1,038,871.

53. The appellants' original grounds of appeal fail.

54. The additional tax of $40,000 in this case does not exceed the maximum amount of $3,116,613.

Whether excessive having regard to the circumstances

55. Mr Yeung Ka-sing told us that the Commissioner followed D118/02, IRBRD, vol 18, 90 (Mr Ronny Wong Fook Hum SC, Professor Andrew J Halkyard and Mr Kenneth Kwok Hing Wai SC).

56. In that case, the panel reduced the penalty from 49.49% to 20%. The facts in that case are very different from the facts in this case and the actual decision offers no guide.

57. In paragraph 52, the panel was of the view that the principles established in D53/88, IRBRD, vol 4, 10, and D34/88, IRBRD, vol 3, 336, were equally applicable to late return cases, but as most of the late return cases did not fall into the categories established by those two cases, the level of penalty cases was much lower.

58. The panel went on to quote what was pointed out in D53/93, IRBRD, vol 8, 383, that is:

> *'... a substantially lower penalty was appropriate if the delay or default related to one year of assessment only and if the return was accepted by the Revenue without requiring an investigation.'*

59. The panel stated in paragraph 54 that the approach of the Board was to consider the overall circumstances of each case. It went on to list factors held to affect the level of penalty in cases there cited. The list is clearly not exhaustive and not intended to be such. Nor should a 'headcount' be conducted. As the Commissioner is said to have applied those factors, we consider each of them below:

(a) The length and nature of the delay – the delay is 2 months and 27 days.

(b) The amount of tax involved – the case cited in support of this factor was D2/90, IRBRD, vol 5, 77. At page 80 of D2/90, the panel (Mr William Turnbull, Mr Chan Pang Fee and Mr Foo Tak Ching) said:

> *'The quantum of the penalties is approximately 10% of the tax involved or 3% of the maximum penalties permitted under the Ordinance. It appears to us that the Commissioner has in determining these penalties*

already taken into account the extenuating circumstances and has been lenient. For mere delay in payment of tax which is duly assessed after a proper tax return has been promptly submitted, a penalty of 5% is imposed. The failure to file tax returns until some months after the extended period has expired must merit more serious penalties. The representative for the Taxpayer argued that reference should not be made to percentages but instead lump sum figures should be considered. Whilst we agree that it is possible to use lump sum figures and in certain circumstances it would be appropriate to do so, we cannot agree that it is appropriate to use lump sum figures as the general yardstick. The legislature has chosen to enact the provisions of section 82A of the Inland Revenue Ordinance and to stipulate in that section that penalties are related to a multiple of the tax involved. This must indicate that the quantum of penalty in dollar terms will be substantially more where the amount of tax is large. If the legislature had intended a different result, they would have specified a penalty in a maximum lump sum figure and not a multiple of the tax involved. Accordingly, we consider that the Commissioner has taken the right approach in this case when he imposed penalties which related to the amount of tax involved.'

What it boils down to is that penalty tax depends on the size of the tax involved and the correct approach is to decide an appropriate percentage of the tax involved.

(c) The absence of an intention to evade – depending on the context in which this is stated, it may not be inconsistent with D62/96, IRBRD, vol 11, 633, at paragraph 23 (Robert Wei Wen Nam QC, John Peter Victor Challen and Benjamin Kwok Chi Bun) which stated that:

'The Taxpayer repeatedly stated that he had no intention to evade tax. We accept that. However, while an intention to evade tax is undoubtedly an aggravating factor, lack of such an intention is not a mitigating factor, because no taxpayer should have it.'

Mr Yeung Ka-sing accepted in paragraph 15(c) of his written submission that there was no evidence or suggestion of an intention to evade tax.

(d) Whether there is any loss of revenue – Mr Yeung Ka-sing accepted in paragraph 15(d) of his written submission that there is no significant loss of revenue.

(e) The track record of the tax payer – Mr Yeung Ka-sing accepted in paragraph 15(e) of his written submission that this was the first penalty for non-compliance with section 51(2).

(f) The acceptance of the tax return eventually submitted without further investigation by the assessor – Mr Yeung Ka-sing accepted in paragraph 15(f) of his written submission that this was so.

(g) The lack of education on the part of the taxpayer – the appellant is a corporation but it was represented by a leading firm of professional accountants and its financial statements were audited by a leading firm of professional accountants.

(h) The steps taken to put the taxpayer's house in order – the appellant informed the Revenue out of time that it was chargeable to tax. It also supplied the Revenue on 29 August 2006 with its profits tax commutation with supporting schedules and audited accounts and at the same time requested the issue of the profits tax return. The significance of this is that the assessor could have made an assessment based on the tax computation and the assessor had power under section 60 to make further assessment(s).

However, there is room for improvement in terms of the appellant's filing system, routing and internal communication.

(i) The provision of management accounts – the appellant did better, see (h) above.

(j) Conduct of the taxpayer before this Board – Mr Yeung Ka-sing made no submission against the appellant on this factor. The appellant would have been better off had it not pursued the original grounds and argued only excessiveness on appeal.

60. This is a far less serious case than D118/02. Having considered all the circumstances in this case, including the factors listed in paragraph 54 of D118/02, our decision is that the Assessment, although low, is nevertheless excessive in the circumstances of the case and should be reduced by half.

Conclusion

61. The appellant has discharged the onus of satisfying us that the Assessment is excessive. We allow the appeal in part and reduce the Assessment from $40,000 (3.85%) to $20,000 (1.93%).