Case No. D34/88

Penalty assessment – whether penalties excessive – grounds for reduction: lack of criminal intent, lack of accounting expertise and ultimate submission of correct returns – s 82A of the Inland Revenue Ordinance.

Penalty assessment – correct return lodged out of time – whether penalty could be levied – s 82A of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Edward Chow Kam Wah and Kenneth Ting Woo Shou.

Date of hearing: 15 July 1988.
Date of decision: 24 August 1988.

For six years, the taxpayer company conducted substantial manufacturing operations in large premises and employed numerous people. During that period, it did not submit profits tax returns which had been sent to it by the IRD but was content to pay estimated assessments and even additional estimated assessments (which were lower than its true liability). The taxpayer finally objected to a high assessment and, as a result, it submitted the outstanding returns with audited accounts. The auditor's reports were heavily qualified but, after investigation, the IRD accepted the total amount of profits as disclosed in the accounts.

The Commissioner assessed penalties equal to between 75% and 100% (average 87%) of the tax payable (being 25% and 33%, average 29%, of the maxima permitted).

The taxpayer appealed. It raised the points that its managing director, who had founded the company, had little education and no accountancy background and had been required to devote his full efforts to his company's business. The employee responsible for preparing accounts had little accounting knowledge. Also, the taxpayer pleaded in mitigation that the accounts which were eventually submitted had been correct.

The taxpayer also argued that the Commissioner's practice had always been, in cases where returns were submitted out of time, to levy penalties only on the difference between the tax assessed according to those returns and the tax ultimately due, and not on the whole of the taxpayer's liability. The Commissioner's representative, however, denied that penalties were limited in this way where a taxpayer had initially failed to lodge tax returns.

Held:

The penalties were not excessive.

(a) The fact that the managing director had no accounting background is immaterial, as was the fact that he relied on others who did not have sufficient expertise. The taxpayer's business operations were substantial. It should therefore have hired competent staff.

(b) The starting point for assessing penalties is 100% of the tax underpaid. There were no extenuating circumstances in this case which warranted a reduction.

(c) Lack of criminal intent is not a factor for reduction, since such intent would have resulted in criminal proceedings.

(d) The fact that the taxpayer ultimately submitted returns which were correct is not a factor for reduction, particularly if submission was made only after extreme pressure had been exerted by the IRD. In submitting returns, the taxpayer was merely doing what it was obliged to do.

(e) The dispute concerning the Commissioner's practice in other cases was irrelevant. So far as the Board of Review is concerned, where a taxpayer submits late returns, the maximum penalty is assessed according to the taxpayer's ultimate tax liability. That liability cannot be reduced merely be filing late returns.

Appeal dismissed.

Cases referred to:

D58/87, IRBRD, vol 3, 11
D59/87, IRBRD, vol 3, 17
D2/88, IRBRD, vol 3, 125

Au Shui Bang for the Commissioner of Inland Revenue.
Robert Lew of James Lew & Co for the taxpayer.

Decision:

This is an appeal by a limited company against a number of penalty assessments imposed upon it by the Commissioner under section 82A of the Inland Revenue Ordinance.

The facts were as follows:

1. The Taxpayer was incorporated in 1978 in Hong Kong to take over the business of X Company, a manufacturer of electrical fans solely owned by the managing director Mr A (the managing director). In the provisional profits tax return form on BIR 51C for 1979/80, the Taxpayer declared in August 1979 that it had not yet commenced business or conducted any trade. Subsequent information showed that the Taxpayer actually commenced the business of manufacture of electrical fans in January 1979.

2. Profits tax returns (BIR 51) for the years of assessment 1978/79 to 1983/84 were issued to the Taxpayer, pursuant to section 51(1) of the Inland Revenue Ordinance. Despite the issue of reminders, these returns were not submitted within the stipulated time. The dates of issue of the returns and the dates of issue of the reminders were as follows:

Year of Assessment	Date of issue of Return	Date of issue of Remainder
		$
1978/79	9-7-1984	3-9-1984
1979/80	23-4-1982	14-6-1982
1980/81	23-4-1982	14-6-1982
1981/82	23-4-1982	14-6-1982
1982/83	6-4-1983	17-10-1983
1983/84	2-4-1984	15-8-1984

3. In December 1982, estimated assessments under section 59(3) were raised for the years of assessment 1979/80 to 1981/82 inclusive as follows:

Year of Assessment	Date of Assessment	Estimated Profit
		$
1979/80	24-12-1982	10,000
1980/81	15-12-1982	50,000
1981/82	15-12-1982	80,000

Objections were lodged against the estimated assessments for 1980/81 and 1981/82 but, in the absence of returns and accounts, they were not validated. No objection was raised to the 1979/80 estimated assessment. The tax assessed was duly paid.

4. As the Taxpayer had failed to file a timely return for the year of assessment 1982/83, an estimated assessment under section 59(3) was raised on 18 January

1984 in the sum of $500,000. No objection was raised to this estimated assessment and the tax was paid.

5. In March 1984, a tax inspector of the Inland Revenue Department visited the factory premises of the Taxpayer in order to find out the size and nature of operations of the Taxpayer. He found out that the Taxpayer occupied 20 floors or flats in the building, that each floor or flat was about 3,000 square feet and that the Taxpayer manufactured electrical ceiling fans mainly for export.

6. In May 1984, in the continued absence of profits tax returns, the assessor raised estimated additional assessments for the years of assessment 1979/80 to 1982/83 inclusive as follows:

Year of Assessment	Date of Assessment	Estimated Profit $
1979/80	25-5-1984	490,000
1980/81	25-5-1984	1,200,000
1981/82	25-5-1984	2,920,000
1982/83	25-5-1984	4,500,000

No objection were raised to these four additional assessments. Tax demanded was duly paid but the profits tax returns were still not submitted.

7. On 22 August 1984, the assessor made an estimated assessment for the year of assessment 1983/84 under section 59(3) in the sum of $50,000,000. The Taxpayer objected to the estimated assessment but no return was submitted to validate the objection despite an extension of the objection period to 15 December 1984 being granted.

8. On 23 November 1984, the assessor raised an estimated assessment for the year of assessment 1978/79 under section 59(3) in the sum of $5,000,000. A valid objection was lodged by Anthony Tse & Co (certified public accountants) on behalf of the Taxpayer on 20 December 1988.

9. The profits tax returns for the years of assessment 1978/79 to 1983/84 inclusive were finally furnished by the Taxpayer in December 1984 and January 1985. These returns were supported by audited accounts for the following irregular periods:

Period of Accounts	Profits before Tax Adjustments $

21-11-1978 to 12-2-1981	10,322,401
13-2-1981 to 31-12-1981	22,069,525
1-1-1982 to 30-6-1983	30,836,838
	63,228,764

The Taxpayer ceased business on 30 June 1983 when its business was taken over by a newly formed company, Y Company.

10. After tax adjustments, these profits have been allocated by the Taxpayer between the six years of assessment on the following basis:

Year of Assessment	Basis Periods	Assessable Profits $	
1978/79	28-1-1979 to 12-2-1979	117,980	
1979/80	13-2-1979 to 12-2-1980	4,905,807	
1980/81	13-2-1980 to 12-2-1981	3,928,524	
1981/82	13-2-1981 to 31-12-1981	21,244,780	(odd Period)
1982/83	1-1-1982 to 30-6-1982	9,337,019	(odd Period)
1983/84	1-7-1982 to 30-6-1983	18,939,717	(cessation)
		58,473,827	

11. In the auditors' reports which accompanied the audited accounts (fact 9 supra), it was stated that the auditors were unable to express an opinion as to whether the annexed balance sheets, manufacturing accounts and profit & loss accounts were properly drawn up in accordance with the Hong Kong Companies Ordinance so as to exhibit a true and fair view of the state of the company's affairs. The Inland Revenue Department instituted a detailed investigation into the financial affairs of the Taxpayer.

12. On 2 February 1985, the managing director of the Taxpayer attended an initial interview with investigating officers of the Inland Revenue Department.

13. On 16 April 1985, the Taxpayer submitted a letter of application for late objection for the year of assessment 1983/84. This application was accepted by the Assistant Commissioner on 18 April 1985.

14. On 17 February 1986, an estimated additional assessment for the year of assessment 1979/80 was raised in the amount of $5,000,000. A valid notice of objection was duly lodged on 6 March 1986.

15. During an interview on 24 June 1986, the managing director of the Taxpayer was presented by the investigating officers with proposed tax computations for

the years of assessment 1978/79 to 1983/84 in settlement of the profits tax payable by the Taxpayer. Before the proposed settlement was accepted by the managing director on behalf of the Taxpayer, the officers reminded him about the penalty provisions under the Inland Revenue Ordinance.

16. Revised/additional assessments for 1978/79 to 1983/84 based on the agreed basis of settlement were accordingly issued to the Taxpayer on 2 July 1986. A summary of the assessable profits and tax payable thereon is set out as follows:

Year of Assessment	Assessable Profit $	Tax Thereon $
1978/79	814,081	138,393
1979/80	4,920,617	836,504
1980/81	6,625,665	1,093,234
1981/82	23,391,998	3,859,679
1982/83	20,694,460	3,414,585
1983/84	2,027,006	334,455
	58,473,827	9,676,850

17. Details of payments of tax made by the Taxpayer in accordance with the estimated assessments previously raised were as follows:

Year of Assessment	Date of Payment	Amount Paid $	Total Paid $
1978/79	4-2-85	19,466	19,466
1979/80	6-4-83	1,700	
	14-7-84	83,300	85,000
1980/81	28-1-83	8,250	
	14-7-84	198,000	206,250
1981/82	6-4-83	13,200	
	14-7-84	481,800	495,000
1982/83	6-4-83	13,200	
	26-3-84	69,300	
	14-7-84	742,500	825,000
1983/84	26-3-84	61,875	

27-9-84	20,625	
19-11-84	8,167,500	8,250,000
		9,880,716

18. On 11 July 1986, the Commissioner of Inland Revenue gave notice to the Taxpayer under section 82A(4) of the Inland Revenue Ordinance that he proposed to assess the Taxpayer to additional tax in respect of the years of assessment 1978/79 to 1983/84.

19. On 7 August 1986, the Taxpayer submitted to the Commissioner its representations which were very lengthy. The representations were in the form of a letter from the managing director of the Taxpayer who set out the life history of the managing director and the history of the Taxpayer which was the company he had incorporated to take over his previously unincorporated business. The main thrust of the submission was that the managing director had little education and was a practical but talented mechanic who through his skill, ability, and hard work had been able to create a very successful manufacturing business in a very short period of time. Because of his lack of education, his not having any accountancy knowledge, and the necessity to devote his entire time and effort into making the business a success, the Taxpayer had failed to keep proper accounts and had failed in fulfilling the obligations imposed upon it by the Inland Revenue Ordinance. The managing director also blamed his wife who had been responsible for the accounting affairs of the Taxpayer and an unrelated individual who he employed to handle the accounting affairs of the Taxpayer but who the managing director said had little accounting knowledge.

20. After taking into account the Taxpayer's representations, the Commissioner issued on 8 September 1986 notices of assessment and demands for additional tax under section 82A as follows:

Year of Assessment	Tax Undercharged $	Section 82A Additional Tax $
1978/79	138,393	138,400
1979/80	836,504	836,500
1980/81	1,093,234	1,052,300
1981/82	3,859,679	3,407,600
1982/83	3,414,585	2,743,300
1983/84	334,455	250,800
	9,676,850	8,428,900

21. On 7 October 1986, the Taxpayer, through Messrs James Lew & Co, certified public accountants, gave notice of appeal to the Board against the said assessments to additional tax.

22. At the hearing of the appeal, the Taxpayer was represented by Mr Robert Lew of Messrs James Lew & Co. The managing director was called to give evidence.

23. In his submissions, Mr Lew, and in his evidence, the managing director, summarised and repeated the representations which the managing director had previously submitted in writing to the Commissioner (fact 19 supra). Because of the managing director's lack of education and lack of accountancy knowledge, because he was too busy handling the business affairs of the Taxpayer, because the business was so very successful in such a short period of time, and because the wife and the employee did not properly handle the accountancy and taxation affairs of the Taxpayer which were entrusted to them, the Taxpayer had failed to fulfil its obligations under the Inland Revenue Ordinance.

The representative for the Taxpayer submitted firstly and generally that in all of the circumstances the penalties imposed upon the Taxpayer were excessive, and secondly that the penalties were in excess of the previous practice of the Commissioner in handling such cases. The representative pointed out that, though the Inland Revenue Department had conducted an investigation into the affairs of the Taxpayer, the qualified audited accounts of the Taxpayer as eventually submitted had been accepted by the Inland Revenue Department. He submitted that, where a company makes a full disclosure of its liability to tax and is assessed to tax on that basis, it was the practice of the Commissioner not to charge penalties under section 82A or alternatively, where such penalties were charged, they were calculated and assessed on a maximum of the difference between the tax liability as revealed in the accounts and tax returns filed by the company on the one hand and, on the other hand, the company's ultimate liability to tax.

The representative for the Commissioner did not accept that this submission by the representative of the Taxpayer was correct. He said that, according to his experience, penalties were assessed on the difference between the ultimate liability to tax of a taxpayer and the amount, if any, which the taxpayer had declared in due and proper fulfillment of its obligations under the Inland Revenue Ordinance. As the Taxpayer in this case had originally failed to declare anything, the basis for assessment of penalties was 100% of its ultimate tax liability. Whatever tax returns the Taxpayer might have filed at a later date could not and did not affect the maximum amount of the penalties which could be imposed on the Taxpayer.

Both the representative for the Taxpayer and the representative for the Commissioner cited a number of recent Board of Review decisions, namely, cases D58/87 and D59/87. In addition, the Commissioner's representative referred to case D2/88.

On the facts before us, we have no hesitation in dismissing this appeal. We are unable to find that the penalties imposed by the Commissioner upon the Taxpayer are excessive in all of the circumstances.

The managing director of the Taxpayer who was the de facto mind and management of the Taxpayer was a highly successful industrialist making large profits from a big factory employing numerous people and with a large turnover. He chose to ignore the tax obligations of the Taxpayer. He found it expedient to pay estimated profits tax assessments as he received them, and no doubt knew or should have known that they were substantially below the real profits of the Taxpayer. The best construction which one can place upon the conduct of the Taxpayer and its managing director was that the managing director was too busy to concern himself with the obligations of the Taxpayer under the Inland Revenue Ordinance. It was only when he received estimated assessments in substantial sums that he decided to spend any of his time in sorting out the tax affairs of the Taxpayer.

It is no excuse for the managing director to say that he relied upon his wife and one of his employees and that they were not competent. It was his responsibility to ensure that competent staff were employed. The Taxpayer was not a small family business but a highly successful industrial undertaking with a large factory and turnover. His own lack of accounting knowledge is likewise immaterial.

As previous Boards have stated in cases of this nature, the starting point for assessing an appropriate penalty would appear to be approximately 100% of the tax underpaid. In effect, this means that, for completely ignoring one's tax obligations, one can assume that one is likely to have to pay about double the tax which other citizens who handle their tax affairs properly are required to pay. This is not unreasonable when it is borne in mind that the tax rates in Hong Kong are comparatively low and that the system of taxation in Hong Kong relies upon individual taxpayers making full and frank disclosures of all of their taxable income on a voluntary basis. If this is taken as the starting point for cases of this type, the question then to be decided is whether on the particular facts of this case there are any extenuating circumstances which would merit a decrease in the amount of the penalties. The answer is that there are none which would merit deviating from the general principle.

It is accepted that the managing director and the Taxpayer did not try to evade payment of tax and, in view of the magnitude of the sums involved, we have no doubt that if there had been any evidence of wilful evasion this case would not have been handled under section 82A but would have been a criminal case. The 'one-third of the maximum' guideline would have no application to a case involving criminal evasion, and therefore the fact that there was no criminal intent in this case cannot be an extenuating circumstance which would merit a reduction.

The only real mitigating factor in this case is that the Taxpayer did eventually produce accounts which were apparently accepted by the assessor after investigation as being accurate. However, it must be borne in mind that, by producing and filing such accounts, the Taxpayer did no more than was its obligation under the Inland Revenue Ordinance and it only did so when the Inland Revenue Department had exerted extreme pressure on the Taxpayer by repeatedly issuing estimated assessments.

With regard to the submission made by the representative of the Taxpayer that the penalties were not in line with other past cases, it is not necessary or appropriate for us to enquire into what the Commissioner may or may not have done in relation to other unrelated cases. When penalties have been imposed and the matter is referred to the Board of Review, we must act strictly in accordance with the law. The suggestion made by the tax representative that in previous cases the amount of the penalty had been calculated as a percentage of the difference between the amount of the tax returns ultimately filed and the ultimate tax liability was denied by the Commissioner's representative. However, even if the statement by the Taxpayer's representative was correct, it would only mean that the Commissioner had taken a wrong approach in other cases.

The calculation of the maximum quantum of penalties has been analysed in the previous Board of Review decision No D2/88. The maximum amount of penalty which could be imposed under section 82A in any case is three times the amount of tax underpaid. Where a taxpayer has failed to file a tax return on a due date, the amount underpaid can only be 100% of the total ultimate tax liability and nothing else. If a taxpayer has failed to file a tax return and nothing further is done by the Commissioner, the taxpayer would not pay any tax at all. It is wholly specious to argue that, because a taxpayer files a tax return after pressure has been put upon him by the Commissioner, he has somehow reduced the maximum penalty to which he had already exposed himself. Whilst his subsequent conduct is clearly material in assessing the amount of the penalty, it cannot affect the quantum of the maximum amount which has already been quantified at law. Likewise, by issuing estimated assessments, the assessor does not reduce the maximum amount.

For the reasons given we dismiss this appeal and confirm the penalty tax assessments appealed against.