

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D34/91

Penalty tax – failure to keep accurate business accounts – large estimated assessments – whether extenuating circumstances – section 82A of the Inland Revenue Ordinance.

Panel: Anthony F Neoh QC (chairman), Norman J Gillanders and David B K Lam.

Dates of hearing: 29, 30 and 31 May 1990.

Date of decision: 11 July 1991.

The taxpayer carried on business as a garment manufacturer and failed to keep proper accounts. As the result of an investigation into his tax affairs an assets betterment statement was prepared. It was found that the taxpayer has failed to return his full taxable profits. Additional tax was imposed upon the taxpayer by way of penalty under section 82A of the Inland Revenue Ordinance of various amounts between 116% and 134% of the amount of tax undercharged with an overall average of 122%. The taxpayer appealed and submitted that he had been unable to file correct tax returns because of his limited accounting knowledge and the failure of his professional advisers to handle his tax affairs correctly. He argued that the penalty should be less because of the hardship which he had undergone which included the fact of large estimated assessments which were unreasonable and the attempts by the Inland Revenue Department to enforce the unreasonable assessments.

Held:

The taxpayer had no reasonable excuse and was liable to penalty tax under section 82A of the Inland Revenue Ordinance. It was an extenuating circumstances that the estimated assessments had been very large and that the Inland Revenue Department had obtained a charging order against the taxpayer's property and had obtained a stop order against the taxpayer with the Immigration Department. In view of these extenuating circumstances the penalties should be reduced from an overall amount of 122% to an overall amount of 110%.

Appeal allowed in part.

Cases referred to:

BR 4/72, IRBRD, vol 1, 84

D24/84, IRBRD, vol 2, 136

D34/88, IRBRD, vol 3, 336

D58/87, IRBRD, vol 3, 11

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D56/88, IRBRD, vol 4, 25

Tung Kar Che for the Commissioner of Inland Revenue.
Jimmy Chung of Coopers & Lybrand for the taxpayer.

Decision:

The Taxpayer entered the world of garment manufacturing in 1969. He first worked in a factory for two and a half years; when it closed down, he then went to work for a larger knitting factory until 1980 when he took over his brother's failing garment manufacturing business ('the business'). For the first year, he operated this business at home, and because his expenses were low, he returned a profit. In the second year, that was the financial year 1981/82, he moved into factory premises. He financed his business by means of loans from two customers, banks and his mother-in-law. His strength was in marketing and he therefore spent most of his time in doing this. As to his accounting work he entrusted that to a member of his staff and when the accounting work became too complicated for this member of his staff to handle, he engaged a succession of external certified public accountants who also acted as his tax representatives over the years. The source of his troubles with the Revenue stemmed from his neglect of the accounting work of his business.

Tax returns

2. With the assistance of his tax representative, the Taxpayer submitted tax returns for the years 1980/81 to 1984/85, the gist of which might be summarized as follows:

<u>Year of Assessment</u>	<u>Date of Issue of return</u>	<u>Date of Receipt of Return</u>	<u>Profits/ (Loss) Per Return</u> \$	<u>Tax Representative</u>
1980/81	1-4-1981	28-3-1983	165,016	First
1981/82	1-4-1982	28-3-1983	(299,510)	First
1982/83	6-4-1983	14-1-1984	207,062	First
1983/84	2-4-1984	24-10-1984	245,356	Second
1984/85	1-4-1985	24-1-1986	41,008	Second

3. As the Taxpayer did not submit tax returns for the years of assessment 1980/81 and 1981/82 within time, estimated assessments were raised on him under section 59(3) of

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the Inland Revenue Ordinance ('the Ordinance') on the dates and the amounts shown below:

<u>Year of Assessment</u>	<u>Date of Issue</u>	<u>Assessable Profits</u> \$
1980/81	20-9-1982	130,000
1981/82	28-2-1983	200,000

4. He did not object to the year of assessment 1980/81 but on 28 March 1983, he objected to the estimated amount for the year of assessment 1981/82. As a result of the return for the year of assessment 1980/81, additional tax was assessed for the additional profits of \$35,016 (being the difference between the estimated profits of \$130,000 and the reported profits of \$165,016).

Investigation of the Taxpayer's tax affairs

5. In about 1986, the Revenue began to investigate the Taxpayer's tax affairs and at a meeting held at the Inland Revenue Department in September 1986, the Taxpayer explained to the Revenue that all books and invoices of his business had been passed to his first tax representative for the preparation of accounts and returns for submission to the Revenue. As these records and invoices were still kept by the accounting firm, the Taxpayer sought time from the Revenue to enable him to ascertain if his tax returns were correct.

6. About a fortnight after the interview (that is on 8 October 1986), the Inland Revenue Department sent a letter to the Taxpayer requesting him to submit various accounting records and further information. The Taxpayer applied for time and an extension to 31 December 1986 was granted. However, a request for a further extension to 31 March 1987 was subsequently rejected.

7. By April 1987, the Revenue had received certain records from the Taxpayer but they were by no means complete. Therefore on 21 April 1987, the department further reminded the Taxpayer to send the remaining records. At this time, the department did not have sufficient information but it did compile a list of withdrawals in the personal and business bank account of the Taxpayer up to 1985 with certain gaps on which the department sought further information from the Taxpayer. The Taxpayer, by his third tax representative responded on 8 May 1987 filling some of the gaps and promising to complete the picture as soon as possible.

8. A further interview was conducted on 26 May 1987 when the Taxpayer promised that all the outstanding information would be provided by 15 June 1987. However, that undertaking was not compiled with and on 5 August 1987 the Inland

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Revenue Department again wrote to the third tax representative, seeking the further information promised.

9. On 30 December 1987, the Taxpayer wrote to the Revenue to ask for the preparation of an assets betterment statement ('ABS') saying that he wanted to 'finalise the matter as soon as possible'.

10. On 7 January 1988, the Revenue reminded the Taxpayer of his undertaking to supply all outstanding records and information to enable the Revenue to complete the compilation of the ABS and to achieve early finalisation of the investigation.

11. On 11 January 1989, the Revenue again sought further information. By then the Taxpayer had instructed the present tax representative ('the tax representative'). The tax representative replied on behalf the Taxpayer on 20 April 1989 supplying further information.

The Taxpayer's explanation

12. In his evidence before the Board, the Taxpayer explained that his first tax representative did not devote much of its senior staff time on the Taxpayer's affairs. Furthermore, although the first tax representative had returned certain records (which records had already been sent to the Inland Revenue Department), certain other records for the years 1982 to 1984 were not returned to him and the first representative's staff had indicated to him that such records had gone missing. The second tax representative was according to the Taxpayer very good. However the Taxpayer was unable to afford his fees and therefore he had no alternative but to change to the third representative who began to represent him in late 1986. At that time, the Taxpayer began to experience great difficulties in his business and the years 1986 and 1987 were a time of great confusion. He told his third and the present tax representatives as well as the Inland Revenue Department all that he knew and tried his best to retrieve papers from his first tax representative. He was the only manager of the business and had spent his time in the marketing and manufacturing aspects, leaving very little time to attend to accounting. Accordingly, he had had to leave such work to a member of his staff and a succession of public accountants starting with his first tax representative. The Board sees no reason to disbelieve the Taxpayer.

The First ABS

13. The Inland Revenue Department sent the first ABS on 20 January 1989. This comprised eleven schedules and contained the following basic information:

	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>	<u>1984/85</u>
	\$	\$	\$	\$	\$
Betterment Profits	1,180,861	130,441	798,004	1,008,703	360,639
<u>Less:</u> Returned/	165,016	-	206,494	218,519	41,008

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assessed profit of the business	_____	_____	_____	_____	_____
Discrepancies	<u>1,015,845</u>	<u>130,441</u>	<u>591,510</u>	<u>790,184</u>	<u>319,631</u>

Revised ABS

14. The tax representative, on behalf of the Taxpayer proposed on 31 March 1989, a revised ABS which sought to reduce the Inland Revenue Department's calculated betterment profits of \$3,497,265 to \$1,097,369.

Final ABS

15. After a meeting held at the Inland Revenue Department on 22 August 1989, the Revenue and the Taxpayer agreed the final ABS in which adjustments were restricted to three items. These adjustments are set out as follows:

	\$	
Betterment profit for the period 1-4-80 to 30-4-84		3,497,265

Less adjustment:

(i) Payment to a Mr X	35,000		
(ii) Mortgage loan interest	51,913		
(iii) Payment on account received from a customer		<u>1,117,228</u>	<u>1,204,141</u>

(accompanied by an undertaking by the company which took over the business in 1984 that this amount will be absorbed into its profits and loss account) \$2,293,124

16. Thus, the following final agreed betterment profits picture appears:

	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>	<u>1984/85</u>
	\$	\$	\$	\$	\$
Betterment Profits	558,268	394,055	533,882	534,745	93,243
<u>Less:</u> Returned assessed profit	165,016	-	206,494	218,519	41,008
	_____	_____	_____	_____	_____

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Discrepancies	<u>393,252</u>	<u>394,055</u>	<u>327,388</u>	<u>316,226</u>	<u>52,235</u>
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The nature of an ABS

17. Where the tax affairs of a taxpayer are in such a state of disarray that the assessor is unable to verify from records supplied by the taxpayer the accuracy of the returns, some rational method had to be found to estimate the profits. The preparation of an 'assets betterment statement' had traditionally been the method adopted by the Revenue and this method has now been regarded as something of a standard practice in the accounting profession. We respectfully adopt the following definition of an ABS by a previous Board in BR 4/72:

'The final assets betterment statement represents nothing more than an account of how the assessor has arrived at an estimate in formulating an assessment. No pretence is made as to either the accuracy or precision of such statement. It is merely a calculation of taxpayer's income on a "net assets basis". If a taxpayer is aggrieved by the assessment found on such a statement, it is for him to show how and to what extent it is incorrect or excessive. If he fails to do that the assessment will be confirmed. It is for the taxpayer to displace the assessment.'

18. The final agreed ABS showed substantial discrepancies between the returned profits and the agreed betterment profits. Prima facie that represents an admission that profits had been understated in the returns which were thus, by definition, incorrect.

The Commissioner's assessment of additional tax under section 82A(1)

19. From October 1986 when the first recorded meeting with Inland Revenue Department took place, the Taxpayer had been warned by the officers of the department to the effect that even if his tax affairs were settled, the Taxpayer may be liable to a penalty under section 82(A)(1) equivalent to not more than treble the undercharged tax as a result of his failure to make correct tax returns.

20. Thus, once the final ABS was agreed, the Revenue wrote, on 20 December 1989, to the Taxpayer indicating that due to his understatement of profits in his returns for the years of assessment 1980/81 to 1984/85, he was liable to be assessed under section 82A to additional tax not exceeding treble the amount of \$211,633, which was the amount of tax payable on the understated profits. At the same time, the department sought representation, if any, from the Taxpayer.

21. Representations were sent by the Taxpayer in a letter dated 17 January 1990. These same representations form the essential basis of the appeal before us.

22. In the event the Commissioner assessed additional tax under section 82A as follows:

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<u>Year of Assessment</u>	<u>Tax Undercharged</u> \$	<u>Additional Tax Under Section 82A</u> \$	<u>Percentage of Penalty</u> %
1980/81	63,486	85,000	134
1981/82	56,272	75,000	133
1982/83	38,856	48,000	124
1983/84	44,140	51,000	116
1984/85	<u>8,879</u>	<u>-</u>	<u>-</u>
	<u>211,633</u>	<u>259,000</u>	122

Duty of taxpayer to make accurate tax returns

23. Whilst the Board believes that the Taxpayer is a businessman who has little accounting knowledge and that, accordingly, he had had to entrust his accounting work to his staff and later, when the business grew, to a succession of outside professional accountants, this nonetheless does not exempt him from the statutory duty (which is personal to him) under section 51 of the Ordinance to furnish a return of his total income in a form specified by the Board of Inland Revenue and to furnish, upon notice in writing by the assessor, such fuller or further returns respecting any matter of which a return is required or prescribed by the Ordinance.

24. The Taxpayer also has a personal duty under section 51C of the Ordinance to keep sufficient records in the English or Chinese language of his income and expenditure to enable the assessable profits of his business to be readily ascertained.

25. As a previous Board in D24/84 observed and we agree:

‘Anyone who carries on business has obligations in respect to that business which include obligations under the Inland Revenue Ordinance. Such obligations cannot be avoided by saying that the taxpayer was ignorant, illiterate or unable to understand what the obligations require.

Likewise, there is no excuse to say that qualified accountants were employed and that this exonerated the Taxpayer. Qualified accountants can do no more than act on the information provided to them in accordance with the instruction given to them. The client and not the accountant must take full legal responsibility for what the client signs.’

Did the Taxpayer make inaccurate returns

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26. The resort to an assets betterment statement meant that the actual profits had had to be a matter of estimate. The admission of any discrepancy, as we have observed in paragraph 18 above, prima facie meant that the original returns of the Taxpayer's profits were admitted to have been understated. Admittedly, it may sometimes be possible for a taxpayer to agree to an assets betterment statement purely as an expedient to avoid protracted investigation into his affairs although he may dispute that he had in fact made incorrect returns. However, a particularly strong onus lies on a taxpayer if he wishes to displace the prima facie inference which arises from the admissions made in the ABS of understated profits. In the Taxpayer's evidence, he was unable even to begin to displace this prima facie inference. Thus the Board is left with his admission that he had understated profits and that his previous returns must necessarily be incorrect.

27. The Taxpayer's tax representative urged upon us the argument that the total sum of \$306,582 charged to tax in the final ABS figure was due to 'technical adjustments' rather than to incorrect accounts/returns. He suggested that these adjustments are in the nature of disallowed interest expenses which are not uncommon in situations where part of the taxpayers' borrowings are used to finance activities not producing assessable income. We are unable to accept this argument in the light of the taxpayer's clear duty to submit accurate tax returns. A return is either accurate or not. If an adjustment has to be made, the return is per se inaccurate. Furthermore, as the affairs of the Taxpayer were in such disarray that he sought the only sensible solution to bring the investigation to finality by way of an ABS, we believe that it is unrealistic to distinguish between 'technical' and 'non-technical adjustment'. One must look to the totality of the facts, and if one does that, one is left in no doubt that the Taxpayer had by his agreement to the ABS admitted to the submission of inaccurate returns.

28. We therefore conclude as follows:

- (a) that the Taxpayer had made incorrect returns for the years of assessment, 1980/81 through to 1984/85; and
- (b) that he had done so (save for the year 1984/85) without reasonable excuse in the light of his clear duty to keep accurate records and to submit correct returns; for the failure of which duly he had given no reasonable explanation.

29. Thus, there is no doubt that the Taxpayer is liable to be assessed to additional tax under section 82A of the Ordinance.

Guiding principle

30. We adopt as our guiding principle, the observations of a previous Board in D34/88:

- 'As previous Boards have stated in cases of this nature, the starting point for the assessing of an appropriate penalty would appear to be approximately 100% of

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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.'

31. We further adopt, as our guiding principle as to whether or not extenuating circumstances exist, the observations of a previous Board in D58/87 (confirmed in D56/88), as follows:

- (a) the sophistication of the taxpayer;
- (b) the sophistication of the taxpayer's business;
- (c) the absence of evidence that the scheme was deliberate or designed to conceal profits; and
- (d) the co-operation of the taxpayer.

Extenuating circumstances

32. Notwithstanding that we believe that the Taxpayer did not deliberately file incorrect tax returns and that he had had no training in accounting and that his business, being that of a garment manufacturer, could not be regarded as being a sophisticated business, we do not find that this alone could exonerate him from his clear duty under the law to file correct tax returns. We therefore find no ground for reducing the additional tax assessed by the Commissioner under section 82(A) below the starting point of 100%.

33. We do however believe that he had tried his best to supply information to the Inland Revenue Department. His experience with his first tax representative had not been a happy one. We believe him when he told us that his first tax representative did not return to him the records for the years 1982 to 1984.

34. We further believe his evidence to the effect that he had suffered great strain mentally and financially due firstly, to the investigation of his tax affairs and secondly, to the estimated additional assessments of profits tax raised from him. As to the first matter, it can only be said that the strain was caused by his failure to comply with clear duties imposed by the Ordinance to file accurate tax returns and to keep adequate business records. Although we sympathize with his unfortunate choice of outside help with his accounting, and that he did try his best to supply the information requested by the department, we cannot regard such strain as affording any good ground by itself for reducing the assessment. However, we take a wholly different view as to the second matter.

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35. On 30 June 1987, the assessor raised the following estimated additional profits tax assessments on the Taxpayer:

<u>Year of Assessment</u>	<u>Additional Assessable Profits</u>	<u>Tax Demands</u>
	\$	\$
1982/83	2,000,000	300,000
1983/84	2,500,000	375,000

36. Furthermore, at about the same time, an estimated additional salaries tax assessment showing an estimated income of \$1,500,000 with tax payable at \$255,000 for the year of assessment 1984/85 was raised.

37. This meant that in addition to his extant tax bills, the Taxpayer had had to face a further tax bill of \$930,000. This proved to be a crushing blow to him as by then his business was experiencing serious cash flow difficulties. Had these additional assessments been fully justified, we would have considered these consequences to have been brought on by the Taxpayer's own failure to make accurate tax returns. However, when we compare these additional assessments to the first ABS which showed profit discrepancies of \$591,510 and \$790,184 for the years of assessment 1982/83 and 1983/84 respectively, we can completely understand the Taxpayer's sense of grievance. Furthermore, these profit discrepancies were in fact finally reduced to \$327,388 and \$316,226 for these same years.

38. The annual accounts of the business purported to show that the net sales of the Taxpayer were at the relevant time in the region of \$4,000,000. Raising an additional estimated profits tax based on additional profits of \$2,000,000 derived from these sales would imply that the Taxpayer's business was making over 50% net profits on sales in the relevant years. This rate of return occurs to the Board as being impossible, or at least highly improbable for any garment manufacturer, and suggests to us that the Revenue may have assumed a sales figure in its calculations at an excessively high level for a garment manufacturer of the Taxpayer's apparent sophistication and limited financial resources.

39. The subsequent collection effort mounted by the Revenue resulted in a charging order made by the District Court against the Taxpayer's property. Also adding to his difficulties, a stop order was filed by the Revenue with the Immigration Department with the result that the Taxpayer was unable to leave Hong Kong and personally liaise with his overseas customers. All this added to the difficulties already faced by his business.

40. We therefore believe that the additional assessments estimated by the Revenue and the subsequent collection effort had, in the circumstances, been unduly harsh on the Taxpayer and he had been put to suffering which might otherwise have been ameliorated had a more realistic estimation of additional tax been made.

41. Accordingly, in all the circumstances, we determine that the Commissioner's assessment should be reduced overall to 110% of the undercharged tax instead of the 122%

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determined by the Commissioner. We shall leave the Revenue and the Taxpayer to agree to appropriate apportionment of this reduction to the respective years of assessment under appeal.

42. Finally we would like to thank the representative on both sides for their careful submissions.