

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D40/88

Penalty assessment – whether penalties excessive – statement of relevant criteria – s 82A of the Inland Revenue Ordinance.

Penalty assessment – whether taxpayer could argue that he was not liable to pay tax – ss 70 and 82A of the Inland Revenue Ordinance.

Penalty assessment – whether taxpayer had a reasonable excuse – illiteracy and failure to keep proper records – s 82A of the Inland Revenue Ordinance.

Panel: Denis Chang QC (chairman), Chan Pang Fee and Duncan A Graham.

Dates of hearing: 3, 4 and 16 December 1987 and 6 January 1988.

Date of decision: 30 September 1988.

The taxpayers carried on business as book publishers and sellers. For five years, they submitted profits tax returns which disclosed between about 6% to 18% of their actual taxable profits. After investigations by the IRD, the taxpayers accepted an assets betterment statement. The IRD issued notices of assessment based on this statement, and the taxpayers did not object.

Subsequently, the Commissioner issued penalty assessments to the taxpayers for their failure to submit proper returns. The penalties were equal to between 90% and 119% (average 104%) of the tax undercharged.

The taxpayers appealed, and argued:

- (1) that they have not earned the profits indicated in the assessments upon which the penalties were based;
- (2) that they had a reasonable excuse for submitting incorrect returns in view of their failure to keep proper records and their illiteracy; and
- (3) that the penalties were excessive having regard to the facts that the taxpayers were of humble origin, had very little education and had suffered great stress during the IRD's investigations into their affairs.

Held:

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- (a) In an appeal against a penalty assessment, a taxpayer may not argue that the assessment upon which the penalty is based is wrong. This is because section 70, which states that assessments shall be 'final and conclusive for all purposes, deems the taxpayer's profits to be the amount set out in such assessment.
- (b) Ignorance, illiteracy and inability to comprehend one's obligations do not constitute a reasonable excuse for failing to comply with one's obligations under the Inland Revenue Ordinance.
- (c) Relevant considerations in determining whether a penalty is excessive include the existence of wilfulness, the antecedents of the taxpayer, the nature of his business, the amount of tax undercharged in relation to the amounts returned, an interest element and the conduct and co-operation of the taxpayer in response to the tax investigation.
- (d) On the facts, the penalties were excessive and would be reduced by 25%.

Appeal allowed in part.

Cases referred to:

D24/84, IRBRD, vol 2, 136

Au Shiu Bang for the Commissioner of Inland Revenue.  
Andrew P C Lam of T C Foo & Co for the taxpayer.

### Decision:

Mr A is appealing against the imposition of additional tax by way of penalty assessed upon him under section 82A of the Inland Revenue Ordinance for making incorrect profits tax returns of X Company for the years of assessment 1978/79 to 1981/82 inclusive, and Mrs A is appealing against the imposition of the additional tax by way of penalty upon her under section 82A of the Inland Revenue Ordinance for making incorrect profits tax returns of Y Company for the years of assessment 1982/83 and 1983/84.

The following is a statement of agreed facts:

1. The Taxpayers are husband and wife. Mr A was the sole proprietor of X Company which commenced business in 1974. He reported to the Business Registration Office that this business ceased in March 1982. Mrs A, in the capacity of sole proprietress, obtained a new business registration certificate later which the name of Y Company and the date of commencement was

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reported to be 19 March 1982. Despite the change of business registration certificate, the business name in Chinese had not been changed and Mr A continued to play an active role in operating and managing the business. During the years of assessment under appeal, both X Company and Y Company was involved in publishing and selling books.

2. On 29 November 1976, a profits tax return for the year of assessment 1975/76 was issued to Mr A for completion. The completed return was received by the Inland Revenue Department on 8 December 1976 showing an assessable profit of \$19,770. This return was accepted by the Inland Revenue Department.
3. By letter dated 12 April 1977, the Inland Revenue Department informed Mr A inter alia of the following:
  - (i) he would not be required to make annual profits tax returns each year in the future because his declared income was considerably less than his personal and family allowances;
  - (ii) he must inform the Department if, at any time, any one of the events listed therein occurs;
  - (iii) failure to make such notification may amount to an offence under the Inland Revenue Ordinance;
  - (iv) he was still required by law to keep sufficient records of his income and expenditure so that his assessable profits could be readily ascertained, and to retain such records for at least seven years;
  - (v) he was advised to keep the letter for easy reference.
4. On 30 September 1981, a profits tax return for the year of assessment 1980/81 was issued to Mr A for completion. The completed return was received by the Inland Revenue Department on 5 December 1981 showing an assessable profit of \$17,773.
5. A summary of the profits tax returns subsequently issued to the Taxpayers and filed by them is extracted as follows:

<u>Year of Assessment</u>	<u>Date of Issue</u>	<u>the Inland Revenue Dept</u>	<u>Returned Profits</u> \$	<u>Submitted by</u>
1978/79	17-2-83	3-5-1983	15,301	Mr A
1979/80	26-4-83	3-5-1983	17,393	Mr A
1981/82	17-2-83	3-5-1983	18,102	Mr A

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1982/83	6-4-83	26-10-1983	28,936	Mrs A
1983/84	2-4-84	29-10-1984	38,234	Mrs A

6. The profits tax returns submitted by Mr A for 1978/79 to 1981/82 were accepted by the assessor and assessments were made in accordance with the returned profits with computational adjustments. The assessor did not accept the return for 1982/83 and commenced enquiries.
  
7. On 17 January 1984, Mr A was interviewed by an assessor in the profits tax unit of the Inland Revenue Department, during which he confirmed that the profits tax returns submitted by him for 1978/79 to 1981/82 were true and correct. The assessor also explained to him the penalty provisions under section 80, 82 and 82A of the Inland Revenue Ordinance.
  
8. On 10 July 1984, Mr A attended an interview with two investigation officers of the Inland Revenue Department. During the interview, he admitted that his business did not keep proper books and records and he was once again reminded of the penalty provisions under the Inland Revenue Ordinance.
  
9. On 25 July 1984, Mrs A, accompanied by Mr A, attended an interview with two investigation officers of the Inland Revenue Department during which Mrs A had no objection to Mr A's presence when their financial affairs were discussed. The officers also explained to the Taxpayers the penalty provisions under the Inland Revenue Ordinance.
  
10. During the course of the investigation, a protective additional assessment for 1978/79 was issued to Mr A on 12 February 1985 with additional assessable profit of \$400,000. Mr A lodged a valid notice of objection to this protective assessment.
  
11. On 2 May 1985, an assets betterment statement covering the period from 1 April 1978 to 31 March 1984 showing a total discrepancy of \$6,166,603 was issued to the Taxpayers with a covering letter inviting them to make representations.
  
12. On 15 May 1985, additional profits tax assessments for 1979/80 to 1981/82 and original profits tax assessments for 1982/83 and 1983/84, based on discrepancies quantified in the assets betterment statement, were raised on the Taxpayers in the following manner:

<u>Year of Assessment</u>	<u>Assessable/Additional Assessable Profits</u>	<u>Issued to</u>
1979/80	\$ 657,418 (Additional)	Mr A

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1980/81	1,490,997	(Additional)	Mr A
1981/82	1,383,225	(Additional)	Mr A
1982/83	957,648	(original)	Mrs A
1983/84	1,001,222	(original)	Mrs A

13. On 27 May 1985, the Taxpayers, through their newly appointed tax representative, Mak Hing Cheung & Co, lodged valid notices of objection to the assessments for 1979/80 to 1983/84 inclusive.
  
14. Basing on additional explanations and information furnished by the Taxpayers, the assessor compiled revised assets betterment statements dated 16 April 1986 and 25 September 1986 and issued them to the Taxpayers for agreement.
  
15. On 3 October 1986, Mr A attended another interview with two investigation officers during which he expressed that he and his wife had decided to accept the second revised assets betterment statement. He handed to the officers the second revised assets betterment statement duly signed by him and his wife. Before accepting the duly signed second revised assets betterment statement from Mr A, the officers asked him to bring the statement home and to discuss the matter further with his wife. The officers also reminded him of the penalty provisions under the Inland Revenue Ordinance. Mr A indicated that he and his wife had decided to abandon their claims and to accept the second revised assets betterment statement. He then handed the second revised assets betterment statement to the officers. The note of interview together with a Chinese translation was issued to Mr A for confirmation on 15 October 1986. Mr A confirmed and returned the note of interview on 21 October 1986 with one amendment only. He added at the end of para 5 which concerned the penal action by the Commissioner of Inland Revenue after the basic tax had been agreed, 'that at the outset, he did not understand tax law and he was illiterate and therefore he was innocent on paying the tax'.
  
16. Based on the second revised assets betterment statement, revised additional profits tax assessments for 1978/79 to 1981/82 and revised assessments for 1982/83 and 1983/84 were issued to Mr A and Mrs A on 5 November 1986 in the following manner:

<u>Year of Assessment</u>	<u>Revised Assessable/ Revised Additional Assessable Profits</u>
	\$
1978/79	215,096 (Revised Additional)
1979/80	494,955 (Revised Additional)
1980/81	744,385 (Revised Additional)
1981/82	1,194,057 (Revised Additional)

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1982/83	583,185 (Revised)
1983/84	592,720 (Revised)

17. The following is a comparative table of the assessable profits before and after investigation and the calculation of tax undercharged:

<u>Year of Assessment</u>	Profits that would have been assessed if the returns were accepted as correct \$	Profits assessed after Investigation \$	Profits Under-stated \$	Tax Under-charged \$
1978/79	34,174	249,270	215,096	36,881
1979/80	41,471	536,426	494,955	79,890
1980/81	46,186	790,671	744,485	119,232
1981/82	<u>48,443</u>	<u>1,242,500</u>	<u>1,194,057</u>	<u>188,831</u>
Total	<u>170,274</u>	<u>2,818,867</u>	<u>2,648,593</u>	<u>424,834</u>
1982/83	108,236	583,185	474,949	71,242
1983/84	<u>103,834</u>	<u>592,720</u>	<u>488,886</u>	<u>73,333</u>
Total	<u>212,070</u>	<u>1,175,905</u>	<u>963,835</u>	<u>144,575</u>

Percentage of profits understated to profits assessed after investigation for 1978/79 to 1981/82 is 93.95%.

Percentage of profits understated to profits assessed after investigation for 1982/83 and 1983/84 is 81.96%.

18. The Commissioner of Inland Revenue was of the opinion that Mr A had, without reasonable excuse, made incorrect profits tax returns for the years of assessment 1978/79 to 1981/82 in respect of X Company, and that Mrs A had, without reasonable excuse, made incorrect profits tax returns for the years of assessment 1982/83 and 1983/84 in respect of Y Company. On 2 February 1987, he gave a notice to each of the Taxpayers under the terms of section 82A(4) of the Inland Revenue Ordinance that he proposed to assess the Taxpayers to additional tax in respect of the years of assessment 1978/79 to 1981/82 inclusive, and 1982/83 to 1983/84 inclusive.
19. In response to the notice, the Taxpayers submitted to the Commissioner written representations on 16 February 1987.

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20. After taking into account the Taxpayers' representations, the Commissioner issued notices of assessment 1978/79 to 1983/84 inclusive on 12 March 1987 in the following amounts:

<u>Year of Assessment</u>	<u>Amount of Additional Tax</u> \$	<u>Assessed on</u>
1978/79	44,000	Mr A
1979/80	93,000	Mr A
1980/81	130,000	Mr A
1981/82	193,000	Mr A
1982/83	68,000	Mrs A
1983/84	<u>66,000</u>	Mrs A
Total	<u>594,000</u>	

The Taxpayers gave notice of appeal against the assessments to additional tax under section 82B on 3 April 1987.

### The scope of the appeal; sections 82A and 70

The notice of appeal was by way of a letter. The matters raised included pleas of hardship, illiteracy, insufficient records, loss of relevant evidence owing to lapse of time (evidence which it was alleged would, among other things, have supported certain disputed items involving gold and share transactions dealt with in the second revised assets betterment statement), an allegation that the information supplied to the Inland Revenue Department was 'not incorrect but only incomplete', a plea of innocence and what Mr Andrew Lam, the solicitor appearing for Mr A and Mrs A, called 'coercion'. This word was not actually used in the notice of appeal but there was a reference in the letter to the revised assets betterment statement having been signed 'under the situation that there was no room for resistance.'

Whilst we have not found it easy to discern the precise grounds, we allowed the appeal to proceed after certain clarifications made by Mr Lam. We asked Mr Lam whether he was contending that there was 'reasonable excuse' within the meaning of section 82A of the Ordinance and, if so, the reasons for so contending. His answers indicated to us that, although he would like to argue that there was 'reasonable excuse' as one of his grounds, he was primarily contending that his clients' business could not have produced the profits that were agreed to in the revised assets betterment statement and on which assessments had already been made on 5 November 1986 and which had become final and conclusive under section 70 of the Ordinance. The relevant assessments were based on the figures finally agreed on 3 October 1986 in the circumstances stated in the agreed statement of facts.

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Under section 70 of the Ordinance, the relevant assessments made on 5 November 1986 became final and conclusive ‘for all purposes of this Ordinance as regards the amount of such assessable income or profits or net assessable value.’

In our view, ‘all purposes of the Ordinance’ includes determining the issue as to whether the relevant returns were or were not ‘incorrect’ within the meaning of section 82A thereof.

The consequence is that the assessable profits for the relevant periods are conclusively deemed to be the amounts assessed. The relevant returns made by Mr A and Mrs A are therefore for present purposes conclusively presumed to be incorrect in that the amounts of assessable profits returned were far below the amounts thus assessed. That is, the assessable profits had been understated. There is no basis in the light of the agreed statement of facts for any suggestion that, if the assessable profits were incorrectly returned, it was not because of any omission or understatement of anything in respect of which the Taxpayer was required by the Ordinance to make a return.

By reason of the statutory provisions and in the light of the matters stated in the agreed statement of facts, we ruled that the Taxpayers could not contend that the amount of assessable profits had not been understated or that the same had been correctly returned.

### ‘Reasonable Excuse’

We turn next to the question of ‘reasonable excuse’. The notice of appeal did not in terms raise this as a ground of appeal but, as we gathered from the various matters stated in the notice as clarified by Mr Lam, the Taxpayers were contending that they had not kept proper accounting books and records for business as a result of a letter dated 12 April 1977 from the Inland Revenue advising Mr A that he would not be asked to file annual profits tax returns each year in the future. However, as stated in paragraph 3 of the agreed statement of facts, the same letter also went on to say: ‘Although you are not required to make annual profits tax returns, you are still required to keep sufficient records of your income and expenditure so that your assessable profits can be readily ascertained, and to retain such records for at least seven years.’

We did not (and do not) see how, in the light of the agreed statement of facts, this letter could form the basis of any defence of ‘reasonable excuse’, nor could the plea of illiteracy – and we so ruled. In D24/84, IRBRD, vol 2, 136 the Board made the following comment: ‘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 required.’ We respectfully agree.

### ‘Excessive having regard to the circumstances’



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Mr Lam, however, also made it clear that he wished to rely on section 82B(2)(c) of the Ordinance, namely 'that the amount of additional tax, although not in excess of that for which [the taxpayer] is liable under section 82A, is excessive having regard to the circumstances.' We ruled, against the Revenue's submission to the contrary, that the Taxpayers should be allowed to proceed on this ground. There is a discretion under section 66(3) vested in the Board to allow a taxpayer, on such terms as the Board may determine, to proceed even on a ground which is not stated in his statement of grounds of appeal.

The ground based on section 82B(2)(c) goes only to quantum, not liability. Liability is assumed under the said provision. In looking at the circumstances, therefore, the Board must be careful not to accept as a 'mitigating factor' what in reality is a denial of initial liability, for example, an allegation that the returns were as a matter of fact not incorrect.

On the other hand it would not stop a taxpayer from showing, for example, how the omission or understatement had occurred, for example, as a result of an error and not wilful evasion. Furthermore, the antecedents of a taxpayer, the nature of his business, the amounts of tax undercharged in relation to the amounts returned, the interest element and the conduct of the taxpayer in response to the tax investigation (including whether he co-operated with the tax authorities) are among the relevant considerations.

In our judgment, there are mitigating factors in the circumstances of this case. Mr A and Mrs A, who gave evidence, are undoubtedly people of humble origins and have no or very little education. Mr A was for many years prior to the commencement of the bookselling business in 1974 a street hawker, selling fruit. His wife was also a street hawker. She sold clothes and continued in that occupation even after the start of the bookselling business. A hard-working and enterprising couple, they have since its inception been running the bookstore virtually all by themselves, wholeselling (as well as retailing) simple Chinese story-books, comics and magazines. They have also for years been engaged in gold, property and share transactions. Whether all these transactions are to be categorised as trading transactions or investments is not a matter which we have to or can decide in this appeal. However, because the assets betterment statement method of assessment was used to ascertain the assessable profits of the bookshop, it became necessary for Mr A and Mrs A to prove their sources of income and, among other things, to establish any alleged gains in these transactions to the assessor's satisfaction (subject to their appeal remedies should they disagree with the relevant assessments). The exercise proved to be an excruciating ordeal for the Taxpayers despite the fact that they engaged an accountant to advise them during the negotiations with the Revenue over the assets betterment statement. Mr A said, with obvious feeling and a deep sense of grievance, that he suffered so much mental anguish that his health failed and that at one point he was almost driven to suicide.

The Revenue can of course in no way be blamed for something which has been brought about by a taxpayer's own default. We are perfectly satisfied that, in the present case, it has brought no undue pressure on the Taxpayers to agree to the final revised assets betterment statement although it was only with reluctance that the Taxpayers signed the

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final assets betterment statement. We are also satisfied that the Revenue did inform the Taxpayers of their legal rights and of the possibility of tax penalties being levied on them, although we think it unlikely that the Taxpayers knew that, if the Commissioner did choose to levy a tax penalty, the conclusiveness of the underlying assessments (if not appealed from) based on the revised assets betterment statement would preclude him from saying that the amounts of assessable profits were other than what had already been agreed, assessed and paid.

In all the circumstances, a significant penalty should still be imposed but, everything considered (including the pleas of hardship made on behalf of the Taxpayers), we think that the penalty charged is excessive for each of the relevant years and we reduce each of the relevant amount by 25%. The appeal is allowed to the extent indicated and the relevant penalty assessments are to be revised to the same extent.