INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D48/89

Penalty tax assessment– reasonable excuse – penalties excessive – section 82A of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Gillian M G Stirling and David Wu Chung Shing.

Date of hearing: 23 June 1989.
Date of decision: 11 September 1989.

For a number of years, the taxpayer failed to file its tax returns on time. Various estimated assessments were issued. The explanation given by the taxpayer was that the profits arose from one large building contract and that the taxpayer had not been able to assess its substantial profits until after the contract had been completed and all accounts relating thereto finalised. The taxpayer submitted that it had a reasonable excuse for delaying the filing of its tax returns for the years of assessment 1984/85 and 1985/86 because it has not been able to finalise its audited accounts because they depended upon the profit made from the contract in question. It was further submitted that if the taxpayer did not have a reasonable excuse, the quantum of the penalties imposed was excessive in the circumstances.

Held:

The taxpayer did not have a reasonable excuse for failing to file its tax returns. It is wrong to say that because of contingencies a company is not able to produce true and fair accounts. The taxpayer should have produced audited accounts and filed tax returns in the usual way and could have taken into account any contingencies which might then have existed. With regard to the quantum of the penalties, the penalty for the first year was approximately 21% and for the second year 18.5% of the maximum penalty. The quantum of the penalties in dollar terms was large but only because the profits were likewise large. It was not considered that penalties of the amount imposed were excessive.

Appeal dismissed.

Woo Sai Hong for the Commissioner of Inland Revenue.
Anthony Lui of Lui, Chow & Co for the taxpayer.

Decision:

This is an appeal by a private limited company against certain additional tax assessments imposed by the Commissioner under section 82A of the Inland Revenue Ordinance. The Taxpayer argues that the penalties should not have imposed because the Taxpayer had a reasonable excuse for not filing tax returns on the due date or alternatively that the quantum of the assessments is excessive.

The facts of the case are as follows:

1. The Taxpayer commenced business in Hong Kong in October 1980.

2. For the year of assessment 1981/82 the Taxpayer failed to submit its profit tax return and the assessor issued an estimated assessment on the Taxpayer on profit of $50,000. A second estimated assessment was then issued in the sum of $60,000 making a total of $110,000. The Taxpayer filed notice of objection to this second assessment and reported taxable profits of $108,341.

3. For the year of assessment 1982/83 the Taxpayer filed its profits tax return which disclosed a loss of $205,451 and this tax return was accepted by the assessor.

4. For the year of assessment 1983/84 the Taxpayer failed to file its profits tax return and the assessor issued an estimated assessment on the Taxpayer on profits of $210,000 against which the carry forward loss of $205,451 was offset making a net taxable profit of $4,549. This estimated assessment was issued on 19 April 1985.

5. On 18 March 1987 the Taxpayer filed its profits tax return for the year of assessment 1983/84 which showed a taxable profit of $752,074. After setting off the above mentioned loss and making certain other adjustments the assessable net profit for the year of assessment 1983/84 was $535,209. Between the issue of the estimated assessment on 17 April 1985 and the eventual filing of a tax return on 18 March 1987 the Inland Revenue Department took no action against the Taxpayer in relation to the Taxpayer's assessable profits for the year of assessment 1983/84.

6. On 1 April 1985 a profits tax return form for the year of assessment 1984/85 was issued to the Taxpayer by the Inland Revenue Department. The Taxpayer failed to return this form in due time and made no application for extension of time.

7. On 23 December 1985 the assessor issued an estimated assessment on the Taxpayer on assessable profits of $250,000 for the year of assessment 1984/85. No objection was lodged against this estimated assessment.

8. On 1 April 1986 a profits tax return form for the year of assessment 1985/86 was issued to the Taxpayer. The Taxpayer failed to submit this return in time or apply for any extension of time.

9. On 20 October 1986 the assessor raised an estimated assessment on the Taxpayer on assessable profits of $1,000,000 for the year of assessment 1985/86. The Taxpayer did not lodge any objection against this estimated assessment.

10. On 16 February 1987 the assessor raised an estimated additional assessment on the Taxpayer in the sum of a further $1,000,000 for the year of assessment 1985/86. No objection was lodged against this further estimated assessment.

11. On 30 April 1987 the assessor raised a further estimated assessment in the sum of $2,000,000 on the Taxpayer for the year of assessment 1984/85 and a third estimated assessment in the sum of $2,000,000 for the year of assessment 1985/86. No objection was lodged by the Taxpayer against either of these estimated additional assessments.

12. On 11 November 1987 the tax representatives for the Taxpayer filed with the Inland Revenue Department tax returns showing assessable profits of $6,264,373 for the year of assessment 1984/85 and $13,333,671 for the year of assessment 1985/86. On 18 December 1987 the assessor issued to the Taxpayer a second additional assessment in the sum of $4,014,373 and a third additional assessment in the sum of $9,333,671 in respect of the two years of assessment 1984/85 and 1985/86 respectively. These two additional assessments were in accordance with the tax returns which the Taxpayer had now filed.

13. On 25 April 1988 the Commissioner gave notice to the Taxpayer that he proposed to assess the Taxpayer to additional tax by way of penalty under section 82A of the Inland Revenue Ordinance in respect of the years of assessment 1984/85 and 1985/86.

14. On 18 May 1988 the tax representatives for the Taxpayer filed with the Commissioner representations on behalf of the Taxpayer. On 27 June 1988 the Commissioner after taking into account the representations filed on behalf of the Taxpayer imposed upon the Taxpayer additional tax under section 82A of the Inland Revenue Ordinance in the sum of $730,000 for the year of assessment 1984/85 and $1,370,000 in respect of the year 1985/86.

On 26 July 1988 the Taxpayer gave notice of appeal against these two section 82A additional assessments.

15. The assessable profits for the two years in question namely 1984/85 and 1985/86 were derived from one contract only. The Taxpayer did not have any other material business during that time.

16. The one contract related to the construction of a large and unique building in Hong Kong. The Taxpayer was a sub-contractor for an American company which had obtained the contract for the supply of a curtain wall for this building. The American principal provided all of the materials and the technology for the curtain wall and it was the job of the Taxpayer to carry out the installation of the curtain wall in Hong Kong.

17. Because of the design criteria for the curtain wall the work to be performed by the Taxpayer was very difficult. The construction method was such that if there were any defects in the curtain wall or if it was necessary to remove any part of the curtain wall for inspection purposes, a large amount of additional work and expense had to be undertaken and incurred by the Taxpayer. Many problems arose in the course of the Taxpayer carrying out its work. To complicate matters further the work done by the Taxpayer was not accepted as being in accordance with the contractual terms until the entire curtain wall had been installed and completed. This meant that the Taxpayer was not able to calculate with any degree of certainty what would be the quantum of claims that might be made against the Taxpayer under its contract nor what would be the cost to the Taxpayer of carrying out any remedial works which might be necessary.

18. The claims and counter claims between the Taxpayer, the American company which was the Taxpayer's principal and the owner of the building were not finally settled until March 1987.

At the hearing of the appeal the Taxpayer was represented by its tax representative. The representative submitted that the Taxpayer had a reasonable excuse for delaying the filing of its tax returns for the years of assessment 1984/85 and 1985/86. The representative said that the tax returns must be supported by audited accounts. He said that likewise the Taxpayer could not object to the estimated assessments without audited accounts. He submitted that because of the extraordinary nature of the business of the Taxpayer it was not possible for the Taxpayer to produce audited accounts. He said that the profit of the Taxpayer came from the one long term contract which involved the years of assessment 1984/85 and 1985/86 and that the business was of an extraordinary nature. He said that numerous claims were made against the Taxpayer under the long term contract which could not be resolved until the long term contract came to an end and that it was not possible to produce accurate accounts which would reflect a true and correct view of the Taxpayer's affairs at that time. He submitted that it was not until March 1987 that agreement was reached between the Taxpayer, its American principal, and the owner of the building.

The representative for the Commissioner drew our attention to the accounting standards applicable to contingencies and said that it is no excuse not to produce audited accounts because there are contingencies. He said that no requests for extension of time to file tax returns had been made by the Taxpayer. He said that in spite of various estimated assessments it was not until 11 November 1987 that the Taxpayer made disclosure of the very substantial profits which it made from this contract. He said that if there were contingencies which would affect the profit of the Taxpayer then the Taxpayer should have taken into account such contingencies when preparing its audited accounts and that the existence of contingencies was not an excuse to simply not produce accounts or file tax returns.

With due respect to the representative for the Taxpayer we are not able to agree with his submissions that the Taxpayer had a reasonable excuse for failing to file its tax returns. It is wrong to suggest that because of contingencies a company is not able to produce true and fair accounts. In the present case if the contingencies were of such a magnitude that the entire profit from the contract was in jeopardy then the Taxpayer should have produced accounts which would have made full provision for the entire profit and would not have brought the profit into final account until after all claims were settled in March 1987. However on the facts before us we would seriously doubt whether the contingencies were of such a vast magnitude. No evidence has been given as to the number or quantum of the claims. From the fact that the Taxpayer accepted the estimated tax assessments and paid them it would appear to us that the Taxpayer was satisfied that its profit from this contract would exceed the amount of the estimated assessments. However it is not necessary for us to speculate in this regard. As we have said, even if the contingencies were of an immense magnitude, full provision could have still been made and there was no excuse not to file tax returns.

Having decided in favour of the Commissioner on this first point it is now necessary for us to consider whether the quantum of the additional assessments imposed under section 82A are excessive having regard to the circumstances. Here again we find in favour of the Commissioner and are not able to say that the penalties are excessive. The Inland Revenue Ordinance imposes substantial penalties of up to three times the amount of the tax undercharged in cases where taxpayers fail in their obligations under the Inland Revenue Ordinance. In this case the Commissioner has imposed a penalty for the year of assessment 1984/85 of $713,000. The tax undercharged in respect of that year was $1,158,909. In respect of the year of assessment 1985/86 the amount of the penalty is $1,370,000 as opposed to the tax undercharged of $2,466,729. In respect of the first year the amount of the penalty is 20.99% of the maximum penalty and in respect of the second year is 18.51% of the maximum penalty.

Obviously the amount of the penalties in dollars is substantial but then the profits and the amount of tax undercharged were likewise very substantial. The Inland Revenue Ordinance provides for penalties based on a multiple of the tax undercharged and not a sum in dollars. Accordingly it is appropriate to calculate the amount of penalties based

on multiples or percentages and naturally where the amount of tax is high the amount of the penalty in dollar terms will likewise be high.

In assessing a suitable penalty under section 82A it is also appropriate to take into account the fact that the Taxpayer totally ignored the Inland Revenue Department and its obligations under the Inland Revenue Ordinance. There was no attempt to explain the difficulties which the Taxpayer was encountering. Had the Taxpayer applied for extensions of time and explained the problems, it is likely that the assessor would have required audited accounts with provisions for the contingencies and that tax could have been assessed on the profit disclosed after taking into account such reasonable provisions as were appropriate at the time. In the event that the assessor considered that the provisions were excessive, he could have taken the matter up with the Taxpayer and an acceptable solution could have been found. Instead the Taxpayer took the law into its own hands and decided that it could not or would not file tax returns until the entire contract had been completed and a final settlement reached between the various parties involved. The Taxpayer unilaterally decided to file its tax returns when it decided it was appropriate to do so without reference to the Inland Revenue Department. The assessor had no way of knowing that the potential profits of the Taxpayer were very substantially in excess of its previously returned profits which formed the basis of the estimated assessments issued by the assessor. Our system of taxation could not continue to operate if taxpayers generally behaved like the Taxpayer did in this case and such conduct cannot be tolerated.

In the circumstances we find that the quantum of the two additional tax assessments imposed under section 82A not to be excessive. Accordingly we dismiss the appeal and confirm the assessments appealed against.