

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D52/93

Penalty tax – incorrect tax return – failure to notify Commissioner – quantum of penalty – section 82A of the Inland Revenue Ordinance.

Panel: Robert Wei Wen Nam QC (chairman), Michael Choy Wah Ying and David A Morris.

Date of hearing: 12 October 1993.

Date of decision: 24 January 1994.

The taxpayer filed an incorrect tax return and failed to inform the Commissioner that he was liable to pay profits tax.

The taxpayer was the sole proprietor of certain businesses. Following an investigation by the Inland Revenue Department it was ascertained that he had not notified the Commissioner that he was chargeable to profits tax and that in respect of two years of assessment he had filed incorrect tax returns. The taxpayer submitted that he was illiterate and had no knowledge of taxation. He further submitted that he had not been able to keep proper accounting records. He further submitted that during the investigation by the Inland Revenue Department he had been very co-operative. The penalty imposed was equal to an amount of approximately 116% of the tax undercharged.

Held:

A penalty of 116% of the tax undercharged was not excessive. Illiteracy and lack of knowledge is no excuse. Likewise it is no excuse to say that you were unable to keep proper records and accounts. With regard to cooperating during the investigation, the Board noted that the taxpayer continued to file incorrect tax returns even when he knew his affairs will be investigated.

Appeal dismissed.

Chan Cheong Tat for the Commissioner of Inland Revenue.

Taxpayer in person.

Decision:

1. In this appeal an individual (hereinafter referred to as the taxpayer) carrying on two businesses (hereinafter referred to as the first business and the second business

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respectively) is appealing against the additional tax assessments (hereinafter referred to as the penalty assessments) raised on him by way of penalty under section 82A of the Inland Revenue Ordinance. The penalty assessments were imposed on him for:

- (i) making incorrect profits tax returns in respect of the first business for the years of assessment 1985/86 and 1989/90;
- (ii) failing to inform the Commissioner of Inland Revenue in writing that he was chargeable to profits tax in respect of the first business for the years of assessment 1986/87, 1987/88, 1988/89 and 1990/91; and
- (iii) failing to inform the Commissioner of Inland Revenue in writing that he was chargeable to profits tax in respect of the second business for the years of assessment 1986/87 to 1990/91.

2. The following undisputed facts are from the statement of facts prepared by the Inland Revenue Department for the purposes of this appeal.

2.1 The Taxpayer was the sole proprietor of the first business which commenced in mid-1983. It consisted of the retailing of Chinese foods.

2.2 In October 1986, the Taxpayer submitted a profits tax return in respect of the first business for the year of assessment 1985/86 declaring that the assessable profits were \$38,824. As he had elected for personal assessment for that year of assessment and in view of the small amount of profits returned, no profits tax assessment was raised.

2.3 On 20 November 1986, the assessor issued a standard letter to the Taxpayer advising him that an annual profits tax return in respect of the first business would not be called for, but he must inform the Commissioner if, among other things, the assessable profits exceeded \$58,000. Paragraph 4 of the letter was in the following terms:

‘Although you are not required to make annual profits tax returns, you are still required by law 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.’

2.4 With a view to reviewing the tax liability of the first business, the assessor issued to the Taxpayer a profits tax return for the year of assessment 1989/90 on 30 April 1990. The Taxpayer on 19 June 1990 completed and submitted the said return, declaring that the assessable profits were \$78,690. Personal assessment was elected by the Taxpayer for the same year of assessment. Again no profits tax assessment was issued for the year of assessment 1989/90 due to the small amount of returned profits. A second standard letter was issued to the Taxpayer on 19 February 1991 advising him, on this occasion, that he would not be asked to make an annual profits tax return for the first business, but he must inform the Commissioner if the assessable profits exceeded \$80,000.

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2.5 In October 1991, the Investigation Unit of the Inland Revenue Department commenced an investigation into the tax affairs of the Taxpayer. On 8 November 1991 the Taxpayer, accompanied by his tax representative and a relative, attended an interview with two investigation officers. In the course of the interview, he disclosed:

- (a) that no proper accounting records in respect of the first business were kept;
- (b) that he also carried on the second business which engaged in the importing of goods from Country A for sale to customers in Hong Kong and Country B upon receipt of purchase orders from the customers; and
- (c) that no proper accounting records were kept in respect of the second business.

The investigation officers then explained to the Taxpayer the penalty provisions of the Ordinance and issued to him profits tax returns for the years of assessment 1985/86 to 1990/91 in respect of the second business. The Taxpayer was also asked to place a deposit sufficient to meet his back duty liabilities with the Commissioner of Inland Revenue within one month from the date of the interview.

2.6 On 11 November 1991 profits tax returns were issued to the Taxpayer in respect of the first business for the years of assessment 1986/87, 1987/88, 1988/89 and 1990/91. On 9 January 1992 the Taxpayer placed a deposit of \$100,000 with the Commissioner.

2.7 On divers dates the Taxpayer submitted profits tax returns with supporting accounts for the years of assessment 1986/87, 1987/88, 1988/89 and 1990/91 in respect of the first business. The returns showed the following particulars:

<u>Year of Assessment</u>	<u>Date of Filing Return</u>	<u>Basis Period</u>	<u>Returned Profits</u>
1986/87	11-1-1992	year ended 31-3-1987	\$137,675
1987/88	26-2-1992	year ended 31-3-1988	\$131,261
1988/89	25-3-1992	year ended 31-3-1989	\$370,224
1990/91	2-5-1992	year ended 31-3-1991	\$278,981

2.8 On divers dates the Taxpayer submitted profits tax returns with supporting accounts in respect of the second business for the years of assessment 1985/86 to 1990/91, which showed the following particulars:

<u>Year of Assessment</u>	<u>Date of Filing Return</u>	<u>Basis Period</u>	<u>Returned Profits</u>
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1985/86	11-1-1992	year ended 31-3-1986	Nil
1986/87	11-1-1992	year ended 31-3-1987	\$82,795
1987/88	28-2-1992	year ended 31-3-1988	\$409,658
1988/89	25-3-1992	year ended 31-3-1989	\$206,291
1989/90	1-4-1992	year ended 31-3-1990	\$538,870
1990/91	2-5-1992	year ended 31-3-1991	\$113,611

2.9 After making extensive enquiries, the assessor informed the Taxpayer on 23 June 1992 that there were discrepancies between her workings in regard to the profits earned by the Taxpayer and the profits calculated by the tax representative as reflected in the profits tax returns and requested the Taxpayer to contact his tax representative to arrange an interview.

2.10 An interview with the Taxpayer and his tax representative was held on 10 August 1992. During the interview the investigation officers advised the Taxpayer and his tax representative that the returned profits of both the first business and the second business were not acceptable in the light of information available to the Revenue. Because of the absence of accounting records, the investigation officers suggested to the Taxpayer that the profits in respect of these two businesses be quantified by way of the assets betterment method. On the basis of the investigation officers' calculation, the Taxpayer agreed during the interview that over the period from 1 April 1985 to 31 March 1991, the assets of himself and his wife had increased by some \$4,000,000. The Taxpayer was also informed that the tax payable would be in the range of \$700,000 to \$900,000 depending on the final betterment profits to be ascertained. The Taxpayer considered that the amount of estimated tax payable was excessive and he also mentioned to the investigation officers that there were many businessmen and smugglers who had failed to pay tax. The investigation officers reminded the Taxpayer that the revenue law requires a person to pay tax if he has profits chargeable to Hong Kong tax. The penalty provisions of the Ordinance were once again explained to the Taxpayer in detail.

2.11 The Taxpayer's tax representative telephoned the investigation officer on 18 December 1992 to explain that he was very busy since the last interview and proposed to arrange another interview for February 1993.

2.12 The investigation officers interviewed the Taxpayer and his tax representative on 3 February 1993. After compromising on certain loans and living expenses, the investigation officers handed a 'Head & Tail Assets Betterment Statement' to the Taxpayer showing betterment profits amounting to \$5,040,957 for the period from 1 April 1985 to 31 March 1991. After due consideration and having obtained assistance from his tax representative, the Taxpayer indicated that he was prepared to accept the betterment profits of \$5,040,957 for his two businesses.

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2.13 During the same interview, the Taxpayer and his tax representative indicated that the betterment profits be allocated in the following manner:

- (a) Returned profits of the second business for the years of assessment 1985/86 to 1990/91 (totalling \$1,351,225) be accepted and left intact; and
- (b) Balance of the betterment profits (\$5,040,957 - \$1,351,225 = \$3,689,732) be apportioned to the first business for the years of assessment 1985/86 to 1990/91 by reference to the respective annual returned sales.

2.14 Witnessed by his tax representative, the Taxpayer signed two settlement statements which set out the betterment profits in respect of the two businesses for the years of assessment in question. In signing the settlement statements, the investigation officers had explained and the Taxpayer had signified his understanding that the case would be submitted to the Commissioner for consideration of penal action under the Ordinance.

2.15 Based on the betterment profits of \$5,040,957 as shown in the Assets Betterment Statement, the assessments for the years of assessment 1986/86 to 1990/91 were revised/assessed as follows:

(a) The First Business

<u>Year of Assessment</u>	<u>Assessable Profits</u> \$
1985/86	298,868 (revised)
1986/87	623,564
1987/88	715,808
1988/89	915,053
1989/90	442,767
1990/91	<u>693,672</u>
	3,689,732

(b) The Second Business

<u>Year of Assessment</u>	<u>Assessable Profits</u> \$
1985/86	Nil (revised)
1986/87	82,795
1987/88	409,658
1988/89	206,291
1989/90	538,870
1990/91	<u>113,611</u>
	1,351,225

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2.16 The following is a comparative table of the assessable profits in respect of the two businesses before and after investigation and the amount of tax undercharged:

(a) The First Business

<u>Year of Assessment</u>	<u>Profit before Investigation</u> \$	<u>Profits after Investigation</u> \$	<u>Profits Understated</u> \$	<u>Tax Undercharged</u> \$
1985/86	38,824	298,868	260,044	50,807
1986/87	-	623,564	623,564	106,005
1987/88	-	715,808	715,808	118,108
1988/89	-	915,053	915,053	141,833
1989/90	78,690	442,767	364,077	66,415
1990/91	-	693,672	693,672	104,050
	117,514	3,689,732	3,572,218	587,218

The percentage of profits understated to total profits assessed after investigation is 96.8%.

(b) The Second Business

<u>Year of Assessment</u>	<u>Profit before Investigation</u> \$	<u>Profits after Investigation</u> \$	<u>Profits Understated</u> \$	<u>Tax Undercharged</u> \$
1986/87	-	82,795	82,795	14,075
1987/88	-	409,658	409,658	67,593
1988/89	-	206,291	206,291	31,975
1989/90	-	538,870	538,870	80,830
1990/91	-	113,611	113,611	17,041
		1,351,225	1,351,225	211,514

The percentage of profits understated to total profits assessed after investigation is 100%.

2.17 On 22 March 1993 the Taxpayer submitted a request to pay the balance of the basic tax of \$698,732 by a down payment of \$300,000 and the balance by monthly instalments of \$50,000. The Taxpayer explained that although the total cash at bank as at 28

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February 1993 was \$1,412,775, he needed to provide money for the purchase of goods. His request was rejected.

2.18 In respect of the first business, the Commissioner on 30 April 1993 gave a notice under section 82A(4) of the Ordinance to the Taxpayer informing the Taxpayer of his intention to assess additional tax by way of penalty in respect of his making of incorrect profits tax returns and his failure to comply with the requirements under section 51(2).

2.19 In respect of the second business, the Commissioner on 30 April 1993 gave a notice under section 82A(4) of the Ordinance to the Taxpayer informing the Taxpayer of his intention to assess additional tax by way of penalty in respect of his failure to comply with the requirements under section 51(2).

2.20 By letter dated 17 May 1993, the Taxpayer's new tax representative submitted on behalf of the Taxpayer written representations to the Commissioner.

2.21 Having considered the Taxpayer's representations, the Commissioner issued on 28 June 1993 notices of assessment and demand for additional tax under section 82A of the Ordinance for the years of assessment in question in the following amounts:

(a) The First Business

<u>Year of Assessment</u>	<u>Tax Undercharged</u> \$	<u>Section 82A Additional Tax</u> \$	<u>Additional Tax as Percentage of Tax Undercharged</u>
1985/86	50,807	64,800	128%
1986/87	106,005	135,100	127%
1987/88	118,108	145,100	123%
1988/89	141,833	163,300	115%
1989/90	66,415	71,700	108%
1990/91	<u>104,050</u>	<u>105,300</u>	101%
	587,218	685,300	117%

(b) The Second Business

<u>Year of Assessment</u>	<u>Tax Undercharged</u> \$	<u>Section 82A Additional Tax</u> \$	<u>Additional Tax as Percentage of Tax Undercharged</u>
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1986/87	14,075	17,900	127%
1987/88	67,593	83,000	123%
1988/89	31,975	36,800	115%
1989/90	80,830	87,300	108%
1990/91	<u>17,041</u>	<u>17,300</u>	102%
	211,514	242,300	115%

2.22 By letter dated 21 July 1993, the Taxpayer gave notice of appeal to the Board of Review against the above assessments to additional tax.

3. The notice of appeal contained the following grounds of appeal:

‘My ground of appeal is that the amount of additional tax imposed is excessive having regard to the circumstances leading to my omission and understatement. In particular, due consideration has not been given by the Commissioner to the following mitigating factors:

- (1) that I am an illiterate person educated to primary school level without the accounting and taxation knowledge required to record my business transactions to satisfy the tax reporting requirements under the Inland Revenue Ordinance;
- (2) that the omission and understatement are due to lack of proper records rather than wilful intention to evade tax; and
- (3) that I have adopted a very co-operative attitude towards the investigating officers of the Inland Revenue Department leading to the early settlement of the case which was based on the arbitrary assets betterment statement prepared by the department with the expectation that my co-operative attitude would be considered favourably by the Commissioner in the assessment of additional tax.’

4. At the hearing, the Taxpayer gave evidence to the effect that he carried on a small business inside a side door, that business transactions were in cash and that there was no room for keeping books and records. Further, he stated that he could not afford to pay the penalties.

5. We first deal with ground (1). Illiteracy and lack of knowledge are not reasonable excuses for failing to keep proper records. We are aware that the Taxpayer is only appealing against the quantum of the penalties, but we do not consider illiteracy and lack of knowledge to be mitigating factors either. It is the duty of a taxpayer to see that proper records are kept either by him or by others for him; failure to perform that duty does not in our view mitigate infringements of section 82A.



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6. As for ground (2), we have already stated in paragraph 5 above that failure to keep proper records is not a mitigating factor. Nor, in our view, is lack of an intention to evade tax, although the presence of such an intention is an aggravating factor.

7. With respect to ground (3), we note that the Taxpayer failed to return his true profits even while his tax affairs were under investigation. As Mr Chan, the Commissioner's representative pointed out, the profits tax returns of the first business for the years of assessment 1986/87, 1987/88, 1988/89 and 1990/91 submitted by the Taxpayer subsequent to the initial interview and in the course of the investigation reported only 31% of the actual profits as shown below:

<u>Year of Assessment</u>	<u>Returned Profits</u> \$	<u>Actual Profits</u> \$
1986/87	137,675	623,564
1987/88	131,261	715,808
1988/89	370,224	915,053
1990/91	<u>278,981</u>	<u>693,672</u>
	918,141	2,948,097

8. Before the commencement of the investigation in October 1991, the Taxpayer filed two returns in respect of the first business: one for the year of assessment 1985/86 declaring assessable profits in the amount of \$38,824 and the other for the year of assessment 1989/90 declaring assessable profits in the amount of \$78,690 (see paragraphs 2.2 and 2.4 above). In each case no profits tax assessment was raised in view of the small amount of the returned profits; in each case he was advised in writing that he must inform the Commissioner if in future years his assessable profits should exceed \$58,000 or \$80,000 as the case might be (see paragraphs 2.3 and 2.4 above). Furthermore, he was warned that he was required by law to keep sufficient records of income and expenditure and to retain such records for at least seven years (see paragraph 2.3 above). The Taxpayer failed to keep sufficient records despite the warning, nor did he inform the Commissioner of his income in subsequent years which without exception grossly exceeded the stated amount (see paragraph 2.16(a) above). Moreover, the declared profits for the year of assessment 1985/86 and the year of assessment 1989/90 were gross understatements (see paragraph 2.16(a) above). After the commencement of the investigation and as a result of the initial interview, the Taxpayer filed four returns in respect of the first business (see paragraph 7 above); even in those cases the returned profits were without exception grossly understated.

9. No return was filed in respect of the second business before the commencement of the investigation in fact the Taxpayer did not inform the Commissioner that he was

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chargeable to profits tax in respect of the second business for the years in question; the profits for those years thus withheld from the knowledge of the Revenue and undercharged were substantial (see paragraphs 2.8 and 2.16(b) above).

10. It was after extensive enquiries over a period of 16 months that the Revenue were able to arrive at the betterment profits to which the Taxpayer agreed (see paragraphs 2.12 to 2.14 above). Viewing the Taxpayer's conduct throughout the history of this case, we do not find him co-operative either before or during the investigation. On the contrary, we find that he displayed throughout an extremely cavalier attitude towards his tax obligations. He may not have had proper records (through his own fault), but he must have had a good idea of the profit he was making, particularly in view of the fact that he was able to agree with the investigation officers that over the six-year period in question, his and his wife's assets had increased by some \$4,000,000 (see paragraph 2.10 above). We accept that the Taxpayer did not deliberately embark upon any tax evasion scheme to defraud the Revenue, but he certainly hoped that, as he had no proper records, he could perhaps get away with paying less tax than he should.

11. As to the ground raised in the course of his evidence that there was no space for the keeping of records, the answer is that he must make room, either in his shop or elsewhere, for the making and keeping of records. We see no merit whatsoever in that ground.

12. The normal measure of a penalty is 100% of the tax undercharged, assuming that there are no aggravating or mitigating factors. Here there are no mitigating factors, but there are aggravating ones (see paragraph 10 above). The penalties in question work out at an average of 116% ( $927,600/798,732$ ) of the tax undercharged; that, in our view, is not excessive.

13. It follows that this appeal is dismissed and that the additional tax assessments in question are hereby confirmed.