

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D57/93

Penalty tax – filing incorrect tax returns – matters to be taken into account when assessing quantum of penalties – section 82A of the Inland Revenue Ordinance.

Panel: T J Gregory (chairman), Douglas C Oxley and David Wu Chung Shing.

Date of hearing: 18 November 1993.

Date of decision: 14 February 1994

The taxpayer filed profits tax returns for his business in respect of a total of six years. Following an investigation by the Inland Revenue Department it was found that the tax returns which had been filed were incorrect. Subsequently the Commissioner imposed penalties amounting to approximately 133% of the tax which would have been undercharged.

Held:

The penalties were not excessive in the circumstances. It was necessary to take into account a number of factors. These include the sophistication of the taxpayer and his business, whether there was an intention to deceive, cooperation by the taxpayer and the use to which the taxpayer has put the unpaid tax. Although the normal penalty in such cases would be an amount equal to the tax which would have been underpaid, in the present case the penalties imposed by the Commissioner were not excessive.

Appeal dismissed.

Cases referred to:

D10/81, IRBRD, vol 1, 404

D18/87, IRBRD, vol 2, 391

D58/87, IRBRD, vol 3, 11

D38/87, IRBRD, vol 2, 422

Chor Hong Chung for the Commissioner of Inland Revenue.

Taxpayer in person.

Decision:

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1. THE SUBJECT MATTER OF THE APPEAL

The Taxpayer appealed against assessments to additional tax imposed under section 82A of the Inland Revenue Ordinance ('the Ordinance') with respect to each of the years of assessment 1983/84 to 1988/89 ('the relevant years').

2. THE FACTS

The following facts were elicited either from the Taxpayer's notice of appeal and/or his evidence.

2.1 The Taxpayer filed profits tax returns with respect to his firm, ('Firm A') for each of the relevant years as follows:

<u>Year of Assessment</u>	<u>Basis Period (year ended)</u>	<u>Date of Filing Return</u>	<u>Profits Per Return</u> \$	<u>Assessed Profits</u> \$
1983/84	31-3-1984	11-6-1984	5,917	107,956
1984/85	31-3-1985	19-7-1985	8,863	111,642
1985/86	31-3-1986	23-12-1986	2,538	63,003
1986/87	31-3-1987	3-10-1987	8,022	119,138
1987/88	31-3-1988	5-5-1988	2,137	171,210
1988/89	31-3-1989	3-5-1989	625	218,966

2.2 On a date unknown to the Board but, patently, prior to 24 April 1990, the Inland Revenue Department ('the Revenue') undertook a review of the Taxpayer's affairs. The Taxpayer was interviewed on 24 April 1990 and, thereafter, on several other occasions, the final interview being on 2 April 1993. In addition to these interviews the Taxpayer was contacted on several occasions, either by telephone or by letter, with requests to supply information. Some information was provided whilst other information, whilst promised, was not provided.

2.3 During the course of these interviews the assessor raised the following estimated assessments on Firm A:

<u>Year of Assessment</u>	<u>Date of Issue</u>	<u>Additional Assessable Profits</u> \$
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1983/84	22-2-1990	100,000
1984/85	26-3-1991	200,000
1985/86	20-3-1992	200,000
1986/87	23-2-1993	350,000

2.4 At an interview on 2 April 1993 the Taxpayer agreed:

2.4.1 To accept an assets betterment statement for the period from 1 April 1983 to 31 March 1988 on the basis of a draft statement previously prepared by the Revenue conditional upon deductions totalling some \$1,667,255 specifically requested by him; and

2.4.2 To accept a betterment profit of \$300,000 for the year of assessment 1988/89.

2.5 A written record of this interview was sent to the Taxpayer for confirmation and comment. This was returned on 13 May 1993 duly signed and without any alterations on the part of the Taxpayer.

2.6 On 4 May 1993 assessments were raised on the basis of the agreement reached at the meeting on 2 April 1993 as follows:

<u>Year of Assessment</u>	<u>Assessment</u>	<u>\$</u>
1983/84	Revised Additional Profits	192,044
1984/85	Revised Additional Profits	188,358
1985/86	Revised Additional Profits	236,997
1986/87	Revised Additional Profits	180,862
1987/88	Additional Profits	128,790
1988/89	Assessed Profits	300,000

2.7 A comparative table of the assessable profits before and after the investigation and the tax under-charged is as follows:

<u>Year of Assessment</u>	<u>Assessable Profits before the Investigation</u>	<u>Assessable Profits after the Investigation</u>	<u>Profits Understated</u>	<u>Tax Undercharged</u>
	\$	\$	\$	\$

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1983/84	107,956	300,000	192,044	39,942
1984/85	111,642	300,000	188,358	45,465
1985/86	63,003	300,000	236,997	51,000
1986/87	119,138	300,000	180,862	44,967
1987/88	171,210	300,000	128,790	32,198
1988/89	<u>218,966</u>	<u>300,000</u>	<u>81,034</u>	<u>19,605</u>
	<u>791,915</u>	<u>1,800,000</u>	<u>1,008,085</u>	<u>233,177</u>

2.8 The returned profits amounted to 56% of the profits assessed as a result of the investigation.

2.9 On 11 June 1993 the Commissioner gave notice to the Taxpayer under section 82A(4) of the Ordinance that he proposed to impose penalties by way of additional tax in respect of each of the relevant years. Having received written representations on 2 July 1993 the Commissioner issued notices and assessments and demands for additional tax under section 82A of the Ordinance for each of the relevant years. These notices and the percentage of the penalty to the tax which would have been undercharged but for the investigation are as follows:

<u>Year of Assessment</u>	<u>Tax Undercharged</u> \$	<u>Section 82A Additional Tax</u> \$	<u>Percentage of Additional Tax to Tax Undercharged</u>
1983/84	39,942	53,900	134.9%
1984/85	45,465	61,300	134.8%
1985/86	51,000	68,800	134.9%
1986/87	44,967	60,700	134.9%
1987/88	32,198	42,300	131.3%
1988/89	<u>19,605</u>	<u>24,100</u>	122.9%
	<u>233,177</u>	<u>311,100</u>	

2.10 By letter dated 16 August 1993 the Taxpayer gave notice of appeal against the above particularised notice of assessment and demand for additional tax.

3. THE CASE FOR THE TAXPAYER

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The Taxpayer was not represented. As, in the opinion of the Board, his notice and grounds of appeal comprised what amounted to a submission, the Board felt it more appropriate to take the Taxpayer through his grounds of appeal, subject to the rights of the Revenue to take exception to any particular question or line of questioning from the Board.

3.1 In-chief:

The Taxpayer's evidence may be summarised as follows although this summary does not necessarily follow the order in which his evidence was given.

3.1.1 Personal particulars:

3.1.1.1 The Taxpayer was born in the People's Republic of China where he completed his secondary school education. He came to Hong Kong in 1963.

3.1.1.2 His wife was born in Hong Kong. He said that her family was poor and her education was minimal.

3.1.1.3 When he came to Hong Kong he obtained employment.

3.1.2 Firm A:

3.1.2.1 Firm A was started by himself and his wife in 1979. Throughout the relevant years its business was the making of Product X. Initially Firm A's customers were local companies who sub-contracted work to it. Later on Firm A acquired at least one client of its own.

3.1.2.2 Before Firm A was established he had friends in the same industry but he had not sought advice from them on organizing a business.

3.1.2.3 When Firm A was first started his wife worked full-time as an instructor whilst he worked part-time, the balance of his time being spent as a driver.

3.1.2.4 During its first year or so Firm A had no direct employees. During this initial period all work was done by individuals who worked from their homes. After that initial period Firm A employed three workers. After a further year or so work was also undertaken by persons working from home. After 1984 Firm A took on six more employees. The maximum number of employees Firm A ever had was about 20.

3.1.2.5 In 1983 Firm A engaged a lady to keep the books. She had no qualifications. However, she was skilled in mathematics and was able to calculate wages. This lady also did the tax returns. She worked for Firm A for about three years whereafter another lady was employed. This lady's employment lasted

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approximately one year. She was not a qualified bookkeeper although she held some form of school leaving certificate. She also did the tax return for that year. When she resigned she was not replaced because of the then scarcity of office staff.

3.1.2.6 After the resignation of the second 'bookkeeper', friends of the Taxpayer or companies offering the necessary services were used or engaged to write up the books on an annual basis. They were also used or engaged to complete Firm A's tax returns. The Taxpayer relied on their professed expertise to complete the tax returns correctly. After the relevant period a limited company with an office was employed for this purpose.

3.1.2.7 Between 1983 and 1992 the monthly bank statements and orders were retained. There was no daily cash journal for 1983 but one was kept whilst 'bookkeepers' were employed. After the second 'bookkeeper' left the bank statements were relied upon and these were checked every month by the Taxpayer.

3.1.2.8 During the period 1985 to 1989 Firm A banked exclusively with one bank and this bank provided the finance required by Firm A for it to be able to operate.

3.1.2.9 The Taxpayer had annexed to his notice and grounds of appeal appendices giving the monthly totals of Firm A's 'Income' and 'expenditure' as extracted from the monthly statements from this bank. He confirmed that the income was the receipts from Firm A's customers and that the expenditure was operating costs. The monthly repayments due to the bank with respect to borrowings to finance the purchase of real estate commenced in the year of assessment 1985/86 and were drawn from this account.

3.1.2.10 Firm A had ceased business after the relevant years. A limited company, 'Firm A Limited' had been incorporated with an authorised and paid up capital of \$100,000, the issued shares being owned equally by the Taxpayer and his wife. Firm A Limited provided the Taxpayer and his wife with their residential accommodation.

3.1.2.11 On at least one occasion the Taxpayer had taken part in a trade promotion to overseas. This particular promotion took place in April 1990.

3.1.3 The Properties:

3.1.3.1 In 1981 a residential unit in Place 1 was purchased at a cost of \$224,000. The purchasers were the witness and his wife. A down payment of 10% was made by the Taxpayer and the balance was financed by a 15-year mortgage from a bank, a bank different to the bank referred to in sub-paragraph 3.1.2.8 above. Throughout ownership the property was rented out. It was sold in 1987 for \$285,000.

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3.1.3.2 In 1988 an industrial unit in Place 2 was purchased for \$850,000. The purchasers were the witness and his wife. The down payment of \$150,000 was made from Firm A's bank account with the bank which provided it with facilities, refer sub-paragraph 3.1.2.8 above. The agreement with this bank was that the balance was to be repaid by monthly instalments over 10 years. The balance owing to Firm A's bank was repaid in 1992 and the property was still in their ownership but was rented out.

3.1.3.3 In 1987 a residential unit in Place 3 was purchased at a price of \$650,000. The purchasers were the witness and his wife. The down payment of \$260,000 was financed out of the proceeds of sale of their then residence in Place S. The balance was financed through a mortgage to Firm A's bank which required monthly instalments over a period of 10 years. This property was also sold in 1992.

3.1.3.4 In 1989 an industrial unit in Place 4 was purchased. The purchasers were the witness and his wife. The purchase price was \$2,169,375 and this was financed by a loan from Firm A's bank totalling \$2,200,000. This loan was to be repaid by monthly instalments over a period of 10 years. This property was sold in 1992 for \$3,100,000.

3.1.4 The investigation:

3.1.4.1 He had not appreciated the obligations assumed when a business was commenced. Initially, it was a very small operation and could not afford to employ a bookkeeper. The Taxpayer had relied on friends or third parties to write up the books at year end and complete the tax returns. Firm A had never made much money as was demonstrated by the fact that its bank account was overdrawn at each year end.

3.1.4.2 He had agreed to the Revenue's proposal with respect to the betterment profit and the apportionment over the relevant years to terminate the investigation. He confirmed that he had been advised that the Commissioner had power to impose penalties.

3.1.4.3 He had read the record of the interview on 2 April 1993 and had signed and returned it.

3.2 Cross-examination:

At the conclusion of the Taxpayer's evidence the Board advised the representative of the Revenue that cross-examination of the witness was unlikely to progress the appeal. The representative indicated that he had questions relating to events subsequent to the relevant years, which the Board indicated would not be allowed, and as to the witness' command of English,

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which the Board indicated would not be regarded as relevant. The representative then indicated that the witness would not be cross-examined.

4. THE CASE FOR THE REVENUE

In a written submission, the representative for the Revenue:

- 4.1 Stated that the Taxpayer had made incorrect returns without reasonable excuse.
- 4.2 There was no substance in the Taxpayer's contention that he had no intention to submit incorrect returns. He had the obligation to provide those who wrote up his books and those he engaged to complete his tax returns with the correct information. He could not pass the blame on to third parties.
- 4.3 The Taxpayer had admitted that he had not kept proper books and records. This, of course, was a factor which had made the investigation more difficult. The fact that the betterment profit was established by means of an assets betterment statement was attributable to the Taxpayer's failure to keep proper records. Throughout the investigation the purpose of an assets betterment statement had been explained to him and, at the final interview, the Revenue had allowed a substantial claim under various heads by the Taxpayer.
- 4.4 The Taxpayer had claimed throughout that the business had made virtually no profit and that this was demonstrated by the fact that his bank account was always overdrawn. The Taxpayer was labouring under a comprehensive misconception. His main source of income had been from the profits of Firm A which had supported his family, permitted the increase in the business assets and enabled payment of the monthly instalments to the bank from which the borrowings for the purchase of real estate had been made. The fact that he had no surplus funds in the bank did not establish that Firm A had not made any profit; he had spent those profits. In computing the betterment profit full allowance had been given for the mortgage loans.
- 4.5 Section 70 of the Ordinance deemed the assessments for the relevant years as final and conclusive for all purposes including sections 82A and 82B. Accordingly, the Taxpayer was precluded from endeavouring to challenge the validity of those assessments.
- 4.6 The Board was also referred to several of its earlier decisions setting out the approach to be adopted by the Board in reaching its decision on appeals of this nature, and refer paragraphs 6.2, 6.3, 6.5 and 6.6 below.
- 4.7 In conclusion the Board was addressed on factors to be taken into account by the Board in assessing the correctness of the penalties including, the degree of sophistication of the Taxpayer and his co-operation during the investigation.

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- 4.8 The Board was also addressed on the purposes of penalties under section 82A, the most important being the ‘deterrent’ effect.
- 4.9 The Board was also requested to accept that an important consideration with respect to penalties was the interest element. An investigation frequently resulted in additional assessments being raised towards the end of the six-year time limit imposed by the Ordinance. It was submitted that the Taxpayer by deferring tax had, de facto, been able to apply the money which ought to have been paid to the Revenue as tax towards the interest incurred with Firm A’s bank under the various mortgages. The Board was advised that the interest paid to the bank amounted to 68% of the tax which would have been paid had the returns been correct. Accordingly, a penalty of 68% of the tax which would not have been recovered but for the investigation would mean that the Taxpayer was no better off or no worse off as a result of the investigation. Accordingly, in this particular appeal it was only that part of the total penalties in excess of 68% of the tax which represented the deterrent factor. It was submitted that on a mathematical basis the cost to the Taxpayer of the penalties was, in fact, 65.4% or approximately one fifth of the maximum which the Commissioner is empowered to impose under the Ordinance.
- 4.10 As the Taxpayer had not put forward any valid excuse the Board was requested to dismiss the appeal.

5. REPLY OF THE TAXPAYER

- 5.1 When he attended the final interview he was not told that he had been engaged in tax evasion.
- 5.2 His wife had been required to attend interviews and he regarded this as a trap.
- 5.3 Based on the profitability of Firm A he had overpaid tax and the penalty was excessive.
- 5.4 To repay the mortgages he had had to borrow from his mother and sisters and he had agreed to the Revenue's proposal to avoid the possibility of them being investigated.

6. REASONS FOR THE DECISION

- 6.1 Section 82B(2) of the Ordinance reads:

‘On an appeal against assessment to additional tax, it shall be open to the taxpayer to argue that:

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- (c) the amount of additional tax ... is excessive having regard to the circumstances.'

6.2 As it is not uncommon in appeals against one or more assessments to additional tax under section 82A, essentially the Taxpayer was dissatisfied with the additional assessments to profits tax to which he had agreed by accepting the betterment profit calculated by the Revenue. However, as the Board stated in D10/81, IRBRD, vol 1, 404:

'If a taxpayer agrees to an assessment for tax founded on an assets betterment statement ... and he pays or is paying the tax so assessed he must be taken to admit that it relates to a liability to which he is chargeable to tax. His liability under the assessment cannot be reopened. It is final and conclusive: section 70.'

6.3 That decision was reaffirmed in D18/87, IRBRD, vol 2, 391. It was stated that a taxpayer who agrees to an assets betterment statement may not adopt a stand in an appeal which necessarily implies that the assets betterment statement was incorrect.

6.4 Accordingly, in this appeal the Board is obliged to consider whether, in the circumstances the assessments to additional tax under appeal were excessive.

6.5 In D58/87, IRBRD, vol 3, 11, the basis upon which the Commissioner assessed his penalties was reviewed, namely the gravity of the case, the loss suffered by the Revenue, the co-operation given by the taxpayer and other relevant considerations.

6.6 In D38/87, IRBRD, vol 2, 422, the Board took into account the sophistication of a taxpayer, the sophistication of a taxpayer's business, the absence of evidence that the scheme was deliberate or designed to conceal the liability to tax and the co-operation of the taxpayer.

6.7 Applying D38/87 to the Taxpayer:

6.7.1 The sophistication of the Taxpayer:

The Board was satisfied that the Taxpayer is an astute businessman. He was sufficiently astute to commence operations in a controlled manner, retaining a separate employment and using home workers whilst Firm A was establishing its reputation and building up the operation as demand increased. Although he may have wished the Board to accept that during the relevant years he ran a marginal operation, basically as a sub-contractor for others, the Board is satisfied that this is far from the case, and refer sub-paragraph 6.7.2 below. The Board is satisfied that he was not a person who was content to wait for others to come and pass down the more simple tasks on a sub-contract basis. He was a

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person with the ability to go out and obtain business and, patently, retain the business he secured. It would be entirely incorrect for the Board to ignore his personal abilities which created and maintained what became a profitable business.

6.7.2 The sophistication of the Taxpayer's business:

Whilst the making of Product X may not be a sophisticated operation in the technical sense, it is an operation which requires careful control of quality and careful control over the use of the materials to maximise the number of Product X capable of being produced from each roll of material. The fact that the business was able to maintain its customers, and thereby able to support the acquisition of the real estate, satisfies the Board that the controls exercised by the Taxpayer and his wife were of a high quality, the mark of a sophisticated operation.

6.7.3 Was it the Taxpayer's intention to deceive the Revenue?

6.7.3.1 It is perfectly clear from the facts that the Taxpayer was the author of his own misfortune.

6.7.3.2 On his own admission, during the relevant years he did not maintain proper books of accounts and, although he was aware of his obligations under the Ordinance, evidenced by his engagement of professional entities to prepare accounts and handle the tax returns, he did no more than rely on these entities to create his accounts from bank statements and papers and documents retained by him. This is a highly risky method of retaining accounts as papers and documents can easily be misplaced or overlooked with the inevitable result that incorrect accounts and tax returns are prepared.

6.7.3.3 The evidence was that Firm A had never employed a proper bookkeeper and that when the second bookkeeper with basic bookkeeping ability resigned it was not possible to replace her because of the then scarcity of employable people. The Board has frequently stated that that is not an excuse. A business has responsibilities under the Ordinance and the proprietor(s) have an obligation to ensure that the business is in a position to discharge those responsibilities. That the existence of these entities in Hong Kong who discharge these duties was known to the Taxpayer but, on his evidence, it was only later in the relevant years that he engaged them.

6.7.3.4 It was clear to the Board that the Taxpayer had convinced himself that the investment in real estate should be treated as separate from Firm A's basic business. However, the fact of the matter is, as the Revenue submit, that the profits from Firm A's business activities financed the acquisition by the Taxpayer and his wife, as opposed to Firm A, of the real estate. As the representative for the Revenue pointed out, that burden was somewhat

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lightened by moneys which ought to have been paid by way of tax were being applied towards that expense.

6.7.3.5 The Board is not satisfied that there was a deliberate intention to evade tax although the Board is satisfied that the witness was far more astute than he would have liked the Board to believe.

6.7.4 Co-operation of the Taxpayer:

On the facts the Board is unable to find that the Taxpayer had fully co-operated with the Revenue. The fact that he did not maintain full accounts and records would have precluded him from being fully co-operative, if co-operation is viewed from the perspective of the Commissioner. However, what, apparently, the Taxpayer failed to do was to accept that he would be unable to meet the Commissioner's requirements. Had he done so at an earlier date the investigation could, perhaps, have been concluded more rapidly. In that respect his co-operation was deficient.

6.8 Are the additional assessments excessive?

6.8.1 The Board would normally expect the maximum assessment to be no more than the amount of tax which would have gone unrecovered but for the investigation or, to put it another way, one third of the maximum penalty permitted by the Ordinance.

6.8.2 In many cases the taxpayer has either supported an unprofitable business with the money which ought to have been paid by way of tax or simply dissipated the taxable income. Those are not reasons to find a penalty excessive.

6.8.3 This appeal differs as, as the Revenue pointed out in its submission, the moneys which ought to have been paid to the Revenue for tax have been gainfully applied, namely to meet obligations to Firm A's bank in respect of principal and interest on the loans advanced to finance the real estate. In this instance it is perfectly clear that the Taxpayer has been considerably advantaged. The Commissioner might well be expected to take a more serious view of a case in which a distinct advantage has been obtained by the filing of returns understating the taxable income.

6.8.4 In light of the foregoing the Board is of the view that although the penalties are in excess of an amount equal to the tax which would have been unrecovered but for the investigation, the Taxpayer has not established any circumstances which would lead the Board to the conclusion that the additional assessments to tax under section 82A are excessive or that the Taxpayer has been so unfairly or harshly treated by the Commissioner as to merit some reduction to the penalty.

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7. DECISION

For the reasons given the Board dismisses this appeal.