Case No. D59/96

Penalty tax – whether 3.55% penalty excessive – mitigating and aggravating circumstances – whether 5% surcharge under section 71(5) minimum penalty under section 82A(1).

Panel: Kenneth Kwok Hing Wai SC (chairman), Anthony N C Griffiths and Tse Tak Yin.

Date of hearing: 18 September 1996.
Date of decision: 25 October 1996.

The taxpayer was 4 months and 10 days late in submitting its profits tax return. The Board found that the taxpayer had not proved the fact alleged to constitute a reasonable excuse. On the issue whether 3.55% ($100,000) penalty was excessive having regard to the circumstances:

Held:

That the 5% surcharge under section 71(5) is not and should not be the minimum penalty under section 82A(1); that the Board must have regard to the actual circumstances; that the purpose of enforcing the submission of returns on time is a means to an end; that section 82A is not and must not be used as a means to generate revenue; that a clear record and that there was no actual loss of revenue are mitigating factors of some importance; that the fact that the taxpayer was tardy in its responses and that the taxpayer persisted in its hopeless appeal on liability were aggravating circumstances; and that the penalty was reduced to 1% ($28,187).

Appeal allowed.

Cases referred to:

D33/89, IRBRD, vol 4, 359
D11/93, IRBRD, vol 8, 143
D42/93, IRBRD, vol 8, 318
D31/94, IRBRD, vol 9, 196
D64/94, IRBRD, vol 9, 361
D24/94, IRBRD, vol 9, 226

Wong Yan Man for the Commissioner of Inland Revenue.
Felix Lee of Messrs Andrew Ma & Co for the taxpayer.

Decision:

1. This is an appeal against the assessment dated 15 April 1996 by the Commissioner of Inland Revenue, assessing the Taxpayer to additional tax under section 82A of the Inland Revenue Ordinance, chapter 112 ('the IRO'), in the sum of $100,000.

2. The year of assessment is 1994/95 ('the relevant year of assessment'). The relevant provision is section 82A(1)(d) in respect of the requirements of the notice given to the Taxpayer under section 51(1) of the IRO to furnish profits tax return. The amount of tax involved is $2,818,764. $100,000 is 3.55% of the amount of tax involved.

The facts

3. From the agreed 'Statement of Facts', the agreed 'Statement of Facts – Additions', and the documents placed before us at the hearing, we make the following findings of fact.

3.1 The Taxpayer was incorporated in Hong Kong on 14 September 1989 and commenced business on 11 October 1989. It carried on the business of a gem dealer.

3.2 The Taxpayer closes its accounts annually on 31 July.

3.3 The Taxpayer's record in the submission of profits tax returns is as follows:

Year of Assessment	Date of Issue of Return	Deadline for Submission	Date of Receipt of Return	No of Days Late
1991/92	1-4-1992	1-5-1992	15-5-1992	14
1992/93	1-4-1993	1-5-1993	4-5-1993	3
1993/94	6-4-1994	6-5-1994	10-5-1994	4

3.4 On 3 April 1995, a profits tax return for the relevant year of assessment ('the Return') was issued to the Taxpayer under section 51(1) of the IRO, requiring the Taxpayer to complete and return the same within 1 month from that date.

3.5 On 16 June 1995, an estimated profits tax assessment was issued for the relevant year of assessment under section 59(3) of the IRO in the amount of $15,670,000 with tax payable thereon of $2,585,550. The due date for payment of tax for the relevant year of assessment and provisional tax for the year of assessment 1995/96 in the sum of $2,820,822 was 6 November 1995.

3.6 No objection to the estimated assessment was lodged by the Taxpayer.

3.7 On 25 July 1995, the Inland Revenue Department ('IRD') received the Return (with profits tax computation, and an unsigned balance sheet and profit and loss account) showing assessable profits of US$2,211,017 (equivalent to HK$17,083,422, converted at $7.7265). However, it was not a complete Return as it was not supported by audited accounts. In a covering letter dated 24 July 1995, the Taxpayer's Representative informed IRD that the audited accounts were being arranged for signature by the directors overseas and would be submitted to IRD as soon as possible when they were in hand.

3.8 The audited accounts were received by IRD on 13 September 1995, that is to say, the delay was 4 months and 10 days.

3.9 The Return was accepted by IRD as correct and on 6 October 1995, the assessor raised an additional profits tax assessment for the relevant year of assessment under section 60 of the IRO in the amount of $1,413,422 ($17,083,422 - $15,670,000). The due date for payment of tax in the sum of $466,428 was 30 November 1995.

3.10 No objection to the additional assessment was lodged by the Taxpayer.

3.11 Tax in the sum of $2,820,822 assessed under the estimated assessment was duly paid by the Taxpayer on 6 November 1995.

3.12 Tax in the sum of $466,428 assessed under the additional assessment was duly paid by the Taxpayer on 30 November 1995.

3.13 On 29 February 1996, the Commissioner gave notice to the Taxpayer in terms of section 82A(4) of the IRO that he proposed to assess the Taxpayer to additional tax by way of penalty for the relevant year of assessment in respect of the failure to comply with the requirements of the notice given to it under section 51(1) of the IRO.

3.14 On 21 March 1996, IRD received written representations from the Taxpayer's Representative.

3.15 On 15 April 1996, the Commissioner, having considered and taken into account the Taxpayer's representations, assessed the Taxpayer to additional tax under section 82A of the IRO in the sum of $100,000 for the relevant year of assessment ('the Assessment'). The due date for payment was 16 May 1996.

3.16 Additional tax in the sum of $100,000 was duly paid by the Taxpayer on 15 May 1996.

3.17 By letter dated 10 May 1996 and received by the Board of Review on 13 May 1996, the Taxpayer lodged its appeal against the Assessment on the ground that the Assessment was excessive.

3.18 There is no actual loss of revenue in this case. This was conceded and confirmed by the Representative for the Commissioner who also acknowledged that the normal due dates, that is, due dates for payment of tax in cases where the returns were submitted on time were around the period from 6 to 30 November 1995.

The hearing

4.1 At the hearing before us, the Taxpayer produced a bundle of copy documents marked 'A-1'. The Taxpayer did not call any witness to give oral evidence.

4.2 The Commissioner adduced no evidence, whether oral or written.

4.3 The Representative for the Taxpayer contended that:

(a) The Taxpayer had a reasonable excuse for the delay in that:

> 'The reason that [the Taxpayer] had not filed its tax return for the year of assessment 1994/95 and relevant audited financial statements on time was because [the Taxpayer] had, for the first time, encountered difficulties in obtaining in good time all the relevant financial information and documentation from its overseas associated companies which were located in five different countries namely Countries A, B, C, D and E. During the financial year ended 31 July 1994, [the Taxpayer] had increased and diversified significantly in its investments in overseas companies, the costs of which had increased from US$1,579,877 to US$3,025,863. These financial information and documentation from the overseas companies were required by [the Taxpayer's] auditors before they could finalise and complete [the Taxpayer's] audited financial statements. In these circumstances, [the Taxpayer's] audited statements for the year ended 31 July 1994 could only be completed and sent to the directors overseas for their signatures in August 1995 and finally these were filed with [IRD] on 12 September 1995.'

(b) The penalty in the sum of $100,000 was excessive having regard to the circumstances.

4.4 The written submission of the Commissioner drew our attention to sections 51(1), 82A(1)(d) & (ii), and 68(4) of the IRO, and 5 decisions of the Board of Review, namely:

(a) D33/89, IRBRD, vol 4, 359,

(b) D11/93, IRBRD, vol 8, 143,

(c) D42/93, IRBRD, vol 8, 318

(d) D31/94, IRBRD, vol 9, 196, and

(e) D64/94, IRBRD, vol 9, 361.

Our Decision

Issue under section 82B(2)(a)

5.1 The first issue for our decision is whether the Taxpayer was liable for additional tax.

5.2 The excuse put forward is that (emphasis added):

> 'because [the Taxpayer] had, for the first time, encountered difficulties in obtaining in good time all the relevant financial information and documentation from its overseas associated companies which were located in five different countries namely Countries A, B, C, D and E.'

5.3 Note 3 of the 'Notes to the Financial Statements 31 July 1994' listed interests in the following 6 overseas associated companies for the relevant year of assessment:

Name	Place of Incorporation	Percentage of Issued Equity Shares Held	
		1994	**1993**
(1) 'B'	Country B	50%	50%
(2) '1st A'	Country A	50%	50%
(3) 'C'	Country C	50%	50%
(4) 'D'	Country D	50%	50%
(5) 'E'	Country E	50%	50%
(6) '2nd A'	Country A	40%	-

5.4 While the Taxpayer might have acquired more shares during the relevant year of assessment in one or more of first 5 overseas associated companies with a corresponding increase in the issued share capital of such company or companies (a matter upon which there is no evidence), the only new overseas associated company is the 6th, namely '2nd A', which was incorporated in Country A, the same as that of '1st A'.

5.5 The audited accounts for the year of assessment preceding the relevant year of assessment were qualified by the auditors (also the Representative for the Taxpayer) in, inter alia, these terms:

> 'We were unable to inspect the relevant documentation in respect of the cost of [the Taxpayer's] investment in an overseas associated company amounted to US$500,000.'

> 'We were unable to inspect share certificates which were kept overseas in respect of [the Taxpayer's] investments in overseas associated companies as at 31 July 1993. Furthermore, the results of [the Taxpayer's] overseas associated companies and the information relating to the equity method of accounting for these overseas associated companies are not disclosed in the financial statements as no current financial information on these overseas associated companies were available (Note 3 to the financial statements refers). This is not in accordance with the Statement of Accounting Practice No 10 issued by the Hong Kong Society of Accountants. We were therefore unable to ascertain the underlying value of [the Taxpayer's] investments in these overseas associated companies, the cost of which had been incorporated in the financial statements to the extent of US$1,579,875.'

5.6 For the year preceding the relevant year of assessment, the Taxpayer did not have any then current financial information on any of the 5 overseas associated company. Thus, any difficulty which the Taxpayer might allegedly have encountered subsequently in respect of the relevant year of assessment in obtaining relevant financial information and documentation cannot possibly be the first encounter, at least not in relation to the same 5 overseas associated companies. Further, it is noteworthy that the return for the year preceding the relevant year of assessment was received by IRD by 4 days after the due date.

5.7 The only new overseas associated company, '2nd A' was incorporated in Country A, the same as that of '1st A'.

5.8 'A-1' comprises an incomplete selection of correspondence, with no explanation having being offered for omitting potentially relevant documents referred to in the documents included in 'A-1', and with obvious gaps all over the place. On the basis of 'A-1':

(a) By letter dated 22 February 1995, the Representative for the Taxpayer requested certain information and documents from the Taxpayer in respect of '2nd A'.

[pages 1-2 (3b)]

(b) The Taxpayer responded to the requests by letter dated 10 July 1995.

[page 19 (3b)]

(c) The Taxpayer further responded on 12 July 1995.

[page 21 (2nd)]

(d) By fax dated 14 July 1995, the Taxpayer's Representative enclosed 'financial statement of '2nd A' and asked whether the number of shares held should be 400

instead of 40 if the percentage shareholding was 40% since the issued share capital of 'A-2' was 1,000 shares.

[page 23 (2)]

(e) By fax dated 19 July 1995, the Taxpayer's Representative stated that:

'Please advise if you will send us the latest accounts of 'C' for our audit purposes. If not, we will only incorporate the financial information of ... and '2nd A' under the equity method in [the Taxpayer's] audited accounts for the year ended 31 July 1994'

[page 24 (2)]

(f) By fax also dated the 19 July 1995, the Taxpayer told its Representative that the Taxpayer had 400 shares, not 40, and that its Representative was correct.

[page 27 (4)]

(g) It is clear from Note 3 of the Notes to the Financial Statement that '2nd A' was not one of the 3 overseas associated companies in respect of which no current financial information were available.

[page 23 of the documents attached to the agreed Statement of Facts]

5.9 On the basis of the materials placed before us, the Taxpayer had responded to all the queries by its Representative in respect of '2nd A' to his apparent satisfaction by 19 July 1995.

5.10 In the light of the above, we deprecate the Taxpayer and its Representative for having the audacity to put forward the following assertion of fact in support of their contention of having a reasonable excuse, that is to say, that the Taxpayer:

> 'for the first time encountered difficulties in obtaining in good time all the relevant financial information and documentation from its overseas associated companies.'

5.11 Under sections 82B(3) and 68(4) of the IRO, the burden of proving that the Assessment is incorrect is on the Taxpayer. We find that the Taxpayer has not proved the fact alleged to constitute a reasonable excuse. If anything, the Taxpayer has disproved the alleged fact.

5.12 The Representative for the Taxpayer cited no authority on what constituted 'reasonable excuse'. Indeed, the Representative cited no authority at all.

5.13 The Taxpayer's case on the first issue is frivolous and vexatious, obviously unsustainable, an abuse of the process of appeals to the Board of Review, a waste of time and resources of the Board of Review, a waste of public funds and a waste of time, costs and resources of IRD. In our decision, the Taxpayer fails on the first issue, and fails miserably.

Issue under section 82B(2)(c)

6. The second issue for our decision is whether the Assessment was excessive having regard to the circumstances.

7. We do not consider any of the authorities cited on behalf of the Commissioner to be of any real assistance to us. The circumstances were very different, or the reports were too brief on this issue.

7.1 In D33/89, there was a delay of 12 months, with a history of delays of more than 4 months and almost 5½ months for the preceding 2 years. The Board upheld a penalty of $170,000 with the amount of tax undercharged being $457,292 (which we work out to be 37.18%).

7.2 In D11/93, there was a delay of what the taxpayer in that case said was 'only a few months'. The Board upheld a penalty of just over 20% on the ground that the managing director decided that it was more important to spend time visiting customers, clients, and vendors of his company than it was in filing tax return for the company.

7.3 In D42/93, there was a delay of over 3½ months, with a history of delay in the preceding 5 years. The Board reduced the penalty of 14.66% to 10% on the ground that the taxpayer in that case paid too much tax under the estimated assessment.

7.4 In D31/94, there was a delay of 1½ months, with a history of late filing in previous years ranging from approximately 2 months to over 7 months. The Board held that 8.74% (the reference in the headnote to 10% appears to be mistaken) was not excessive in the circumstances of that case.

7.5 In D64/94, the Board held at page 368 that 6% was:

> *'not unreasonable given the shortness of the delay. This is particularly so in view of the fact that a surcharge of 5% is routinely imposed on taxpayers who fail to make payment on the due date, even if the delay is one day only, and in cases where the unpaid assessment was made without there having been any default on the taxpayer's part.'*

D24/94, IRBRD, vol 9, 226

8.1 Neither party cited D24/94 where there was a delay of 1 month and the Board reduced the penalty from 3.2% ($80,000) to 0.2% ($5,000). The Board in that case noted that the Revenue accepted that the taxpayer was not seeking to evade tax; that it was not a

series of failures on the part of the taxpayer to file a return within time; that a request for an extension of time, admittedly at the 11th hour, was rejected even though the management accounts had been filed; that it was an agreed fact that the tax payable by the taxpayer for the relevant year was paid within the time it would have been payable had the return been filed within time; that the Board appreciated that the tax computation and its supporting schedules was not lodged until the return was lodged but the only likely practical effect of that was that the profit disclosed by the management accounts was likely to exceed the taxable profit, as was the fact in that appeal; that the 1st estimated assessment was issued after the management accounts had been filed but this assessment, according to the Revenue's representative, was the product of a computer system and it was superseded almost immediately by a revised assessment based on the profit disclosed by the management accounts and that the Board was satisfied that the taxpayer was treated with undue harshness and that whilst some penalty was merited a penalty of $80,000 was, in the particular circumstances applicable to that appeal, excessive.

8.2 The circumstances of this case are by no means on all four the same as those in D24/94. The Representative for the Commissioner sought to distinguish it on the ground that no management accounts had been submitted. But the Taxpayer did submit the Return (with profits tax computation, and an unsigned balance sheet and profit and loss account) on 25 July 1995 (although 2 months and 22 days late), and the Return was accepted by the Commissioner as correct.

D64/94 and the section 71(5) 5% surcharge

9. We do not understand D64/94 or any of the cases cited by the Representative for the Commissioner as deciding that having regard to the surcharge of 5% under section 71(5) of the IRO, 5% is or should be the minimum penalty under section 82A(1). If the Legislature had intended a 5% minimum for section 82A(1), it would have enacted such minimum in express terms, and would not have provided in section 82B(2)(c)the 'it shall be open to the taxpayer to argue that ... the amount of additional tax ... is excessive having regard to the circumstances'. To read in a 5% minimum is to make nonsense of the discretion of the Board under section 82B(2)(c) to consider the question of excessiveness having regard to the circumstances. Further, there is actual loss of revenue in a section 71(5) case, but there may be no intended and no actual loss of revenue in an additional tax case.

Circumstances of this case

10.1 In deciding the question under section 82B(2)(c) whether the amount of additional tax is excessive having regard to the circumstances, we must have regard to the circumstances.

10.2 Circumstances are actual, not hypothetical.

10.3 The purpose of enforcing the submission of returns on time is a means to enforce payment of the correct amount of tax on time, not an end in itself.

10.4 Section 82A is not and must not be used as a means to generate revenue.

10.5 Nor should it be used or abused to oppress, harass or bully taxpayers or their tax representatives.

10.6 A clear record is a mitigating factor of some importance.

10.7 So is the fact that there is no actual loss of revenue.

10.8 The 'punishment' must fit the 'crime'.

11. The delay in this case was 4 months and 10 days.

12. There are the following mitigating circumstances:

(a) The Commissioner expressly stated that it was not his case that the late filing was a deliberate act to postpone the payment of tax.

(b) The Taxpayer's record (see 3.3 above) in the submission of returns is almost as good as, but not, a clear record.

(c) There is no actual loss of revenue.

(d) The significance of the issue of the estimated assessment lies in the fact that IRD should and did receive the tax assessed thereunder. To the extent that issuing the estimated assessment brought about extra work and expense on the part of IRD, the Taxpayer must pay for it.

(e) The Taxpayer did not object to the estimated assessment or the additional assessment. Thus, IRD has not been burdened by having to deal with any objection.

(f) The Taxpayer submitted the Return on 25 July 1995. Although it was incomplete in that there was no audited accounts and although it was 3 months and 22 days late, it showed that the Taxpayer did make an effort to comply with its duty to report its tax position. Further, IRD accepted the Return as correct. The work in computing the additional assessment should not have been materially different from the work involved in assessing on the basis of a return submitted on time, the only extra work being to deduct the tax assessed under the estimated assessment and the Taxpayer must pay for this extra work.

(g) Tax under the estimated assessment and additional assessment had been duly paid. This is not a mitigating factor in itself, but it completes 'the chain' in coming to the conclusion that there is no actual loss of revenue in this case.

(h) The additional tax of $100,000 was paid on 15 May 1996. To the extent that we see fit to reduce the Assessment, IRD will have gained an element of interest.

13. But for the following factors, we would have further reduced the Assessment:

(a) The Taxpayer was tardy in responding to the requests by its Representative for information and documents and the Taxpayer could have reported its tax position and submitted the audited accounts earlier than the 25 July 1995 and the 13 September 1995.

(b) The fact that the Taxpayer persisted in its hopeless appeal on liability. This aggravating factor is mitigated by the fact that the Taxpayer succeeds on the appeal on 'quantum'.

14. For the reasons given above, in our decision, we consider that the penalty of $100,000 (3.55%) is excessive having regard to the circumstances; allow the appeal and reduce the Assessment to $28,187 (1%).

15. Lastly, we record our indebtedness to Ms Wong and her colleague for their assistance given to us at the hearing of this appeal.