Case No. D69/97

Penalty tax – delay by corporate taxpayer in filing profits tax returns – whether penalty tax assessments excessive or incorrect.

Panel: Robert Wei Wen Nam SC (chairman), Mathew Ho Chi Ming and Mitzi Leung Leung Mei Chee.

Date of hearing: 3 September 1997.
Date of decision: 29 October 1997.

An additional (penalty) tax assessment for the year of assessment 1994/95 was raised on the taxpayer, a private limited company, for failing to file its profits tax return within the time specified. Its main contention is that there was a deadlock between F and C, its only two shareholders and directors and that, as a result, the taxpayer was unable to comply with its statutory obligation of filing the return within time under section 51(1) of the Inland Revenue Ordinance (the IRO). The Board took the view that under section 57(1) of the IRO the directors were collectively and singly answerable for carrying out the company's obligations imposed by the IRO. It was common ground that it was necessary for both F and C to sign the audited accounts before they could be filed together with the return. Without both their signatures on the audited accounts, the return could not be filed. C did not sign the audited accounts until about 17 April 1996, with the consequence that the taxpayer failed to file its profits tax return on or before 3 May 1995, the expiry date for filing the return.

Held:

The question is whether both F and C, the only two directors of the taxpayer, took all reasonable steps to carry out the statutory obligation on behalf of the taxpayer. If the answer is yes, the taxpayer has a reasonable excuse for the failure to file the profits tax return in time. If the answer is no, there will be no reasonable excuse. On the facts, neither F nor C took all reasonable steps to resolve the impasse or to have the return filed in time. There was therefore no reasonable excuse for its failure to file the return within time, nor was the penalty, being 9.3% of the tax undercharged, excessive.

Appeal dismissed.

Cases referred to:

D53/93, IRBRD, vol 8, 383 at 389
D2/88, IRBRD, vol 3, 125 at 130

B J Brown for the Commissioner of Inland Revenue.
Howard Wong of Messrs Alan Lam & Norris Yang for the taxpayer.

Decision:

Nature of appeal

1. This is an appeal by a private limited company (the Taxpayer) against the additional tax assessment raised on it for the year of assessment 1994/95 for failing to file its profits tax return within the time specified. Its main contention is that there was a deadlock between its only two shareholders and directors and that, as a result, the Taxpayer was unable to comply with its statutory obligation of filing the return within time under section 51(1) of the Inland Revenue Ordinance (the IRO).

Facts agreed or not in dispute

2. The Taxpayer was incorporated in Hong Kong on 7 March 1989. At all material times, it had two shareholders, F and C, each holding 50% of the issued capital. They were also the only two directors of the Taxpayer.

3. F and C were also the only two shareholders in A Ltd, each holding 50% of the issued capital. Likewise, F and C were directors of A Ltd. The other director B was inactive and was not a resident in Hong Kong.

4. Both the Taxpayer and A Ltd close their accounts on 30 April.

5. Sometime in November 1994, differences developed between F and C. C decided to withdraw his participation in the affairs of the Taxpayer and A Ltd. As a result, there was a deadlock between them and the business of the Taxpayer and A Ltd came to a standstill. In order to resolve the impasse, F retained his solicitors and offered to take over C's shares in the Taxpayer.

6. By a letter dated 6 December 1994 and written by his solicitors to C, F started negotiations by offering to buy all C' shares in the Taxpayer and A Ltd at a valuation in accordance with the audited financial statements as at 30 November 1994.

7. Negotiations continued until July 1996 when final agreement was reached for the purchase by F of C's shares in the Taxpayer and A Ltd at a valuation based on the management accounts as at 30 November 1994.

8. The negotiations were interspersed with arguments concerning the inspection and signing by C of the audited accounts of the two companies for the accounting period ended 30 April 1994 which were sent to C for his signature in anticipation of the profits tax returns for the year of assessment 1994/95.

9. By letters dated 11 and 20 March 1995, A Ltd and the Taxpayer through their solicitors respectively requested C to sign the audited accounts. By a letter dated 24 March 1995, C's solicitors replied, inter alia, as follows:

> 'Our client however has already made it clear to your client on 15 March 1955, that although in principle he would have no objection in signing the financial statements for the Companies, he must be satisfied first that the financial statements reflect the true position of the Companies and has indicated to your client that he would like to examine the accounts of the Companies together with his own accountant.
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> ...
>
> We would mention very clearly that the suggestions which were made by your client that our client should pay for the use of the premises during the time of inspection as well as for electricity and time spent by the staff of the Companies in producing vouchers and other documents is (sic) not to be borne by our client, although our client will of course pay the cost of his own accountant.
>
> Once our client is satisfied that the financial statements represent the fair state of the financial affairs of the Companies, our client will sign the financial statements in the state they are at present, if no modification is to be made after the examination which he would have made, or otherwise in the form which will then reflect the true state of affairs of the Companies.'

10. On 3 April 1995, the Inland Revenue Department issued to the Taxpayer a profit tax return form for the year of assessment 1994/95, requiring it to complete and return the form within one month from 3 April 1995, together with a certified copy of the balance sheet, auditor's report and profit and loss account and a tax computation.

11. On 10 April 1995, the Taxpayer's tax representative wrote to the Commissioner of Inland Revenue requesting an extension of time to 3 June 1995 for filing the Taxpayer's profits tax return for the year of assessment 1994/95 'as the directors are looking into the detailed affairs of the company to ensure correctness of the financial statements.'

12. On 11 April 1995, the Taxpayer's solicitors wrote to C's solicitors requesting C's accountant to contact the Taxpayer's accountant for inspection of the books and accounts and stating that 'our client shall charge your client for any unnecessary expenses incurred by any unreasonable and excessive disruption in the matter herein', that the

deadline for filing the tax returns were respectively ’16 and 29 April 1995’ and that ‘our client shall hold your client liable for any penalty for delay in this respect.’

13. On 20 April 1995, C’s solicitors replied, complaining about the lateness of the letter dated 11 April 1995 and stating:

> ‘It is out of the question that our client should sign accounts which have not been verified by him. Any penalty imposed must rest squarely on your client who has unreasonably denied access to the accounts to our client.
>
> As to the charging of “unnecessary expenses” we would remind you that any such expense which the Companies may see fit to claim would require the approval of the Board of the Companies. Our client, as Director, would oppose the passing of any resolution which would seek to obtain any payment from him for verifying the accounts of the Companies in circumstances when he is perfectly justified and entitled to such verification.’

14. On 22 April 1995, the Taxpayer’s solicitors wrote to C’s solicitors stating that the Taxpayer and A Ltd had in mid-January 1995 requested C to sign the audited financial statements and had subsequently through their solicitors sent letters to C dated 11 and 20 March 1995 respectively, that C had taken an unreasonable approach to the matter and that the reason for C to request inspection of the accounts before signing the audited financial statements could be ‘either that he wanted to make life more difficult or that he wanted to strengthen his bargaining power in the proposed takeover.’ The letter further stated, inter alia:

> ‘We have to emphasize that whilst our clients recognize your client’s right to inspect the accounts in case of doubt, your client’s right must be exercised with good reasons in a proper and reasonable manner. Your client has never raised any doubt to any part of the audited financial statements. If your client is casting doubt on the whole audited financial statements, he is also casting doubt on the integrity of the Companies auditor because the very purpose of auditing the accounts is to protect the shareholders.
>
> In such circumstances, our clients are of the view that if your client could not find out any major faults or doubts on the audited financial statements, any expenses incurred by the Companies in entertaining your client’s request will be a waste of the Companies’ resources and time and become “unnecessary expenses”. Any delay as a result thereof that attracts penalty from the Government will also become “unnecessary expenses”. We cannot see why such unnecessary expenses should be borne by the Companies rather than by your client ...
>
> As such, we have no alternative but to reiterate our clients’ definite instruction that they shall charge your client for any unnecessary expenses incurred by any unreasonable and excessive disruption in the matter herein.’

15. On 26 April 1995, C' solicitors replied to the letter dated 22 April 1995, stating, inter alia, that before signing the financial statements, C would like to satisfy himself that they reflect the true position of the Companies, and that they were confused by the contention that C only had the right to inspect the accounts 'in case of doubt'. The letter went on to point out that section 121(3) of the Companies Ordinance provides that the books of account must at all times be open to inspection by the directors. The letter further stated:

> 'Finally, our client is certainly not wishing to make life more difficult for your client, or wanting to strengthen his bargaining power. He merely wishes to safeguard his position and wishes to exercise his statutory right, as set out in section 121 of the Companies Ordinances ...'

16. On 28 April 1995, the Taxpayer's solicitors replied to the letter dated 26 April 1995. The reply ended by stating:

> 'We hereby reiterate that should your client intend to inspect the accounts, he may contact Company B (the Taxpayer's accountants) at once.'

17. On 1 May 1995, C's solicitors replied to the letter dated 28 April 1995, stating, inter alia:

> '...Our client has repeatedly asked for access to the accounts which your client has not denied but has made subject to conditions and restrictions which our client has found unacceptable.
>
> ...
>
> It is however now noted that our client may inspect the books of account at the offices of the auditors of the Company without our client having to bear personally "expenses" in relation to such inspection and arrangements will now be made for this inspection to take place as speedily as possible...'

18. On 6 May 1995, the Taxpayer's solicitors wrote stating, inter alia:

> 'We see the need to clarify your misunderstanding to our previous correspondence.
>
> Our clients have not denied your clients' access to the accounts. Our clients' position is that they would charge your client should there be any unnecessary expenses incurred by unreasonable, excessive disruption caused by your client.
>
> Our clients have not said that your client should <u>only</u> have access to the accounts in case of doubt. Our clients also have <u>not</u> imposed any condition or restriction on your client. We believe that you have misconceived our letter dated 22 April 1995.'

19. In the meantime, the Taxpayer's auditor had received a letter dated 2 May 1995 from C in the capacity of director of D Ltd, requesting that his accountants, Company E, be allowed access to all books and records of the Taxpayer for the years ended 30 April 1994 and 1995 in connection with the acquisition of his shares in the Taxpayer. By another letter dated 6 May 1995, the Taxpayer's solicitors queried the capacity of C in requesting inspection of the books of account and the purpose of the proposed inspection.

20. On 10 May 1995, the assessor wrote to the Taxpayer's tax representative refusing the request for an extension of time for submission of the profits tax return for the year of assessment 1994/95.

21. On 5 June 1995, the Taxpayer's solicitors wrote to C's solicitors informing them about the refusal of an extension of time for submitting the profits tax return and stating:

> 'We understand that your client's accountant has inspected the financial statements of the Companies on 25 May 1995. Your client's prompt response in the matter will be appreciated.'

22. On 20 June 1995, the Taxpayer's solicitors wrote to the assessor stating:

> '...the delay in submitting the 1994/1995 return by our client is due to the fact that one of our client's directors C has refused or otherwise failed to sign the Company's financial statements.'
>
> 'We are now dealing with the solicitors acting for C. Meanwhile please withhold your action pending our reply.'

23. On 27 June 1995, the Taxpayer's solicitors wrote to C's solicitors enclosing copy correspondence with the Inland Revenue Department and stating:

> '...your client's failure to sign the financial statements will cause loss to the Companies. Our client shall hold yours liable for failure to discharge his duty as director of the Companies...'

24. On 11 July 1995, the assessor wrote to the Taxpayer refusing to withhold action on the return and requesting submission of management accounts for the relevant period to facilitate issue of estimated assessment.

25. By letter dated 12 July 1995, the Taxpayer's tax representative submitted to the Commissioner of Inland Revenue management accounts for the relevant period.

26. On 9 August 1995, the assessor raised an estimated assessment for the year of assessment 1994/95 in the amount of $7,200,000 with tax charged thereon of $1,188,000.

27. By a notice dated 14 November 1995, the Commissioner heldover part of the provisional tax and demanded payment of $1,125,235 which the Taxpayer paid on 16 November 1995.

28. On about 17 April 1996, the audited accounts were finally signed. On that day, the Taxpayer's tax representative submitted the profits tax return on behalf of the Taxpayer. The return showed an assessable profit of $7,190,562.

29. On 5 July 1996, the Commissioner gave notice to the Taxpayer under section 82A of the IRO of his intention to assess additional tax in respect of the late submission of its profits tax return.

30. By two letters respectively dated 9 and 12 July 1996, both the tax representative and the solicitors of the Taxpayer made representations to the Commissioner on behalf of the Taxpayer.

31. On 8 August 1996, the Commissioner, having considered the representations, assessed the Taxpayer to additional tax in the sum of $110,000 for the year of assessment 1994/95.

32. By letter dated 7 September 1996, the Taxpayer's solicitors filed on behalf of the Taxpayer a notice of appeal with the Board of Review against the assessment of additional tax.

Representation and witnesses

33. At the hearing of this appeal, Mr Wong of Messrs Alan Lam & Norris Yang represented the Taxpayer, while Mr Brown, senior assessor, represented the Commissioner of Inland Revenue. F, shareholder and director of the Taxpayer, was present. No witness was called. Evidence consisted of documents put in by the parties the authenticity of which is not disputed.

Findings and reasons

34. The main grounds of appeal are the usual ones: (1) there is a reasonable excuse for the late filing of the profits tax return, and, further and/or alternatively, (2) the additional tax assessment is excessive. There is a further alternative ground to ground (1), namely, that the Inland Revenue Department has not sufficiently considered the Taxpayer's representations. There is also the ground that there is no tax undercharged.

Reasonable excuse

35. In support of the ground of reasonable excuse, Mr Wong relied on the following factors.

35.1 There was a deadlock between the two shareholders and directors.

35.2 Prior to the issuance of the profits tax return, the Taxpayer had requested C to sign the audited accounts.

35.3 There had been an attempted takeover and negotiations had commenced before the issuance of the return.

35.4 After the issuance of the return, the Taxpayer repeatedly requested C to sign the audited accounts.

35.5 The Taxpayer did apply for extension of time for filing the return but the application was refused.

35.6 At the request of the Inland Revenue Department, the Taxpayer submitted its management accounts and profits tax was assessed accordingly.

35.7 There was no intention to delay or evade the payment of tax. The Taxpayer paid the tax immediately after the holdover. The tax was paid within the time it would have been payable had the return been filed on time.

36. Mr Wong submits that, in those circumstances, the Taxpayer has done all it could in order to comply with the law, yet, due to the deadlock which was beyond the Taxpayer's control, its hands were tied. That, he contends, affords a reasonable excuse.

37. A corporation, such as the Taxpayer, cannot act on its own, but must act through others, usually its directors. As for its obligations under the IRO, section 57(1) thereof provides, so far as it is relevant, as follows:

> *'57(1) ... any director ... of a corporation ... shall be answerable for doing all such acts, matters, or things as are required to be done under the provisions of this IRO by such corporation...'*

In our view, the directors are collectively and singly answerable for carrying out the company's obligations imposed by the IRO.

38. We are concerned with the Taxpayer's obligation under section 51(1) of the IRO to file its profits tax return for 1994/95 within one month of the date of issue, that is, on or before 3 May 1995, together with a certified copy of the balance sheet, auditor's report, and profit and loss account and a tax computation. Section 129B(1) of the Companies Ordinance requires every balance sheet to be approved by the board of directors and signed by two of the directors. It was common ground that it was necessary for both F and C to sign the audited accounts before they could be filed together with the return. Without both their signatures on the audited accounts, the return could not be filed. C did not sign the audited accounts until about 17 April 1996, with the consequence that the Taxpayer failed to file the profits tax return on or before 3 May 1995, the expiry date for filing the return.

39. The assessor raised the additional tax assessment in question against the Taxpayer on the basis that the Taxpayer's failure to file the return within time was without reasonable excuse (see section 82A(1)(d) of the IRO). The Taxpayer's answer to that was that there was a reasonable excuse. Being a company, the Taxpayer has no mind of its own. The question is really whether both F and C, the only two directors of the Taxpayer, took all reasonable steps to carry out the statutory obligation on behalf of the Taxpayer. If the answer is yes, the Taxpayer has a reasonable excuse for the failure to file the profit tax return in time. If the answer is no, there will be no reasonable excuse.

40. The wrangle over the question of inspection of the books of account began in about mid-March 1995 (see paragraph 9 above). The relevant correspondence was between the Taxpayer and A Ltd on the one side and C on the other, through the respective solicitors. However, there is a compelling inference that the Taxpayer's letters were written by the solicitors on F's instructions, and so we find. On 24 March 1995 C through his solicitors put his position in writing, insisting on examining the accounts without paying any expenses which might be incurred by the Taxpayer on account of the examination (see paragraph 9 above).

41. On the other hand, the Taxpayer's solicitors' letters stated that C should bear any 'unnecessary expenses incurred by any unreasonable and excessive disruption' and that 'unnecessary expenses' would include any expenses incurred in entertaining C's request for an inspection should the inspection fail to 'find out any major faults or doubts' in the audited financial statements (see paragraphs 12 and 14 above).

42. The quarrel eventually subsided when the Taxpayer's solicitors wrote on 6 May 1995 to C's solicitors 'to clarify your misunderstanding' (see paragraph 18 above).

43. It was stated in the Taxpayer's solicitors' letter dated 5 June 1995 (see paragraph 21 above) that C's accountant had inspected the 'financial statements of the Companies' on 25 May 1995. That statement has not been denied by C, and we accept it. For reasons best known to himself, C did not sign the audited accounts of the Taxpayer until about 17 April 1996 (see paragraph 28 above). The profits tax return was filed on that day, that is, 11 months and 15 days from 3 May 1995, the expiry date for filing the return.

44. At all relevant times, C was concerned with his right to inspect the accounts of the Taxpayer without having to bear any expenses which might be incurred by the Taxpayer on account of the inspection. He did not give any priority to his duty as a director to see that the profits tax return was filed in time. On the other hand, F insisted that C should bear 'unreasonable expenses', including expenses incurred by the inspection if it should fail to find any 'major faults or doubts', forgetting that the purpose of an inspection was to verify the accounts. In our view, neither F nor C took all reasonable steps to have the return filed in time. For example, they could have agreed that the accounts be inspected at an early date, each party reserving his full rights over the question of the expenses of the inspection. C could then have signed the audited accounts if the result of the inspection was satisfactory (as the fact was) and the return could have been filed in time. No step was taken in that direction. Nor was any other reasonable step taken to resolve the impasse.

45. It follows that the Taxpayer has, without reasonable excuse, failed to file its profits tax return for the year of assessment 1994/95 within the specified time.

Alternative ground to ground of reasonable excuse

46. Despite the fact that F and C agreed in July 1996 that F should purchase C's shares in the Taxpayer at a valuation, C refused to sign the audited accounts of the Taxpayer and A Ltd for the year ended 30 April 1995. For this reason, there was delay in submitting the profits tax returns for the year of assessment 1995/96. Accordingly, the Commissioner issued notices under section 82A(4) to both Companies on 7 October 1996 and 16 January 1997 respectively. The Taxpayer and A Ltd through their respective solicitors made representations which were basically on similar grounds to those in the present case, namely, that there was a deadlock between the two shareholders and directors and that one of them, C, refused to sign the audited accounts which were prepared in time. The Commissioner issued a 'warning letter' in each case by way of reply which was in identical terms and was as follows:

> '**PROFITS TAX**
> **Year of Assessment 1995/96**
>
> I have considered your representations in response to my notice to you under section 82A(4) of the IRO in respect of the profits tax return for the year of assessment mentioned above.
>
> In view of the circumstances I have decided that no action will be taken against you on this occasion. However you are advised that any further offence of this nature will not be treated so leniently.

47. Mr Wong contended that by the above-mentioned replies the Commissioner accepted that there were reasonable excuses and decided to take no action and therefore that the Commissioner should do likewise in the present case. We disagree. There was no question of any reasonable excuse in the two 1995/96 cases because in the Commissioner's opinion an offence had been committed in each case. As for his decision to take no action, Mr Brown informed the Board that the management accounts were filed within the time allowed for filing of the return, that filing of management accounts within time was regarded by the Revenue as a good mitigating factor, and that the Revenue's view had been explained at meetings with the Hong Kong Society of Accountants. In the present case, the management accounts were filed on 12 July 1995, well after the expiry date of 3 May 1995, and only at the request of the assessor. That was why the Revenue did not decide to take no action. We accept that explanation. Further, we take the view that it is within the discretion of the Commissioner to decide the question of whether to take any or any further action in a particular case, and the Board has no right to interfere.

Quantum

48. Mr Wong submits that there are the following mitigating factors which will be dealt with as they are mentioned.

48.1 The Taxpayer was not seeking to evade tax.

This is not a mitigating factor. Every taxpayer is expected to behave honestly (see D53/93).

48.2 The takeover is now completed. A heavy penalty will not carry any deterrent effect.

The additional tax in question is $110,000, that is, 9.3% of the tax undercharged of $1,186,442. It is not a heavy penalty.

48.3 Requests for extensions were rejected without reasons given.

This is a matter of discretion for the Revenue and not a mitigating factor.

48.4 The Taxpayer paid the tax within the time it would have been payable had the return been filed on time. The Revenue has suffered no loss of revenue.

This is a mitigating factor, but, on the other hand, there was an inordinate delay of 11 months and 15 days in filing the return.

48.5 The Taxpayer had exercised its utmost diligence, but the delay was beyond its control.

The question is whether F and C, the only two directors, collectively and singly took all reasonable steps to avoid delay. For reasons stated in paragraphs 38 to 44 above, we are of the view that they did not.

48.6 The Commissioner failed to give sufficient consideration to the representations made on behalf of the Taxpayer in view of the fact that representations made on similar grounds in the two 1995/96 cases were accepted.

This has been dealt with in paragraphs 46 and 47 above.

49. In all the circumstances, we are of the view that 9.3% of the tax undercharged is not excessive.

No profits tax undercharged

50. The argument is that there is no liability under section 82A of the IRO because there is no tax undercharged. We are unable to accept that. The point has been considered by previous Boards. The Commissioner has power to assess additional tax of an amount not exceeding treble the amount of tax which 'would have been undercharged if such failure

had not been detected' (see D2/88, IRBRD, vol 3, 125 at 130). The amount of tax undercharged is the full amount of tax payable on the assessable profits or income which crystallises as soon as the taxpayer makes a default in filing his tax return (see D53/93, IRBRD, vol 8, 383 at 389).

Decision

51. It follows that this appeal is dismissed and that the additional tax assessment in question is hereby confirmed.