INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D78/02

Penalty tax – incorrect tax return – whether interest rate excessive – section 82A of the Inland Revenue Ordinance ('IRO').

Panel: Benjamin Yu SC (chairman), Francis Lui Yiu Tung and Wong Chi Ming.

Date of hearing: 29 August 2002.
Date of decision: 6 November 2002.

In June 1996, the taxpayer signed an agreement in the name of Company D with the employer whereby Company D agreed to provide computer consultancy services at locations specified by the employer. Remuneration was reckoned on a daily basis. The agreement expired on 15 March 1999. According to the business registration record, Company D ceased business on 31 May 1999. During the relevant period, the taxpayer was a partner of Company D. The other two partners were the grandfather and mother of the taxpayer.

During the period between June 1996 and April 1999, the taxpayer did not report any income in his salaries tax return, but did report the income of Company D in his position as its precedent partner. At the time when the taxpayer reported income received by Company D he claimed deductions for various expenses, which had the effect of reducing the assessable income and the tax payable. Furthermore, he reported that the net profit of Company D was shared among himself and his grandfather and mother. Since his grandfather and mother did not have any other source of income during the relevant years of assessment, they were able to claim personal allowance on the share of profit reportedly received by them.

On 10 October 2001, the assessor informed the taxpayer that he would perform an audit on his tax return for the years of assessment 1997/98 and 1999/2000. The taxpayer fully cooperated and reached an agreement with the Inland Revenue Department ('IRD') on 4 December 2001. Overall, the amount of assessable income that the taxpayer under-reported was 80.2%.

The taxpayer urged upon the Board that he had been fully cooperative with the IRD, and did not expect to be charged a penalty. He submitted that the Commissioner had not been fair in taking interest into account. He argued that had the assessor conducted the tax audit earlier, he would not have continued with the arrangement for so long and it would not be fair to penalise him by charging interest over the period from 1996 to 2001 when it was not his fault that the assessor did not review his tax position until the year 2001.

The Commissioner submitted that the whole scheme adopted by the taxpayer was an attempt to evade his tax liability and considered that the starting point for calculating the tax element in this case should be 50% of the tax undercharged, with an upward adjustment of 7% per annum to account for interest.

Held:

1. The agreement that the taxpayer entered into constituted an admission against the taxpayer that his earlier returns were incorrect and that he had omitted or understated his income liable to be assessed for salaries tax. The burden of showing that he had a reasonable excuse for this omission or understatement rested on him. Since he had chosen not to give evidence, there was no basis on which the Board could come to a view that he had a reasonable excuse for his omission or understatement.

2. The Board was conscious of the fact that the power to impose the penalty additional tax was vested in the Commissioner and that the question that the Board had to decide was whether the tax imposed on a taxpayer in a particular case could be said to be excessive in the circumstances of that case. Here the Board was unable to say that imposing an additional tax of 50% of the tax undercharged could be said to be excessive.

3. Having consulted the best lending rates offered by a major Hong Kong bank for the period from February 1996 to December 2001 and taking into consideration the fact that the interest for the bulk of that period was in excess of 7%, the Board did not disturb the Commissioner's assessment. It may be that in future, the use of a flat rate of 7% may be difficult to justify if the current economic conditions continue for much longer.

Appeal dismissed.

Case referred to:

D124/95, IRBRD, vol 11, 192

Woo Shu Sum for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. This is an appeal by Mr A ('the Taxpayer') against an assessment of additional tax in the sum of $131,000 made by the Commissioner of Inland Revenue on 8 May 2002. The additional tax was assessed under section 82A of the IRO on the basis that the Taxpayer has, without reasonable excuse, made incorrect tax returns for the years of assessment 1996/97, 1997/98, 1998/99 and 1999/2000 inclusive ('the relevant years of assessment') resulting in a sum of $203,626 of tax undercharged.

The facts

2. The following facts are not in dispute and we find them proved:

(a) For a number of years prior to 1996, the Taxpayer was employed by a company called Company B, which has since changed its name to Company C ('the Employer').

(b) In June 1996, the Taxpayer signed an agreement in the name of Company D with the Employer. Under that agreement, the Taxpayer agreed to provide computer consultancy services at locations specified by the Employer. Remuneration was reckoned on a daily basis. The agreement expired on 15 March 1999. According to the business registration record, Company D ceased business on 31 May 1999.

(c) During the relevant period, the Taxpayer was a partner of Company D. The other two partners were a Mr E and a Madam F, who are respectively the grandfather and mother of the Taxpayer. The Taxpayer's grandfather passed away on 11 April 1998. His share in Company D was 25% while the Taxpayer's mother's share was 50%. Upon the death of Mr E, the share of the Taxpayer's mother was increased to 60% and the Taxpayer held the remaining 40%.

(d) During the period between June 1996 and April 1999, the Taxpayer did not report any income in his salaries tax return, but did report the income of Company D in his position as its precedent partner.

(e) At the time when the Taxpayer reported income received by Company D, he claimed deductions for various expenses, which had the effect of reducing the assessable income and the tax payable. Furthermore, he reported that the net profit of Company D (after deduction of expenses) was shared among himself and his grandfather and mother. Since his grandfather and mother did not have

any other source of income during the relevant years of assessment, they were able to claim personal allowance on the share of profit reportedly received by them.

(f) On 10 October 2001, the assessor informed the Taxpayer that he would perform an audit on his tax return for the years of assessment 1997/98 and 1999/2000.

(g) The Taxpayer and his spouse were interviewed by the IRD between October and November 2001. The Taxpayer fully cooperated and reached an agreement with the IRD on 4 December 2001. The effect of that agreement was that the Taxpayer accepted that his assessable income chargeable to salaries tax during the relevant years of assessment should be revised as follows:

Year of assessment	**Income previously assessed**	**Revised assessable income**
	$	$
1996/97	79,818	491,596
1997/98	-	502,544
1998/99	-	498,430
1999/2000	289,407	372,286

In arriving at the figures for the revised assessable income, the IRD had allowed a 20% deduction from the Taxpayer's income. It also agreed to refund tax paid by the Taxpayer's grandfather and mother. Overall, the amount of assessable income that the Taxpayer under-reported was 80.2%.

(h) On 26 March 2002, the Commissioner issued a notice under section 82A(4) of the IRO stating that he was of the opinion that the Taxpayer had, without reasonable excuse, made incorrect tax returns for the relevant years of assessment by understating income chargeable to tax to the extent of $1,495,631 and that the amount of tax undercharged in consequence of the incorrect returns was as follows:

Year of assessment	$
1996/97	70,622
1997/98	64,026
1998/99	56,688
1999/2000	12,290
Total	203,626

(i) The Taxpayer made his representation to the Commissioner in a letter dated 9 April 2002. In that letter, the Taxpayer claimed that he was told by the Employer in 1996 that he could form a company and the Employer could become his client, and that this was not illegal. He also stressed that he had been very cooperative with the IRD and paid his taxes promptly. On 8 May 2002, the Commissioner issued various notices and demands for additional tax amounting to $131,000. This sum was arrived at as follows:

Year of assessment	**Tax underpaid**	**Additional tax**	**Percentage**
	$	$	%
1996/97	70,622	53,000	75.0
1997/98	64,026	47,000	73.4
1998/99	56,688	30,000	52.9
1999/2000	12,290	1,000	8.1
Total	203,626	131,000	64.3

The Taxpayer' s submissions

3. Before us, the Taxpayer repeated the assertion he made in his letter to the Commissioner on 9 April 2002. He claimed that he was asked by the Employer to enter into the new arrangement. He also urged upon us that he had been fully cooperative with the IRD, and did not expect to be charged a penalty. He submitted that the Commissioner had not been fair in taking interest into account. He argued that had the assessor conducted the tax audit earlier, he would not have continued with the arrangement for so long and it would not be fair to penalise him by charging interest over the period from 1996 to 2001 when it was not his fault that the assessor did not review his tax position until the year 2001. He told us that he was having difficulty in meeting the penalty payment.

Has the Taxpayer shown reasonable excuse?

4. Section 82A of the IRO provides as follows:

'Any person who without reasonable excuse –

(a) makes an incorrect return by omitting or understating anything in respect of which he is required by this Ordinance to make a return, either on his behalf or on behalf of another person or a partnership ...

shall, if no prosecution under section 80(2) or 82(1) has been instituted in respect of the same facts, be liable to be assessed under this section to additional tax of an amount not exceeding treble the amount of tax which –

(i) has been undercharged in consequence of such incorrect return ...'

5. The agreement that the Taxpayer entered into constituted an admission against the Taxpayer that his earlier returns were incorrect and that he had omitted or understated his income liable to be assessed for salaries tax. The burden of showing that he had a reasonable excuse for this omission or understatement rests on him. Despite being advised that he had the burden of proving that the assessment was excessive, the Taxpayer elected not to call any evidence or give evidence himself. Since he has chosen not to give any evidence, there is no basis on which this Board can come to a view that he had a reasonable excuse for his omission or understatement. The question remains whether the additional tax imposed was excessive.

Was the assessment excessive?

6. Mr Woo, on behalf of the Commissioner, submitted that the whole scheme adopted by the Taxpayer was an attempt to evade his tax liability. The scheme involved not only the use of the names of the Taxpayer's grandfather and mother in order to claim their respective personal allowances, but also the claim for deductions on expenses which were plainly personal and unrelated to the production of the income. Mr Woo explained that in this case the Commissioner considered the scheme adopted by the Taxpayer to be particularly aggressive. He referred us to the guidelines on additional tax published by the IRD, and explained that the Commissioner considered that the starting point for calculating the additional tax element in this case should be 50% of the tax undercharged, with an upward adjustment of 7% per annum to account for interest.

7. Mr Woo accepted that the guidelines were not binding on this Board, but submitted that the level of penalty was not excessive in the circumstances of the present case, particularly having regard to the fact that the Board (in D124/95, IRBRD, vol 11, 192) had previously stated that the norm for cases where taxpayers have failed in their obligation under the IRO was a starting point of 100% of the amount of tax undercharged.

8. We have not been shown any previous case where the circumstances can be said to be so similar as to afford real guidance to our task. We are conscious of the fact that the power to impose the penalty additional tax is vested in the Commissioner and that the question that this Board has to decide is whether the tax imposed on a taxpayer in a particular case can be said to be excessive in the circumstances of that case. Here, we are unable to say that imposing an additional tax of 50% of the tax undercharged can be said to be excessive. While it is true that had the tax audit taken place earlier, the Taxpayer would not have had to bear the interest over such a long period of time, the interest element that the Commissioner imposed can, in our view, be justified as merely reflecting the fact that the Taxpayer had the use of the money over these years. Initially, we have had doubts as to whether an annual rate of 7% from the year of assessment 1996/97 up to the present date would be excessive in the light of the present economic conditions. However, having consulted the best lending rates offered by a major Hong Kong bank for the period from February

1996 to December 2001 and taking into consideration the fact that the interest for the bulk of that period (up to May 2001) was in excess of 7%, we would not disturb the Commissioner's assessment. It may be that in future, the use of a flat rate of 7% may be difficult to justify if the current economic conditions continue for much longer. But in this case, we cannot say that the assessment of additional tax was excessive. We would dismiss the appeal and confirm the assessment appealed against.