

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D90/01

Penalty tax – incorrect tax returns – whether reasonable excuse – quantum – mitigation – co-operation.

Panel: Kenneth Kwok Hing Wai SC (chairman), Edward Chow Kam Wah and Jason Yuen King Yuk.

Date of hearing: 31 August 2001.

Date of decision: 17 October 2001.

At all material times, the appellant was a medical practitioner. He submitted tax returns which were later found to be incorrect in overstating rental expenses. The appellant contended that he had reasonable excuse as he entrusted his tax reporting to his accountant. He had no intention of overstating his expenses. He also appealed against the assessments, that is, 67.8% of the profits understated, as being excessive.

Held:

1. The Board found no evidence supporting that the appellant had any reasonable excuse.
2. However, the Board found the appellant co-operative in this case.
3. As co-operation is a mitigation, the Board found the assessments excessive and substituting it by 33.89%.

Appeal allowed in part.

Cases referred to:

D18/91, IRBRD, vol 6, 36
D13/85, IRBRD, vol 2, 173
D1/82, IRBRD, vol 1, 407
D24/85, IRBRD, vol 2, 190
D179/98, IRBRD, vol 14, 78

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D52/93, IRBRD, vol 8, 372

Re ICS Computer Distribution Limited [1996] 3 HKC 440

Li Siu Keung for the Commissioner of Inland Revenue.

Wong Yun Tung of Messrs Wong Yun Tung & Co, Certified Public Accountants, for the taxpayer.

Decision:

1. This is an appeal against the following additional assessments ('the Assessments') all dated 11 April 2001 by the Commissioner of Inland Revenue, assessing the Appellant to tax under section 82A of the Inland Revenue Ordinance (Chapter 112) ('IRO') in the following sums:

Year of assessment	Additional tax	Charge number
	\$	
1994/95	91,000	3-2956194-95-4
1995/96	89,000	3-4163752-96-4
1996/97	51,000	3-2516618-97-7
1997/98	41,000	3-3922382-98-8
1998/99	40,000	3-2051813-99-4
1999/2000	<u>37,000</u>	3-1877685-00-8
Total:	<u>349,000</u>	

The relevant provision is section 82A(1)(a) of the IRO for making incorrect returns by understating profits.

The agreed facts

2. Based on the agreed statement of facts, we make the following findings of fact.

3. The Appellant is appealing against the imposition of additional tax by way of penalty assessed upon him under section 82A of the IRO for making incorrect tax returns for the years of assessment 1994/95 to 1999/2000 inclusive in respect of Doctor A ('the Business').

4. The Appellant is a medical practitioner. At all relevant times, he was the proprietor of the Business where he carried out his medical practice. He was also a shareholder and director of Company B ('the Corporation'). The Corporation was a real estate investment company.

5. The financial statements of the Business were prepared by Messrs Peter Y C Lau & Co, Certified Public Accountants ('the First Representative'). On divers dates, the Appellant

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submitted the tax return – individuals for the years of assessment 1994/95 to 1999/2000 inclusive together with supporting financial statements and profits tax computations. He also appointed the First Representative in all these returns as his representative in handling his tax affairs. The returned profits of the Business are summarized as follows:

Year of assessment	Date of issue of return	Date of receipt of return	Basis period	Profits per return \$
1994/95	1-5-1995	29-5-1995	Year ended 31-3-1995	1,398,741
1995/96	1-5-1996	16-5-1996	Year ended 31-3-1996	2,378,205
1996/97	1-5-1997	10-7-1997	Year ended 31-3-1997	2,606,317
1997/98	1-5-1998	3-6-1998	Year ended 31-3-1998	3,536,313
1998/99	3-5-1999	21-5-1999	Year ended 31-3-1999	3,494,023
1999/2000	2-5-2000	17-5-2000	Year ended 31-3-2000	3,382,904

6. In accordance with the returns submitted, the assessor accepted the returned profits for the years of assessment 1994/95, 1995/96, 1997/98 and 1998/99 and raised profits tax assessments for these years on the Business. After making the technical adjustment on the private share of motor car running expenses of \$85,958, the assessor computed the assessable profits for the year of assessment 1996/97, which amounted to \$2,692,275. The First Representative lodged an objection against the profits tax assessment for the year of assessment 1994/95 claiming that the business income included salary of \$204,989 from Hospital C. The objection was eventually settled and the profits was revised to \$1,193,752.

7. On 2 August 2000, the assessor, after examining the Business' accounts for the year ended 31 March 2000, issued a letter to the First Representative asking for information on 'Rent and Rates \$787,949' and 'Overseas Travelling \$26,706'. He also raised a profits tax assessment for the year of assessment 1999/2000 on the Business per returned profits. No objection was lodged against this assessment.

8. On 16 August 2000, the First Representative gave a reply stating that the rent expenses in respect of the Business' address at Address D ('the Premises') were paid to the Corporation in which the Appellant was a shareholder and director. It was a verbal tenancy agreement. In the same letter, they agreed not to claim the overseas travelling \$26,706.

9. On 14 September 2000, the assessor issued a letter to the First Representative asking for details of rent paid to the Corporation in the years of assessment 1994/95 to 1998/99 and further information on agreeing the rent of the Premises between the Business and the Corporation.

10. On 9 October 2000, the Appellant appointed Messrs Wong Yun Tung & Co, Certified Public Accountants ('the Second Representative') to represent him.

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11. On 13 October 2000, the Second Representative gave a reply to the assessor's letter of 14 September 2000. The lease of the Premises made between the Corporation and the Business commenced on 1 December 1994. The rent was agreed verbally between the Appellant and the Corporation. But there was no mention how the monthly rent was determined and they did not supply any details of rent paid by the Business to the Corporation. On page two of the letter they suggested to re-compute the rental expenses of the Business with the following adjustments:

- (a) exclusion of management fee;
- (b) exclusion of rent and rates on residence as quarters; and
- (c) scaling down the rent for the Premises to fair market value.

The results of the adjustments are summarized as follows:

Expenses charged in the Business' accounts

Year of assessment	Management fee paid to the Corporation	Rent of quarter paid to the Corporation	Rent of clinic paid to the Corporation	Revised rent of clinic now claimed	Expenses disallowed in tax computation
	\$	\$	\$	\$	\$
1994/95	226,500	480,000	200,000	96,100	810,400
1995/96	0	480,000	600,000	288,500	791,500
1996/97	0	0	780,000	317,400	462,600
1997/98	0	0	780,000	317,400	462,600
1998/99	0	0	780,000	349,100	430,900
1999/2000	0	0	780,000	349,100	<u>430,900</u>
Total expenses disallowed					<u><u>3,388,900</u></u>

The following copies of rates demand notes were submitted together with the Second Representative's letter dated 13 October 2000:

Types of demand note	Rateable value
	\$
Notice of interim valuation from 1-8-1994	204,000
July to September quarter 2000 demand for rates	106,800

12. On 14 November 2000, the assessor issued a letter to the Second Representative asking for evidence to support the amount of revised rent charged for the years of assessment 1998/99 and 1999/2000.

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13. On 24 November 2000, the Second Representative replied that his client was unable to produce documentary evidence because several floors of the building were sold to doctors and as a consequence it was unlikely to find a unit within the medical center being let out. However, they suggested keeping the rent for the years of assessment 1998/99 and 1999/2000 at the same level as the preceding year. That meant the rent claimed in these two years would be \$317,400 per annum.

14. Having considered the reasons given by the Second Representative and the basis of computing the revised rent, the assessor raised, on 3 January 2001, the following additional profits tax assessments on the Business:

Year of assessment	Additional assessable profits
	\$
1994/95	810,400
1995/96	791,500
1996/97	462,600
1997/98	462,600
1998/99	462,600
1999/2000	<u>489,306</u>
Total:	<u>3,479,006</u>

15. The following is a comparative table of the assessable profits before and after the review and the amount of tax undercharged:

Year of assessment	Assessable profits before review	Assessable profits after review	Profits understated	Tax undercharged
	\$	\$	\$	\$
1994/95	1,193,752	2,004,152	810,400	121,560
1995/96	2,378,205	3,169,705	791,500	118,725
1996/97	2,692,275	3,154,875	462,600	69,390
1997/98	3,536,313	3,998,913	462,600	62,452
1998/99	3,494,023	3,956,623	462,600	69,390
1999/2000	<u>3,382,904</u>	<u>3,872,210</u>	<u>489,306</u>	<u>73,396</u>
	<u>16,677,472</u>	<u>20,156,478</u>	<u>3,479,006</u>	<u>514,913</u>

The percentage of profits understated to profits assessed after review is 17.26%.

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16. By a notice under section 82A(4) of the IRO dated 27 February 2001, the Commissioner informed the Appellant of her intention to assess additional tax in respect of his making of incorrect returns for the Business.

17. By a letter of 16 March 2001, the Second Representative submitted representations on behalf of the Appellant to the Commissioner. Having considered and taken into account the Appellant's representations, the Commissioner issued, on 11 April 2001, the following notices of assessment and demand for additional tax under section 82A of the IRO:

Year of assessment	Tax undercharged	Section 82A additional tax	Percentage of tax undercharged
	\$	\$	%
1994/95	121,560	91,000	74.86
1995/96	118,725	89,000	74.96
1996/97	69,390	51,000	73.50
1997/98	62,452	41,000	65.65
1998/99	69,390	40,000	57.64
1999/2000	<u>73,396</u>	<u>37,000</u>	50.41
Total:	<u>514,913</u>	<u>349,000</u>	67.78

18. By a letter of 9 May 2001, the Second Representative, on behalf of the Appellant, gave notice of appeal to the Board of Review against the assessments to the additional tax for the years of assessment 1994/95 to 1999/2000 inclusive.

The appeal hearing

19. At the hearing of the appeal, the Appellant was represented by Mr Wong Yun-tung of the Second Representative. The Respondent was represented by Mr Li Siu-keung.

20. Neither party called any witness to give oral evidence.

21. Mr Wong Yun-tung supplied us with two copies of D18/91, IRBRD, vol 6, 36. D13/85, IRBRD, vol 2, 173 had been referred to in the papers sent with the notice of appeal, but we have been given neither the citation of the case nor a copy of the report.

22. Mr Li Siu-keung cited the following authorities:

- (a) D1/82, IRBRD, vol 1, 407
- (b) D24/85, IRBRD, vol 2, 190

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(c) D179/98, IRBRD, vol 14, 78

(d) D52/93, IRBRD, vol 8, 372

Our decision

23. The only ground of appeal stated in the notice of appeal dated 9 May 2001 is the Appellant ‘has reasonable excuse in submitting the incorrect tax returns for six years from 1994/95 through 1999/2000’.

24. With our consent given by us under sections 82B(3) and 66(3) of the IRO, with no objection by Mr Li Siu-keung, the Appellant also contended that the Assessments were excessive having regard to the circumstances.

Whether reasonable excuse

25. Quoting from D13/85, Mr Wong Yun-tung contended that:

‘We consider that the correct test to be applied in ascertaining “reasonable excuse” is what one would expect a reasonable person to do in all the circumstances’.

26. We question whether it helps to bring in the ‘reasonable person’ in construing ‘reasonable excuse’. What we are concerned with under section 82A is ‘reasonable excuse’ for what would otherwise be a wrongful act or omission. The test seems to replace it with the act of a ‘reasonable person’. We wonder whether a ‘reasonable person’ would perform a wrongful act such as understating profits. As we have been given neither the citation nor a copy of the case, we do not wish to express any final view on the point.

27. It is not easy to state or summarise the contentions of Mr Wong Yun-tung. He put in three documents. The first is the notice of appeal dated 9 May 2001 with ‘elaboration on grounds of appeal’ and ‘background information’. The second is the letter dated 15 August 2001 making ‘further representations’. The third is the ‘presentation’ submitted at the hearing of the appeal on 31 August 2001. The three documents are largely repetitive, but not identical. There is no indication of where one may find a new point or the changes.

28. Mr Wong Yun-tung contended that the Appellant entrusted tax reporting to a certified public accountant who prepared the Appellant’s financial statements from complete source documents and that the Appellant had no intention to overstate expenses as he took active steps to try to prevent overstatement of rent.

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29. As Rogers J (as he then was) said in Re ICS Computer Distribution Limited [1996] 3 HKC 440 at page 449A, *'this seems to be an attempt to raise an argument without the fundamental evidence to support it'*.

30. There is no evidence that the Appellant kept a complete set of accounting books and records. There is no evidence that the complete set was made available to the certified public accountant. There is also no evidence of any advice which the Appellant might have sought or received from the certified public accountant.

31. Omitting or understating income is not the only way to omit or understate profits.

32. Making a bogus or exaggerated claim for deduction is another way to understate income.

33. The rental expense of the place of business of a taxpayer is normally an allowable deduction. It does not follow that a taxpayer is entitled to claim deduction of rental expense even where that taxpayer has not incurred any. If a taxpayer has not incurred any rental expense but nevertheless claims deduction of rental expense, that taxpayer is making a bogus, and necessarily dishonest, claim for deduction. If a taxpayer has incurred some rental expense but claims deduction of rental expense in a sum exceeding the actual amount of rental expense incurred, that taxpayer is making an exaggerated, and also dishonest, claim for deduction.

34. Whether a taxpayer has incurred an expense, and if so, the amount thereof, is information to be furnished by that taxpayer. It is not a matter for professional advice.

35. There is no evidence that during the six years of assessment the Business had in fact incurred any management fee, any rent of any quarter, any rent of the clinic, or any overseas travelling. There is also no evidence of the amount of any fee or expense which might have in fact been incurred.

36. The only evidence relied on by Mr Wong Yun-tung in support of his contention that the Appellant had no intention to overstate expenses because the Appellant took active steps to try to prevent overstatement of rent is what purports to be a fax dated 21 May said to be in respect of the year of assessment 1998/99 in which the Appellant wrote to the certified public accountant as follows:

‘clinic rent \$90,000 會不會太貴* (if out of market range, will reject)’.

[* would it be too expensive]

37. We assume that this document is authentic. We do not think this document helps the Appellant's case. If anything, it damages his case.

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- (a) If the certified public accountant was, as Mr Wong Yun-tung contended, preparing the accounts from 'complete source documents', then the 'source documents', which we have not seen, must have recorded \$90,000 as clinic rent.
- (b) Mr Wong Yun-tung contended that it was the Appellant who 'will reject', but in the context it should be the Inland Revenue Department ('IRD') which 'will reject'.
- (c) On the basis that it was the Appellant who 'will reject', why did the Appellant agree a rental in the first place but then subsequently questioned whether it would be too expensive and which he 'will reject' 'if out of market range'?
- (d) If the 'source documents' recorded \$90,000 as clinic rent, what 'active step' did the Appellant do to 'prevent overstatement of rent'?
- (e) If the 'source documents' recorded \$90,000 as clinic rent, why did the amount of clinic rent incurred become \$65,000 in the return which the Appellant furnished to the IRD? One may apportion an expense. One may claim deduction of only part of an expense. If an expense had been genuinely and factually incurred, the amount could not be changed at the will of a taxpayer or his adviser.

38. Mr Wong Yun-tung also relied on the prompt submission of tax. Prompt submission is no excuse for making an incorrect return. If the Appellant had not submitted returns on time, then, subject to the question of reasonable excuse, he would have been liable to additional tax under section 82A(1)(d). The fact that the Appellant has not contravened section 82A(1)(d) is not an excuse (and certainly not a reasonable excuse) for contravening section 82A(1)(a). It is not even a mitigating factor. It is the duty of every taxpayer to submit correct returns within the time allowed.

39. Having carefully considered everything which has been said and written on behalf of the Appellant, we do not think the Appellant has made out any reasonable excuse.

Whether excessive in the circumstances

40. In reply to a question from the chairman, Mr Li Siu-keung said it was a case of 'Group b' of 'Disclosure with FULL Information Promptly on Challenge' under the Commissioner's penalty policy. As he did not defend any of the Assessments with reference to the policy, we express no view on the policy.

41. We are impressed by the Appellant's co-operation in this case.

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42. The IRD started with a query by letter dated 2 August 2000 about 'Rent and Rates \$787,949' and 'Overseas Travelling \$26,706' in respect of one year of assessment, that is, 1999/2000 (paragraph 7).

43. Five months and one day later, on 3 January 2001, the Appellant and the Respondent agreed the revised profits for six years of assessment, that is, 1994/95 to 1999/2000 (paragraph 14).

44. By letter dated 13 October 2000, the Appellant volunteered to disallow management fee (\$226,500) and rent for quarters (\$480,000) for the year of assessment 1994/95 and rent for quarters (\$480,000) for the year of assessment 1995/96 (paragraph 11). The IRD had not queried about management fee. The IRD had not expressly queried about rent for quarters although the IRD did ask for details of rent paid to the Corporation for the year of assessment 1994/95 to 1998/99 in the letter dated 14 September 2000 (paragraph 9). These add up to \$1,186,500 or 34.10% of the agreed additional assessable profits of \$3,479,006 (paragraph 14).

45. Mr Li Siu-keung properly conceded that this is not an audit case.

46. In our decision, the Assessments (67.78%) are excessive in the circumstances of this case.

47. There must be a real difference in penalty between those who mitigate their breaches by being co-operative and those who aggravate their breaches by being obstructive.

48. None of the cases cited by the parties assists us on the appropriate quantum given the impressive co-operation by the Appellant.

49. In answer to a question from the chairman, Mr Wong Yun-tung suggested reducing the Assessments by half.

50. In the absence of any assistance by either party on the appropriate amount of penalty and in the absence of any guidance by any previous Board of Review decision, we do not think the suggested 33.89% is unreasonable.

Disposition

51. We allow the appeal and reduce the Assessments as follows:

Year of assessment	Charge number	Additional tax	Reduced by us to
		\$	\$
1994/95	3-2956194-95-4	91,000	45,500
1995/96	3-4163752-96-4	89,000	44,500

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1996/97	3-2516618-97-7	51,000	25,500
1997/98	3-3922382-98-8	41,000	20,500
1998/99	3-2051813-99-4	40,000	20,000
1999/2000	3-1877685-00-8	<u>37,000</u>	<u>18,500</u>
Total:		<u><u>349,000</u></u>	<u><u>174,500</u></u>