¶6-3480 The capital/revenue distinction

As capital receipts are not assessable to profits tax the distinction between income of a capital nature and income of a revenue nature is crucial. Revenue or trading receipts are typically regarded as the "produce" of capital; identifiable and severed from that capital (*Eisner v Macomber* (1919) 252 US 189). If, for example, a person purchases land and leases it to a third party, then the leased property is capital and the rents received (being amounts derived and severed from the capital) are revenue receipts.

A common method for distinguishing a capital receipt from a revenue or trading receipt is to distinguish receipts relating to assets forming part of the permanent structure of a business (eg receipts from the sale of machinery or premises) — in other words, to parallel the capital/revenue distinction with the distinction between fixed and circulating assets:

- *A fixed asset* is — one which "the owner turns to profit by keeping it in his own possession"; it provides the means to make profits (eg machinery used in the course of a taxpayer's business). Fixed assets give rise to capital receipts when sold; and
- *A circulating or trading asset* — is one which the owner turns over and "makes a profit of by parting with it and letting it change masters" (eg goods or produce sold to customers). A circulating asset gives rise to revenue receipts (*Ammonia Soda Co v Chamberlain* (1918) 1 Ch 266; *Van den Berghs Ltd v Clark (Inspector of Taxes)* (1935) 19 TC 390; *Golden Horse Shoe (New) Ltd v Thurgood (Inspector of Taxes)* (1933) 18 TC 280).

Whether a particular item is of a capital or revenue nature ultimately depends on the facts and circumstances of each individual case and is often a question of degree. In *Burmah SS Co v IRC* (1931) 16 TC 67, for instance, two companies had jointly bought a motor vessel and gave it to ship repairers for repair. The repairers took longer than agreed and the owners claimed damages for loss of trading opportunity. The claim was settled and the repairers paid each of the owners a sum of money which the Court held to be a revenue receipt as it was in lieu of lost profit. It was said, however, that it would have been a capital receipt if the companies had put it forward as a reduction of repair costs.

Note that a payment is tested in the hands of the recipient (*IRC v Reid's Trustees* (1949) AC 361). What may be regarded as capital in the hands of the payer may be revenue income in the hands of the payee.

¶6-3520 Profits from disposal of asset — capital or revenue?

When a taxpayer has disposed of an asset, particularly property, it must be determined whether the taxpayer was:

- *realising* an investment — in which case the profits from the disposal will be non-assessable capital gains; or
- *trading* — in which case the profits from the sale will be assessable revenue profits.

When determining whether a taxpayer has been trading and is therefore assessable to tax, the so-called "badges of trade" are influential. These are the identifying features of trade which, when weighed against each other, indicate the nature of the taxpayer's profit generating activity (see ¶6-0500). The most important test, however, is the test of the taxpayer's intention towards the asset in question.

The same rules apply to loss making cases. See also ¶6-0500 and *Case* K23 (2001) HKRC ¶80-754 (*D45/00*).

Significance of taxpayer's intention

A taxpayer's intention toward an asset indicates the nature of the asset and, consequently, the nature and assessability of the gains arising from its disposal. If a taxpayer acquires a plot of land with the intention of holding it for investment or for permanent business use (rather than intending to trade (see ¶6-0780), the plot of land is regarded as a capital asset and the proceeds from its sale are considered non-assessable capital gains.

The relevant question is: what was the taxpayer's intention at the time when the relevant asset was acquired? Was it acquired with the intention of disposing of it at a profit or was it acquired as a long-term or permanent investment? (*Simmons v IRC* (1980) 2 All ER 798).

The Simmons approach has been specifically applied in many cases over the years including: *Chinachem Investment Co Ltd v Commissioner of Inland Revenue* (1989) 1 HKRC ¶90-007 (CA) and *All Best Wishes Limited v Commissioner of Inland Revenue* (1992) 1 HKRC ¶90-067 and the following Board of Review cases:

Case N49 (2004) HKRC ¶81-025 (*D53/03*); *Case* M19 (2003) HKRC ¶80-884 (*D127/01*); *Case* L22 (2002) HKRC ¶80-823 (*D21/01*); *Case* K3 (2001) HKRC ¶80-734 (*D26/00*); *Case* J49 (2000) HKRC ¶80-717 (*D137/99*); *Case* J48 (2000) HKRC ¶80-716 (*D136/99*); *Case* J43 (2000) HKRC ¶80-711 (*D125/99*); *Case* I60 (1999) HKRC ¶80-629 (*D145/98*); *Case* I56 (1999) HKRC ¶80-625 (*D137/98*); *Case* I55 (1999) HKRC ¶80-624 (*D136/98*); *Case* I50 (1999) HKRC ¶80-619 (*D127/98*); *Case* I49 (1999) HKRC ¶80-618 (*D126/98*); *Case* I47 (1999) HKRC ¶80-616 (*D119/98*); *Case* I46 (1999) HKRC ¶80-615 (*D113/98*); *Case* I44 (1999) HKRC ¶80-613 (*D108/98*); *Case* I36 (1999) HKRC ¶80-605 (*D83/98*); *Case* I32 (1999) HKRC ¶80-601 (*D65/98*); *Case* I30 (1999) HKRC ¶80-599 (*D63/98*); *Case* I24 (1999) HKRC ¶80-593 (*D54/98*); *Case* I22 (1999) HKRC ¶80-591 (*D48/98*); *Case* I17 (1999) HKRC ¶80-586 (*D38/98*); *Case* I15 (1999) HKRC ¶80-584 (*D30/98*);

Case I14 (1999) HKRC ¶80-583 (*D28/98*); *Case* I11 (1999) HKRC ¶80-580 (*D24/98*).

The intention of a taxpayer must be determined by reference to both subjective and objective factors. The whole of the evidence must be considered. If a taxpayer displayed a subjective intention to trade when he or she purchased the relevant asset, and the objective facts are consistent with this intention, then a trading intention is identified. If the subjective and objective factors point to different intentions it is necessary for the Board of Review to determine why the conclusions are different and which one is apparently the more truthful in all of the circumstances (*Case* K65 (2001) HKRC ¶80-796 (*D111/00*); *Case* I14 (1999) HKRC ¶80-583 (*D28/98* IRBRD Vol 13, 234); *Case* I11 (1999) HKRC ¶80-580 (*D24/98*); *D61/88* IRBRD Vol 4, 62. In *Case* M32 (2003) HKRC ¶80-897 (*D147/01*), the Board rejected the taxpayer's subjective intention of acquiring the property in question to provide for his retirement as the objective evidence showed that the taxpayer had sold the property and acquired another one with poorer rental yield.

Subjective expressions of intention made in the accounts or minutes of a taxpayer are not, on their own, conclusive. They must be tested against the objective facts and circumstances (*Case* B40 (1992) 1 HKRC ¶80-201 (*D14/92* IRBRD Vol 7, 125); *Chinachem Investment Co Ltd*; *Hillerns & Fowler v Murray* 17 TC 77; *All Best Wishes Ltd*). Self-serving statements made by witnesses are also of limited value unless they are objectively tested and corroborated (*Case* C24 (1993) 1 HKRC ¶80-233 (*D50/92* IRBRD Vol 8, 17; *Case* C10 (1993) 1 HKRC ¶80-219 (*D34/92* IRBRD Vol 7, 356).

A taxpayer who acquired and resold property was found not to have purchased the property as a long-term investment for rental or redevelopment in *D37/87* IRBRD Vol 2, 420. The objective facts of the case pointed to an opposite intention. Among other significant facts: the taxpayer had a history of property purchases and resale and no evidence was shown that the taxpayer had sufficient funds for property redevelopment. The profits derived from the sale were revenue rather than capital in nature. The objective facts similarly pointed to the taxpayer having an intention to trade rather than to invest, in cases *D23/88* IRBRD Vol 3, 283 and *D25/88* IRBRD Vol 3, 294.

In *Case* M58 (2003) HKRC ¶80-923 (*D11/02*), the corporate taxpayer claimed that the subject properties were acquired for redevelopment and it was forced to dispose of them as it failed to acquire the remaining units within the same premises. The Board disbelieved the taxpayer's stated intention as there was no evidence of the taxpayer's prospects of acquiring and redeveloping all the units in the premises. Most importantly, the objective facts showed that the taxpayer had granted lease with no redevelopment break clauses to existing occupiers of the properties and the taxpayer had not taken any steps to evict the occupiers.

In *Case* M71 (2003) HKRC ¶80-936 (*D32/02*), the Board believed that the taxpayer genuinely wanted to bring her mother and her family together under one roof but doubted that the purchase of the property was intended to achieve this goal. The Board found that there were discrepancies between the avowed purposes of acquiring the property and the objective facts of the case.

In *Case* M110 (2003) HKRC ¶80-975 (*D93/02*), the taxpayer was an indigenous villager in the New Territories who applied for a building licence to build a small house on a land lot assigned to him. He claimed that he had intended to use the house as a place of living for his family and they had moved into the house to live. However, the Board concluded that the house was sold for a trading profit as it was not built as a single house but three separate and self-contained flats and the taxpayer sold all of the three flats although he could have repaid the related debts by selling only two of them. The Board also found that there was no indication that the taxpayer would have been able to finance the development himself for long-term investment purposes.

However, in *Case* N17 (2004) HKRC ¶80-993 (*D128/02*), the Board accepted that the taxpayer's contentions were consistent with the objective facts. It accepted that the property was acquired with an intention of using it as a residence and it was disposed of as the taxpayer discovered a staircase at the back of the flat after she moved in.

In *Case* G15 (1997) HKRC ¶80-453 (*D4/96*), the fact that the taxpayers had spent substantial sums to fit out and equip the properties in question supported their claim that the properties had been acquired as capital assets for their business venture. The Board pointed out that, realistically, no property trader would invest substantial sums of money, intending to write them off after a very short period, just so that a property trading transaction would be clothed as an investment.

The fact that a taxpayer has held certain properties for a long period of time is not, on its own, proof of an intention to hold the properties as long-term investments (*Case* N7 (2004) HKRC ¶80-983 (*D116/02*); *Case* A125 (1991) 1 HKRC ¶80-125 (*D16/91* IRBRD Vol 6, 24); *Case* A122 (1991) 1 HKRC ¶80-122 (*D12/91*)). It is only one factor which may be considered. Similarly, the fact that a taxpayer has acquired property at an attractive price does not, on its own, render the transaction a trading transaction (*Case* C1 (1993) 1 HKRC ¶80-210 (*D23/92* IRBRD Vol 7, 268)).

The onus of proving intention is on the taxpayer (*China Map Ltd & Others v Commissioner of Inland Revenue* (2005) HKRC ¶90-172; *Case* Q15 (2007) HKRC ¶81-201 (*D58/06*); *Case* O43 (2005) HKRC ¶81-099 (*D90/04*); *Case* N61 (2004) HKRC ¶81-037 (*D58/03*); *Case* N60 (2004) HKRC ¶81-036 (*D57/03*); *Case* N59 (2004) HKRC ¶81-035 (*D56/03*); *Case* N50 (2004) HKRC ¶81-026 (*D55/03*); *Case* J58 (2000) HKRC ¶80-726 (*D151/99*); *Case* J56 (2000) HKRC ¶80-724 (*D146/99*);

Case I14 (1999) HKRC ¶80-583 (*D28/98* IRBRD Vol 13, 234); *Case* I11 (1999) HKRC ¶80-580 (*D24/98*)).

In *Wong Ning Investment Co Ltd v Commissioner of Inland Revenue* (2000) HKRC ¶90-105, the taxpayer acquired a property in Hong Kong in 1977 from its parent company, Hoi Tung Investment Co Ltd, for a consideration of $1. Due to the Building Authority's view that the site was subject to height and other restrictions, development of the site commenced only in 1979 when the taxpayer finally succeeded in obtaining approval to build a 32-storey residential building over four storeys of car parking spaces. In 1986, before the development was completed, the taxpayer sold the property to an associated company, Istril Ltd, for a consideration of HK$29.050 million. Istril completed the development of the property in 1988. Immediately after the occupation permit was issued in May 1988, Istril rented out the apartments and the apartments had been held for lease since then.

The Inland Revenue Department considered the sale of the property by the taxpayer to Istril in 1986 was in the nature of trade and hence subject to profits tax. It issued a number of assessments accordingly.

The taxpayer objected to one of the assessments and challenged the other two assessments by filing an application under sec 70A of the *Inland Revenue Ordinance* as it had failed to lodge an objection within the stipulated time. The taxpayer, Hoi Tung and Istril were all part of the Chinachem group of companies.

The taxpayer appealed to the Board of Review. Several members of the Chinachem group provided oral evidence to substantiate that the property in question was intended to be held as a long-term investment. The Board dismissed the taxpayer's appeal and confirmed the assessments.

Huen J in the Court of First Instance held that the Board had placed undue emphasis on extraneous matters, particularly on the facts of *Chinachem Investment Co Ltd v Commissioner of Inland Revenue* (1989) 1 HKRC ¶90-007 (CA) (the *CICL* case), to such a material extent as to vitiate its determination of the facts relevant to its decision. The Court of First Instance annulled the assessments on the ground that the Board had erred in law by being heavily influenced by references made to the *CICL* case and by rejecting the following material evidence provided by members of the Chinachem group:

(i) If residential properties were intended to be held as trading stock, it is the practice and policy of the Chinachem group to not rent out the properties before sale;

(ii) Properties intended for renting out would be classified as "fixed assets" whereas properties intended for sale would be classified as "current assets" when transferred out from "leasehold properties under development" upon completion; and

(iii) It was the Chinachem group's practice not to mortgage properties which were trading stock.

It is interesting that Huen J annulled the assessments as opposed to referring the case back to the Board to be reheard.

In *Hui King Yin v Commissioner of Inland Revenue* (2005) HKRC ¶90-142, the taxpayer acquired a property on 7 October 1996 and disposed of it on 9 May 1997. The taxpayer argued that the property was not purchased for trading purposes but instead intended the property to be his place of residence at the time of acquisition. He submitted that he purchased the property because it did not have a swimming pool, unlike another property he originally purchased in the same estate, which he considered would be safer for his sons. However, the taxpayer sold the property when he found out it had bad fungshui. The Board of Review found that the information furnished by the taxpayer's accountants to the Inland Revenue Department on the property transaction shortly after the event took place, where the disposal of the property was classified under the trade nature transactions category, to be an important piece of evidence. The majority of the Board took the view that the taxpayer would put commercial gain before the provision of a settled home for his family and each of his properties would be available for sale at the right price. The Court of First Instance agreed with the Board in holding that the taxpayer had failed to discharge his onus under sec 68(4) of the *Inland Revenue Ordinance*.

In *Real Estate Investments (NT) Limited v Commissioner of Inland Revenue* (2005) HKRC ¶90-154 and *Real Estate Investments (NT) Limited v Commissioner of Inland Revenue* (2006) HKRC ¶90-175, the Court of First Instance and Court of Appeal respectively upheld the Board's decision in concluding that it was unable to come to a positive finding as to the relevant intention. The Courts held that the Board was correct in holding that the taxpayer had not discharged its burden of proof in showing that the relevant intention at the time of acquisition was to hold the property as a long-term investment.

The taxpayer became a member of the Chinachem group in 1978 which included property development as part of its commercial activities. The taxpayer acquired a residential property with the express purpose of redeveloping the site. Shortly after the acquisition of the property in 1979, the taxpayer's share capital was expanded and 40% of its shares came to be owned by subsidiaries of Sun Hung Kai Securities Ltd (SHKSL), a substantial property developer.

The Board was unable to come to a positive conclusion as to the relevant intention and considered that the evidence adduced by the taxpayer was "both limited and unconvincing". The Board also found that the taxpayer's argument that the fact that the property was classified as a fixed asset in the financial statements supported the view that it was a capital asset to be held

Example

T Ltd commenced business on 1 August 2012. The company's first set of accounts was made up to 30 June 2013 (11 months) showing profits of $500,000. The profits tax assessment proceeds as follows:

Year of assessment	*Basis period*	*Profit*
2012/13	No assessment as per sec 18C(2)	—
2013/14	1 August 2012 to 30 June 2013	$500,000

Commencement

The date on which a trade, profession or business commences is normally a simple question of fact. Difficulty may arise, however, in distinguishing between actual commencement and preparation for business.

For a discussion of the case law on this point, see ¶6-1400.

¶6-8780 Basis period for assessment in year of cessation

The normal basis of profits tax assessment for the year that a taxpayer's trade or business ceases is to compute the assessable profits according to the total amount of profits arising in or derived from Hong Kong during the period:

- commencing on the day after the end of the previous basis period; and
- ending on the actual date of the business' cessation (sec 18D(1)).

This basis period applies to a business or trade which ceased on or after 1 April 1975. An alternative basis period applies if a taxpayer's trade or business commenced before 1 April 1974 and ceased or ceases after 1 April 1975.

Where business commenced before 1 April 1974 and ceases after 1 April 1975

Where a trade or business which commenced before 1 April 1974 ceases business after 1 April 1975 the basis of assessment for the year of cessation is the total profit arising or derived during the period:

- beginning on 1 April of the business' final year; and
- ending on the date of cessation (sec 18D(2)).

This special rule applies because businesses which commenced before 1 April 1974 were subject to rules under sec 18 which could cause certain profits to be assessed twice. Compensation was provided for this on cessation by allowing certain profits to drop out of account. Section 18D(2) provides the same compensation under the new "current year" assessment scheme. However,

there is a proviso to sec 18D(2). It does not apply when a person ceases to carry on a trade or business which is subsequently carried on by someone else and the cessation was not the result of the death of a sole proprietor.

Anti-avoidance provision

Following the exploitation of sec 18D(2) by taxpayers who were avoiding tax through the profit drop-out provision, an anti-avoidance provision (sec 18D(2A)) was introduced. That section provides that when a taxpayer ceases to carry on a trade, profession or business on or after 1 April 1979 which commenced before 1 April 1974 then, additional to the profits calculated under sec 18D(2), the taxpayer's assessable profits will include:

(i) in the case of an "excepted trade, profession or business" — the amount by which the profits excluded by sec 18D(2) exceed the "transitional amount"; or

(ii) in the case of any other "relevant trade, profession or business" — the full amount of any relevant profits arising during the "relevant period".

For the purposes of sec 18D(2A):

- "*excepted trade, profession or business*" means a relevant trade, profession or business referred to in the definition of "*transitional amount*" (see below);
- "relevant period" is a period:
  - beginning on the day after the end of the basis period for the penultimate year of the business; and
  - ending on 31 March in that year;
- "relevant profits" are profits which would have been included in the taxpayer's profits but for sec 18D(2) (and apart from Pt VI);
- a "relevant trade, profession or business" is a trade, profession or business to which sec 18D(2) applies and whose basis period for the year preceding the year of assessment in which the cessation occurs ends on a day other than 31 March;
- a "transitional amount" is the profit for the period within the basis period for the year of assessment 1974/75:
  (a) if the assessment for 1974/75 was calculated on the preceding year basis and based on accounts made up to a date other than 31 March, the transitional amount is the profit for the period from the day following the corresponding date in 1974/75 to 31 March 1975; and
  (b) if the assessment for 1974/75 was calculated on the current year basis the transitional amount is the profit for the period from the day following the 1974/75 accounting year end date to 31 March 1975.

Example

Z Ltd commenced business in 1965 and ceased business on 30 June 2013. Its accounts are made up on 31 December each year. Its profits for the relevant years were as follows:

Year ended 31 December 1975	$240,000
Year ended 31 December 2012	$300,000
Six months to 30 June 2013	$500,000

(i) Under sec 18D(2):

Year of cessation	*Basis period according to sec 18D(2)*	*Profits*
2013/14	1 April 2013 to 30 June 2013	$250,000 ($3/6 \times 500,000$)

(ii) Under sec 18D(2A):

- Profits of the "relevant period" which dropped out of assessment under sec 18D(2) (ie profits from 1 January 2013 to 31 March 2013) $250,000
- "Transitional amount" (ie profits from period 1 January 1975 to 31 March 1975: $3/12$ months × $240,000) $60,000

The difference between the two sums ($250,000 – $60,000 = $190,000) is treated as assessable profits under sec 18D(2A), making the total assessable profits of Z Ltd for its year of cessation $440,000, calculated as follows:

		$
Assessable profits under sec 18D(2)		250,000
PLUS		
Assessable profits under sec 18D(2A)	+	190,000
EQUALS		
Total assessable profits	=	440,000

Cessation of trade, profession or business

The date on which a trade, profession or business ceases is basically a question of fact.

For a discussion of business cessation, see ¶6-1440.

¶6-8820 Basis of assessment for short-term business

Special provision is made for businesses which are only carried on for short periods. If a business commenced in a year of assessment (on or after 1 April 1975) and ceased in the following assessment year, the assessable profits for the year of cessation are computed on the basis of the actual profits derived from the date of commencement to the date of cessation (sec 18D(5)).

¶6-8860 Change of accounting date

Special provision is made for the calculation of assessable profits when a taxpayer's accounting date has changed because the taxpayer has either:

- failed to make up an account to the same day as in the previous assessment year; or
- has made up accounts to more than one day.

When a taxpayer's accounting date changes in any year of assessment the taxpayer's assessable profits for that year are computed, and the assessable profits for the previous year are recomputed, on a basis which the Commissioner thinks appropriate (sec 18E(1)).

The Commissioner is required to consider all relevant factors and disregard any irrelevant factors when exercising the discretion provided under sec 18E(1). The Commissioner's mind must be directed to what is the appropriate basis for the computation or recomputation of profits on the facts of the case in question (*Case* A102 (1991) 1 HKRC ¶80-102 (*D71/90* IRBRD Vol 5, 493)).

In exercising the discretion under sec 18E the Commissioner normally endeavours to achieve the following objectives:

- To adopt a basis period using the new accounting date as the last date of the basis period as soon as is reasonable and expedient having regard to:
  - (i) the trend of the profits of the business, so far as it is possible to discern a trend; and
  - (ii) the desirability of maintaining the normal 12-month basis period for the year of assessment unless exceptional circumstances dictate.
- To effect equity by producing a result which will not unduly prejudice either the taxpayer or the Inland Revenue Department (see *Case* A102 (1991) 1 HKRC ¶80-102 (*D71/90* IRBRD Vol 5, 493)).

In *Yick Fung Estates Ltd v Commissioner of Inland Revenue* (2001) HKRC ¶90-112, the Court of Appeal held that, on the construction point, the Commissioner was not entitled to use a basis period of more than 12 months for an "old trader" whose trade, profession or business commenced before 1 April 1974. The Court held that as profits tax was indeed a yearly tax, there would be a presumption that tax was payable on yearly profits.

However, on the other hand, the Court affirmed that the taxpayer's change of accounting date to avoid the tax payable for the nine months between the old and new ones constituted a "transaction" under anti-avoidance sec 61A. There was no need for two parties to be involved. The Court also held that sec 61A had an overriding effect over sec 18E.

The above Court of Appeal decision reversed the Court of First Instance decision *Commissioner of Inland Revenue v Yick Fung Estates Limited; Yick Fung Estates Limited v Commissioner of Inland Revenue* (1999) HKRC ¶90-096 and the Board of Review decision (1998) HKRC ¶80-526.

In certain circumstances the Commissioner may find it appropriate to adopt a basis period which results in the "double use" of part of a taxpayer's profits. This is not necessarily unjust to the taxpayer. "Double use" of profits frequently occurs in taxation law. An injustice only results when the doubly used profits are unusually high (*Case* A102 (1991) 1 HKRC ¶80-102 (*D71/90* IRBRD Vol 5, 493)). In reaching its decision in *Case A102* the Board of Review followed the House of Lords decision in *IRC v Helical Bar Ltd* (1972) 48 TC 221 in which it was recognised that there is a distinction between double taxation and the double use of profits.

Treatment of losses on change of accounting date

The basic aims of the Commissioner when there has been a change of accounting date and the taxpayer has incurred losses are:

- to ensure that relief is not given for the taxpayer's losses more than once; and
- to see that the taxpayer's assessments are based on the new accounting date as soon as possible while at the same time achieving a fair and equitable result.

¶6-8900 Chinese Lunar year as accounting period

Businesses may prepare their accounts by reference to the Chinese Lunar year. The Lunar year is inconsistent in length and does not conform to the statutory definition of "year of assessment". When the accounts of any trade, profession or business are *consistently* made up to the end of the Lunar year, however, the Commissioner has the discretion to accept the accounts as being made up to a corresponding day in each year of assessment (sec 18E(2)(a)). This is done without adjustment or apportionment.

¶6-8940 Apportionment or aggregation of profits

The apportionment (or aggregation) of a taxpayer's profits between periods is permitted when it is necessary in order to accurately compute the taxpayer's profits or losses for a particular year of assessment (sec 18E(3) and (4)). Under normal circumstances any apportionment or aggregation must be made on the

basis of time: that is, having regard to the number of days or months in the respective periods between which the profits are being divided. A different basis may only be used in special circumstances on the Commissioner's direction.

The profits for apportionment are computed before any adjustment for depreciation allowances. Depreciation allowances for fixed assets acquired in the overlapped period are allowed in the former year of assessment, whereas the fixed assets acquired in the drop-out period are included in the latter year of assessment.

PROFITS TAX RATES

¶6-9100 Profits tax rates

When a taxpayer's assessable profits have been determined in accordance with Pt IV of the Ordinance, his or her tax liability is calculated by the application of the appropriate tax rate.

Persons other than corporations (eg individuals, unincorporated associations) are charged to profits tax at the standard tax rate set down in the First Schedule. Corporations are charged at the rate set down in Sch 8.

For the year of assessment 2013/14 the following tax rates will apply:

Taxpayer	*Tax rate 2012/13*
Persons other than corporations	15%
Corporations	16.5%
Corporations to which a share of the assessable profits of a partnership is apportioned under sec 22A and which are charged with profits tax in the name of the partnership under sec 22.	16.5%

For the profits tax rates applicable to earlier years of assessment, see ¶330.

Tax reliefs provided over the years include the following:

- a one-off reduction of 75% of profits tax for 2012/13, subject to a ceiling of $10,000 was proposed in the 2013/14 Budget Speech.
- a one-off reduction of 75% of profits tax for 2011/12, subject to a ceiling of $12,000, was proposed in the 2012/13 Financial Budget and passed under *Inland Revenue (Amendment) Ordinance 2012*).
- a one-off reduction of 75% of profits tax for 2007/08, subject to a ceiling of HK$25,000, was proposed in the 2008/09 Budget Speech and passed under *Revenue Ordinance 2008*.

¶7-3400 When pooling system does not apply

Before the introduction of the pooling system for calculating initial and annual allowances (see ¶7-2900), the allowances were calculated individually for each of the taxpayer's assets. This former system, which is set out in sec 37, is still used in certain circumstances.

When pooling system is impracticable or inequitable

When the Commissioner is satisfied that applying the pooling system would be impracticable or inequitable, he may direct that the former system for calculating allowances be applied (sec 36A(2)). In such a case the taxpayer is entitled to an *initial allowance*:

- for the 1980/81 year of assessment — of 35% of the capital expenditure incurred on the provision of machinery or plant for the purposes of producing profits; or
- for the years of assessment 1981/82 to 1988/89 — an allowance of 55% of the capital expenditure; or
- for the 1989/90 year of assessment and all following years — an allowance of 60% of the capital expenditure (sec 36A(3)).

A taxpayer is only entitled to an *annual allowance* under the former system when, at the end of the basis period of the relevant year of assessment, he or she *owns and has in use* machinery or plant for the purpose of producing assessable profits (sec 37(2)). Under the pooling system, it is enough that the taxpayer has simply owned plant or machinery at some time during the relevant basis period and used it in the production of assessable profits. The Department takes the view, however, that for the purposes of the non-pooling system the words "in use at the end of the basis period" in sec 37(2) should not be too strictly construed. So that if a machine is temporarily idle during the last days of a basis period, it may still be regarded as being in use (DIPN No 7 (Revised), para 20).

Under the non-pooling system, the annual allowance is calculated at the rates set out in the *Inland Revenue Rules* (r 2, see ¶7-3300) on the reducing value of each of the taxpayer's assets, rather than on the reducing value of classes of assets. The "reducing value" is the cost of the asset reduced by any initial or annual allowances already granted for the asset under the non-pool system. The "cost of the asset" is the amount of the actual cost less the notional amount of the annual allowances which would have been made if the taxpayer had used the asset in question to produce assessable profits from the time of its acquisition (sec 37(2A)).

Limitation

A taxpayer cannot claim an allowance for capital expenditure on plant or machinery under sec 37 if a deduction has been allowed for the same capital

expenditure for profits tax purposes on the basis that it is capital expenditure on research and development under sec 16B(1)(b), or capital expenditure on prescribed fixed assets under sec 16G (sec 37(1), 37(3)).

Where taxpayer has ceased to use plant or machinery to produce profits

Where any machinery or plant which qualifies for allowances under the pooling system has ceased to be used wholly and exclusively in the production of assessable profits, the non-pooling system is applied to calculate the allowances available for the relevant asset in the year of assessment in which the cessation of use occurred (sec 39C(3)).

The annual depreciation allowance is calculated at the rates set out in the *Inland Revenue Rules* (r 2; see ¶7-3300) on the reducing value of the particular machinery or plant. The "reducing value" in this situation is the amount which the Commissioner considers the machinery or plant would have realised if it had been sold in the open market at the time it ceased to be used for the production of profits.

¶7-3500 Allowance for plant or machinery acquired under hire-purchase

Initial and annual allowances are granted for machinery or plant acquired under a hire-purchase agreement. The allowances, however, are calculated separately from the pool of the taxpayer's plant. A "hire-purchase agreement" is defined as an agreement for the bailment of goods under which the property in the goods will, or may, pass to the bailee (sec 2(1)).

Initial allowance for capital expenditure

The initial allowance for an item of plant or machinery bought by hire-purchase is spread over the period in which the taxpayer pays instalments. An initial allowance is made to the taxpayer for each year of assessment in which an instalment is paid (sec 37A). The amount of the initial allowance is calculated as a percentage of the capital portion of the instalment payment. The percentage allowances for different years of assessment are as follows (sec 37A(1A)):

Year of Assessment	*Percentage Allowance*
Up to and including 1973/74	20%
1974/75 to 1979/80	25%
1980/81	35%
1981/82 to 1988/89	55%
1989/90 and following	60%

Example — Initial allowances for asset bought by hire-purchase

R Ltd entered into a hire-purchase agreement on 1 September 2013 to purchase machinery to be used in the course of the company's plastic product manufacturing business for the purpose of producing profits. R Ltd agreed to pay $624,000 for the machinery (the cash price of which was $480,000) in 24 equal monthly instalments of $26,000. Each instalment was comprised of a capital element of $20,000 and a revenue element of $6,000. R Ltd's accounts are made up to 31 March.

Initial allowances would be available and calculated as follows:

	$
2013/14	
Capital element of instalments for 2013/14 (7 months × $20,000)	140,000
Initial allowance (60% × capital element)	84,000
(Interest element (7 × $6,000) deductible from R Ltd's profits as a revenue expense under sec 16; see further ¶6-4600)	
2014/15	
Capital element of instalments for 2014/15 (12 months × $20,000)	240,000
Initial allowance (60% × capital element)	144,000
(Interest element (12 × $6,000) deductible)	
2015/16	
Capital element of instalments for 2015/16 (5 months × $20,000)	100,000
Initial allowance (60% × capital element)	60,000
(Interest element (5 × $6,000) deductible)	

Annual depreciation allowance

An annual allowance for wear and tear is granted for plant or machinery acquired under a hire-purchase agreement. The allowance is calculated on the reducing value of the machinery or plant at the rates prescribed by the Board of Inland Revenue (see ¶7-3300) (sec 37A(2)). The "reducing value" of the machinery or plant in this case is the full capital cost of the plant or machinery (ie excluding any interest included in the cost under the hire-purchase agreement) as reduced by any initial allowances or previous annual allowances computed and granted under sec 37A.

When the instalment payments for the relevant plant or machinery are completed and no further initial allowance is due, the reducing value of the asset is included in the relevant class of plant or machinery and annual allowances are calculated, from the year after the asset passes into the

taxpayer's ownership, in the normal manner under the pooling system (see ¶7-3200) (sec 39C(2)).

Limitation

A taxpayer cannot claim an allowance under sec 37A for capital expenditure on plant or machinery acquired under hire-purchase if a deduction has been allowed for the same capital expenditure for profits tax purposes on the basis that it is expenditure on research and development under sec 16B(1)(b), or capital expenditure on prescribed fixed assets under sec 16G (sec 37A(1), 37A(4)).

Balancing allowance concession

Where hire-purchase assets are repossessed by or voluntarily returned to the vendor, the taxpayer's total capital expenditure may exceed the sum of the capital allowances already made as well as any proceeds from the vendor. While the Ordinance does not provide for any balancing allowance to be made for the excess amount, the Inland Revenue Department grants such allowance as a concession (DIPN No 7 (Revised), para 41).

¶7-3700 100% deduction for expenditure on prescribed fixed assets

Under sec 16G, a taxpayer chargeable to profits tax is entitled to a 100% deduction for capital expenditure incurred on prescribed fixed assets. For the definition of prescribed fixed assets and more details on this deduction, see ¶6-5660.

¶7-3900 Environmental protection facilities — profits tax deduction

Section 16I of the *Inland Revenue Ordinance* provides for the deduction of capital expenditure incurred in relation to environmental protection facilities. This section was effective from 27 June 2008. Environmental protection facilities mean any environmental protection machinery or any environmental protection installation. The definition was extended to include any environment-friendly vehicle under *Inland Revenue (Amendment) (No 3) Ordinance 2010*. Schedule 17 of the *Inland Revenue Ordinance* sets out a list of specific environmental protection facilities which are eligible for deduction. The list includes but not limited to low noise construction machinery or plant and vehicle that are registered under schemes administered by the Environmental Protection Department. Eligible environmental protection facilities do not include any machinery or plant in which a person holds rights as a lessee under a lease. For more details on the environmental protection facilities, see ¶6-5720.

Environmental protection machinery

A taxpayer chargeable to profits tax is entitled to 100% profits tax deduction for capital expenditure on environmental protection machinery incurred during the basis period for the year of assessment (sec 16I(2)).

Environmental protection building installation

For specific environmental protection installations to industrial or commercial buildings, a deduction is allowed for 20% of the qualifying capital expenditure in the basis period in which it was actually incurred. The remainder is deductible by four equal deductions over the next succeeding four years, so long as the installation has not been sold at the end of the basis period for the year of assessment concerned.

Environment-friendly vehicles

Effective from the year of assessment 2010/11, a taxpayer chargeable to profits tax is entitled to 100% profits tax deduction for capital expenditure on environment-friendly vehicles in the first year of purchase.

For more details on the deductions for specific capital expenditure incurred in relation to environmental protection facilities, refer to ¶6-5720.

LEASING ARRANGEMENTS

¶7-4000 Availability of allowances restricted

Section 39E restricts the availability of initial and annual allowances for machinery or plant in the case of taxpayers who have entered into certain lease arrangements. Section 39E, introduced into the *Inland Revenue Ordinance* to prevent revenue loss, denies initial and annual allowances to lessors of plant or machinery:

- when the plant or machinery has been purchased from and leased back to the same person (see ¶7-4200ff);
- when a lease arrangement has been entered into in relation to plant or machinery (except ships or aircraft) and the asset is used principally or wholly outside Hong Kong;
- when a lease arrangement has been entered into in relation to a ship or aircraft and the lessee is not an operator of a Hong Kong ship or aircraft; or
- when the asset was acquired through a leverage lease transaction, financed by a "non-recourse debt" (see ¶7-4400ff).

¶7-4100 Meaning of "lease"

For the purposes of sec 39E, a "lease" includes any arrangement by which a right to use machinery or plant is granted to a person by the owner (sec 2(1)). The term also covers arrangements under which the right to use machinery or plant may be successively granted by the lessee to another person.

Hire-purchase agreements and conditional sale agreements are deemed not to fall within the definition of "lease" unless the Commissioner believes that the right to purchase or obtain the property under the relevant agreement would not reasonably be expected to be exercised (sec 2(1)). Lessors, therefore, are normally not precluded from claiming capital allowances when such agreements have been entered into.

For the purposes of sec 39E, a "hire-purchase agreement" is defined as an agreement for the bailment of goods under which the bailee may buy the goods, or under which the property in the goods may pass to the bailee (sec 2(1)). A "conditional sale agreement" is defined as an agreement for the sale of goods under which the purchase price, or part of it, is payable by instalments and the property in the goods must remain with the seller, even if the buyer has possession of the goods, until conditions specified in the agreement have been fulfilled (sec 2(1)).

Lease or purchase agreement?

It is important to draw a distinction between a lease and a purchase agreement. Assessors will carefully consider whether payments made by a "lessee" are lease rentals or whether they are, in substance, consideration for the sale of goods purported to be leased (DIPN No 15 (Revised), para 63).

The following factors are considered when determining whether an agreement is a lease:

- Do any express or implied agreements exist (whether in the lease agreement or in a subsidiary document or correspondence) under which property in the goods would pass from the lessor to the lessee?
- Does the "residual value" of the goods represent their reasonable commercial value at the expiry date of the lease? (The "residual" value is the lessor's anticipated sale price at the end of the lease, from which the amount of monthly lease rentals is usually determined.)

An agreement will generally be regarded as a purchase agreement if the lessee has a right or option to purchase the goods. However, if the Commissioner accepts that such right or option would reasonably be expected not to be exercised, then such an agreement is a lease as defined, notwithstanding its form. An agreement is accepted as a lease only if the lessee does not have an obligation, right or option to purchase the goods during the term of the lease or at its end (DIPN No 15 (Revised), para 65).

Commissioner, not an appeal from the decision of the Commissioner. Therefore, the court could only intervene on public law grounds and it should be mindful of not usurping the function of the Commissioner. This also means that the court must consider the matter by reference to how the case was put before the Commissioner as opposed to how it is advanced by counsel before the court. There is no proper basis for the court to intervene with the decision of the Commissioner on the facts of this case."

In a judicial review, the Court does not normally consider the substantive merits of the taxpayer's case. It would be unusual for the Court to determine in a judicial review whether a taxpayer was liable to pay tax, because the *Inland Revenue Ordinance* set out mechanisms for determining the rights and wrongs of the taxpayer's substantive case. The facts of each case were for the Commissioner and the Board to determine. Should the taxpayer be dissatisfied with the decisions, it may appeal to the Court, not by way of a judicial review, but by way of case stated on questions of law posed by the Board (*Yue Yuen Marketing Company Limited and ors v Commissioner of Inland Revenue* (2010) HKRC ¶90-227). See also *Kinco Investment Holding Limited v Commissioner of Inland Revenue* (2010) HKRC ¶90-233; *Kam Kiu (Hong Kong) Limited v Commissioner of Inland Revenue* (2010) HKRC ¶90-232 and *Honorcan Ltd v Inland Revenue Board of Review* (2010) HKRC ¶90-228.

Chapter 12

OFFENCES AND PENALTIES

¶12-0200 Overview

Failure to fulfil certain obligations imposed by the *Inland Revenue Ordinance* is an offence. The major categories of offence are as follows:

- failure to comply with requirements to make returns and provide accurate information (see ¶12-0900ff);
- fraud and wilful evasion (see ¶12-5100ff); and
- breach of secrecy (see ¶12-8600).

Penalties vary according to the nature of the offence. Penalties may take the form of a fine, imprisonment or both. Alternatively, the offending taxpayer may be required to pay additional tax (see ¶12-5800).

OFFENCES RELATING TO RETURNS AND INFORMATION

¶12-0900 Failure to comply with information requirements

A taxpayer, employer or any other person who, without a "reasonable excuse" (see further ¶12-4400), breaches the return and information requirements of the Ordinance, as described below, is guilty of an offence.

The maximum penalty for these offences is a level 3 fine (see ¶600). The offending person also may be ordered to fulfil his or her obligations, as required under the Ordinance, within a specified time (sec 80(1)).

Any person who has aided, abetted or incited a person to commit one of these offences is deemed to have committed the same offence and is liable for the same penalty (sec 80(4)).

Offences

- Failure to provide full or further returns (as per sec 51(3); see ¶9-1300).
- Failure to provide a statement of assets and liabilities (as per sec 51A(1); see ¶9-2000).
- Failure of a government employee or public body to provide information (as per sec 52(1); see ¶9-3400).
- Failure of an employer to provide statement of remuneration of employees (as per sec 52(2); see ¶9-3000).
- Failure to comply with the Commissioner's request for information (as per sec 64(2); see ¶11-1350).
- Failure to attend an examination or a hearing in answer to a summons (as per sec 64(2) and 68(6); see ¶11-1600 and ¶11-4000).
- Failure to answer questions at an examination or a hearing (as per sec 64(2) and 68(6); see ¶11-1600 and ¶11-4000).
- Failure to notify the Commissioner of change in ownership of land and/or buildings for which a corporation has been exempted from property tax (as per sec 5(2)(c); see ¶5-7200).
- Failure to notify the Commissioner of cessation of: business; ownership of income source; or ownership of land and/or buildings for which tax is chargeable (as per sec 51(6); see ¶9-1100).
- Failure to notify the Commissioner of departure from Hong Kong for a period longer than one month (as per sec 51(7); see ¶9-1100).
- Failure to notify the Commissioner of change of address (as per sec 51(8); see ¶9-1100).
- Failure to keep sufficient rent records (as per sec 51D(1); see ¶9-4500).
- Failure of an employer to notify the Commissioner of commencement of an employee's employment (as per sec 52(4); see ¶9-3100).
- Failure of an employer to notify the Commissioner of cessation of an employee's employment (as per sec 52(5); see ¶9-3200).
- Failure of an employer to notify the Commissioner of departure of an employee from Hong Kong (as per sec 52(6); see ¶9-3300).
- Failure of an employer to withhold money owing to a taxpayer about to leave Hong Kong (as per sec 52(7); see ¶9-3300).
- Failure to notify the Commissioner of inability to comply with a notice requiring sums held to a tax defaulter's credit to be paid to the Commissioner (as per sec 76(3); see ¶10-7200).

Late returns

Penalty actions against taxpayers who submit their tax returns late have increased in recent years as the Inland Revenue Department has begun to

enforce submission deadlines more strictly. The Department has warned taxpayers and their representatives that those who persistently file late returns, without a reasonable excuse, are almost certain to face penalty action.

The maximum fixed fine for the late submission of returns is a level 3 fine (see ¶600). Increasingly, however, substantial additional tax penalties are being imposed upon recalcitrant taxpayers. The Board of Review has indicated that a penalty equal to approximately 5% to 10% of the tax involved is reasonable in cases where there are no aggravating circumstances (*Case* N37 (2004) HKRC ¶81-013 (*D25/03*); *Case* L18 (2002) HKRC ¶80-819 (*D15/01*); *Case* K54 (2001) HKRC ¶80-785 (*D96/00*); *Case* J5 (2000) HKRC ¶80-673 (*D41/99*); *Case* F7 (1996) HKRC ¶80-385 (*D38/95*); *Case* E64 (1995) 1 HKRC ¶80-361 (*D11/95* IRBRD Vol 10, 132); *Case* E59 (1995) 1 HKRC ¶80-356 (*D1/95* IRBRD Vol 10, 71)).

In more serious cases, however, the Commissioner may impose, and the Board of Review is likely to uphold, higher levels of additional tax penalties, particularly in cases involving taxpayers who persistently file late returns. For example, in *Case* G45 (1997) HKRC ¶80-483 (*D63/96* IRBRD Vol 11, 641), as the taxpayer was not a first offender, an additional tax penalty equal to 19.9% (ie double the rate of the last offence) was not outrageous, excessive or unacceptable. In *Case* I48 (1999) HKRC ¶80-617 (*D125/98*), the Commissioner submitted that the Inland Revenue Department's internal guideline had set a range of additional tax of up to 10% for the first offence and up to 20% for the second offence. This guideline for additional tax assessment was held by the Court as not excessive. Accordingly, as the taxpayer in this case was a second offender, an additional tax penalty equal to 14.4% was not excessive. In *Case* E48 (1995) 1 HKRC ¶80-345 (*D68/94* IRBRD Vol 9, 379) an additional tax penalty equal to 48% of the tax involved was imposed on a taxpayer who had a five-year history of filing late returns.

In *Case* I62 (1999) HKRC ¶80-631 (*D150/98*), an additional penalty equal to 26.31% of tax involved was imposed on a taxpayer who had a five-year history of filing tax returns late.

In *Case* K50 (2001) HKRC ¶80-781 (*D89/00*), the Board confirmed the penalties, averaged 80% of the tax undercharged, imposed on the taxpayer for persistently filing its tax returns late for the six years of assessment.

The fact that the authorities are taking a stern view of taxpayers who have a history of late filing is evident in cases such as *Case* F12 (1996) HKRC ¶80-390 (*D43/95* IRBRD Vol 10, 298) in which the taxpayer filed his profits tax returns just over two weeks late. The Commissioner ordinarily would only issue a warning letter in such cases in the past. However, in *Case F12*, because the taxpayer had been repeatedly late in filing its returns, a 5% additional tax penalty was imposed. In *Case* I70 (1999) HKRC ¶80-639 (*D177/98*), the taxpayer filed its profits tax return just over 25 days late. It had a good compliance

record for prior years. A 2.47% additional tax penalty, not a token fine, was imposed.

Failure of deemed employer to comply with notice requirements

A person who is deemed to be an employer of an individual under sec 9A of the Ordinance, because he or she pays remuneration for services provided by the individual to a service company or trust controlled by the individual (see ¶2-0500), is required to comply with the notice requirements of sec 52(4)–(7). In certain circumstances, however, a person may be unsure as to whether the provisions of sec 9A apply to a particular service company or trust remuneration arrangement. To cater for such cases, sec 80(1AA) allows the relevant person to presume, in certain circumstances, that the notice requirements do not apply. According to sec 80(1AA) it is a defence, in proceedings against a person for failure to comply with sec 52(4), (5), (6) or (7), that the person relied upon a statement in writing by the relevant individual (in the form specified by the Commissioner):

- that the company or trust to which the remuneration is paid or credited is not a corporation or trust in relation to which sec 9A applies; or
- that the individual falls within one of the escape provisions so that sec 9A does not apply,

and it was reasonable for him or her to rely upon that statement (DIPN No 25 (Revised), para 50–54; Appendix C).

An individual who makes a false or misleading statement commits an offence and is liable on conviction to a fine at level 3 (sec 80(1AB)).

¶12-1600 Failure to keep proper business records

A taxpayer who, without a "reasonable excuse", fails to keep and maintain proper business records as required under sec 51C (see ¶9-4500), commits an offence (sec 80(1A)) and is liable on conviction to a fine at level 6 (see ¶600). The Court may also order a convicted taxpayer to rectify his or her business records so that they fulfill the requirements of sec 51C.

In *Case* K49 (2001) HKRC ¶80-780 (*D50/00*), the IRD conducted a site inspection of the taxpayer's clinic and found that the taxpayer did not keep any accounting records of his daily total earnings. The taxpayer claimed that he had used code numbers to record the consultation and medicine charges on daily income sheets but these were not retained after the tax return was submitted. The IRD subsequently executed a search warrant on the taxpayer's clinic and home but the daily income sheets were not found. The IRD thus computed the taxpayer's income by multiplying the numeric codes by 10 based on the information obtained from the patient cards.

The Board held that the taxpayer did not keep sufficient records to enable the assessable profits of his practice to be readily ascertained. Furthermore, the

IRD was justified in obtaining a search warrant due to the taxpayer's failure to keep sufficient records, the suspected understatement of income, unavailability of daily income sheets and lack of access to patient cards.

The Board also held that, though the IRD's methodology lacked scientific precision, it nevertheless represented estimates based on the material available. The industrial averages were not used as doctors' charges varied due to differences in location and clientele base.

¶12-2300 Incorrect information

A taxpayer, employer or any other person who, without a "reasonable excuse" (see further ¶12-4400), provides incorrect information, as described below, commits an offence.

The taxpayer who commits this offence is liable on conviction to a fine at level 3 (see ¶600), and a further fine of treble the amount of tax undercharged as a result of the offence (sec 80(2)). For a fine to be imposed, the offence need only have been committed and the Department need not have acted on the incorrect information. Any person who has aided, abetted or incited a person to commit one of these offences is deemed to have committed the same offence and is liable to the same penalty (sec 80(4)).

Offences

- Making an incorrect return by omitting or understating anything which the Ordinance requires to be stated. The omission or understatement may either be on the taxpayer's own behalf, on behalf of another person, or on behalf of a partnership (sec 80(2)(a)).
- Making an incorrect statement in connection with a claim for any deduction or allowance (sec 80(2)(b)).
- Giving incorrect information in relation to a matter or thing affecting anyone's tax liability (sec 80(2)(c)).
- Failing to provide a return if required to do so (as per sec 51(1) or (2A); see ¶9-0300).
- Failing to inform the Commissioner of a tax liability (as per sec 51(2); see ¶9-1000).

When a taxpayer fails to supply a return (under sec 51(1) or (2A)) the Court may, in addition to other penalties, order the taxpayer to comply with the requirements of the sections within a specified time. Failure to comply with that order is in itself an offence.

The Commissioner has the power to levy an assessment of additional tax instead of prosecuting the taxpayer for any of these offences (see further ¶12-5800).

In *Case* L17 (2002) HKRC ¶80-818 (*D12/01*), the taxpayer who had reported incorrect income by making clear mistakes in relation to the sales, costs of sales and year-end stock was charged with additional tax ranging from 101.14% to 111.15% of the tax undercharged.

¶12-3000 Limitation period

Penalties are only imposed under sec 80 for return and information offences if the complaint concerning the relevant offence was made either:

- in the year of assessment in which the offence was committed; or
- within six years after the end of that year of assessment (sec 80(3)).

¶12-3700 Compounding offence or proceedings

The Commissioner has the power to compound any offence and may stay or compound any proceedings before judgment (sec 80(5)). That is, the Commissioner may make an arrangement with the taxpayer so that the taxpayer pays an appropriate penalty instead of being prosecuted.

The prosecution of an offence may only be commenced with the Commissioner's sanction (sec 84(1)), except criminal offences which the Attorney-General has the power to prosecute (sec 84(2)).

¶12-4400 "Reasonable excuse"

"Reasonable excuse" is not defined in the Ordinance. Normally, a taxpayer is regarded as having acted with a reasonable excuse if he or she acted reasonably and in good faith, and a reasonable person would regard the taxpayer's actions as consistent with a reasonable standard of conduct. What may qualify as a reasonable excuse for a technical breach is of a less robust quality than that required in the case of a serious default such as the understating of income.

The following cases provide some examples of what have, and what have not, been accepted as a reasonable excuse.

Reliance on professional advice or services

A taxpayer who, relying on professional advice, honestly believed that he did not have to return certain profits was regarded as having a reasonable excuse in *Case* A127 (1991) 1 HKRC ¶80-127 (*D18/91* IRBRD Vol 6, 36). The Board of Review stressed, however, that the fact that a taxpayer acts on professional advice does not always constitute a reasonable excuse; it always depends upon the facts of the particular case. Reliance on professional advice, for instance, is not a reasonable excuse if the taxpayer should have known that the information was not correct (*D24/85* IRBRD Vol 2, 190).

In *Case* L37 (2002) HKRC ¶80-838 (*D46/01*), the Board held that it was not a reasonable excuse for the taxpayers to shirk their responsibility in keeping proper books and accounts and in submitting proper tax returns promptly to the Revenue. Any alleged default or deficiencies by the auditors and/or tax representatives in the submission of tax returns and accounting records would still not afford a defence to the taxpayer.

Reliance on professional advice on a technical matter was a reasonable excuse in *BR 80/76* IRBRD Vol 1, 259.

It is not a reasonable excuse for filing a late return to claim that the relevant information had been submitted to a tax representative. Even if the taxpayer has furnished his tax representative with all the information required to complete his tax return, he remains ultimately responsible for submitting it to the Inland Revenue by the due date (*Case* Q8 (2007) HKRC ¶81-194 (*D50/06*); *Case* N45 (2004) HKRC ¶81-021 (*D40/03*); *Case* I94 (2000) HKRC ¶80-663 (*D31/99*); *Case* G61 (1997) HKRC ¶80-499 (*D87/96*)).

Reliance on information from Inland Revenue

Reliance on information from the Inland Revenue was not a reasonable excuse in *Case* F25 (1996) HKRC ¶80-403 (*D58/95* IRBRD Vol 11, 24). The taxpayer claimed the he had omitted his income from his salaries tax return after being told by the Inland Revenue personnel that, provided he identified his employer in his return, the Revenue would be able to trace the income figures. According to the Board, however, the taxpayer's conversation with the Inland Revenue did not negate his duty to order his affairs so that he could make a correct return. Similarly, in *Case* G52 (1997) HKRC ¶80-490 (*D74/96* IRBRD Vol 11, 693), the taxpayer claimed that no further warning was given by the Revenue in respect of the deadline of tax returns. Had such warning been given, the taxpayer would have exerted on the tax representative to ensure due observance of the time limit. It was held that the Revenue has no duty to give repeated reminders to the taxpayers to ensure timely submission of returns. It is the duty of professional advisers to protect the interests of their clients by timely submission to the Revenue.

Reliance on employer's returns or advice

Taxpayers who relied on incorrect employer's returns when they completed their own salaries tax returns did not have a reasonable excuse for omitting income from their returns in *Case* S8 (2009) HKRC ¶81-261 (*D35/08*); *Case* O55 (2005) HKRC ¶81-111 (*D9/05*); *Case* J39 (2000) HKRC ¶80-707 (*D91/99*); *Case* J27 (2000) HKRC ¶80-695 (*D113/99*); *Case* F58 (1996) HKRC ¶80-436 (*D109/95*); *Case* F57 (1996) HKRC ¶80-435 (*D108/95*); *Case* F56 (1996) HKRC ¶80-434 (*D107/95*); *Case* F55 (1996) HKRC ¶80-433 (*D106/95*) and *Case* F52 (1996) HKRC ¶80-430 (*D102/95*).