

HONG KONG COURT RULES DIRECTORS WHO SIGNED INCORRECT COMPANY TAX RETURN NOT LIABLE TO PENALTY TAX

In the first decision of its kind, the Hong Kong Court of First Instance has ruled that two company directors who submitted an incorrect tax return on behalf of the company should not be liable for an additional penalty assessment of tax. The Court has also found that an agent of a corporate taxpayer is not precluded from reopening questions regarding the taxpayer's liabilities to profits tax.

BACKGROUND

The appellants in *Koo Ming Kown v Commissioner of Inland Revenue* [2018] HKCFI 2593, Mr Koo and Mr Murakami, appealed against two decisions of the Inland Revenue Board of Review (Board) concerning assessments to additional tax raised by the Commissioner of Inland Revenue under section 82A Inland Revenue Ordinance (Cap. 112) for incorrect statements made in the tax returns of Nam Tai Trading Company Limited, formerly Nam Tai Electronics & Electrical Products Limited (the Company).

In its tax returns, the Company claimed it had incurred certain expenses, particularly management fees paid to its parent company and had deducted these in arriving at the assessable profits. Profits tax assessments were made in three successive years on the basis of the returns and were paid. In 2002, after a tax audit, the Inland Revenue decided to disallow the expenses and raised additional profits tax assessments. The Company appealed to the Board which dismissed the appeal. The Company did not pay the additional tax and was eventually wound up by the court on the petition of the Commissioner on 4 June 2012.

The previous year, in January 2011, the Commissioner took steps to invoke section 82A(1)(a) against the appellants, alleging they had made incorrect returns by understating the Company's assessable profits. The procedure culminated in additional assessments being made of HK\$12.6 million against Mr Koo and HK\$5.4 million against Mr Murakami. Each was said to be liable to additional tax on the grounds that, having signed the tax returns for the Company as a director, they had made incorrect returns within the meaning of section 82A. The appellants appealed to the Board only to see the amounts payable increased by the Board to

Key issues

- The Hong Kong Court of First Instance has ruled that two company directors who signed incorrect company tax returns are not liable to pay penalty tax.
- The court has said the directors were not acting as "agents" or "on behalf of" the company in this respect and it would be unjust to find them personally liable.
- The judgment is the latest in a series of cases in which the procedures of the Inland Revenue Department have been called into question.

HK\$21.8 million against Mr Koo and HK\$6.6 million against Mr Murakami.

SECTION 82A

Section 82A provides that *"any person who without reasonable excuse makes an incorrect return by omitting or understating anything in respect of which he is required (by the Ordinance) to make a return, either on his behalf or on behalf of another person...shall...be liable to be assessed... to additional tax of an amount not exceeding treble the amount of tax which has been undercharged in consequence of such incorrect return or has been undercharged in consequence of the failure to comply with a notice under section 51(1) or (2A), or which would have been undercharged if such failure had not been detected."* (emphasis added).

Godfrey Lam J said the Commissioner's construction of the section - that the directors had "made" the returns because they signed them - had serious ramifications. It would mean that *"whenever there was material incorrectness in a company's tax return, the person who signed it, at least where he is a director, manager, secretary or liquidator, could be subjected to an administrative penalty plus compound interest up to treble the amount of tax undercharged, unless he established a reasonable excuse."*

Acts of the company

The Company could only furnish a return through the acts of natural persons: *"someone had to use a typewriter or a pen to fill in the form, someone had to sign in the box and someone had to post or deliver the completed form to the IRD."* But it did not follow that these individuals had made the return. Making the return was a *"legal act capable of being said to have been done directly by a company albeit through physical steps undertaken by human beings."*

It was also not always accurate or appropriate to say that an individual who does an act in the name of the company is an *"agent"* acting *"on behalf of"* the company, rather the individual was an *"embodiment of the company"*. It was the Company that was issued a notice under section 51(1) to furnish the return on the form sent to it.

If no return was furnished, it would be the Company that would be liable under section 82A(1)(d) for failing to comply with the requirements of the notice. If the legislature wanted to make directors, managers, secretaries and liquidators potentially liable for substantial administrative penalties, it should do so in plain terms. Punishment of the taxpayer company was already a strong deterrent to the officers concerned who could be held accountable by the company for misfeasance or by the shareholders.

Godfrey Lam J concluded that, where a company has been required by notice issued to it under section 51(1) to make a return, it is the company, rather than the individual who signs the document, that furnishes or makes the return in compliance with the requirements of the notice. Accordingly, section 82A(1)(a) did not permit a penalty assessment to be made on the appellants, directors of the Company who signed the tax returns.

FINAL AND CONCLUSIVE?

The Court also considered the Commissioner's argument that where no valid objection or appeal had been lodged within time against an

assessment under section 70, the assessment shall be "*final and conclusive*" as regards the amount of the assessable income and that the appellant directors were unable to challenge it. The Court said it would be "*quite remarkable*" that an assessment could become binding upon and beyond challenge by a third party without any opportunity for objection or adjudication. In the case of Mr Murakami, he had ceased to be a director of the Company in 2002, some 15 years before the tax audit which led to the revised assessments.

Whilst agreeing with the *dicta* in *Moulin Eyecare Trading Ltd (in liquidation) v Commissioner of Inland Revenue* [2014] 17 HKCFAR 218, that the finality of assessments was a major policy aim of the Ordinance, the Court said that this policy consideration did not support the Commissioner's argument. The appellants were not seeking to upset the finality of the assessments against the Company or to re-open them. They merely contended that the assessments should not be treated as binding upon them. It should also be noted that in *Moulin Eyecare*, Lord Walker of Gestinghope NPJ (with whom Ma CJ, Ribeiro PJ and Bokhary NPJ agreed) stated that the general rule embodied in section 70 was "*aimed at achieving finality as between the Commissioner and the taxpayer*" (emphasis added in the judgment of Godfrey Lam J).

In any event, it was at least arguable that the tax returns were not incorrect in understating the amount of assessable profits when they were increased only by the exercise of a statutory power not available to the taxpayer.

ANALYSIS

The judgment is the latest in a series of judgments to examine the nature and effect of Hong Kong's tax code, particularly as it relates to the imposition of profits tax (see our client briefing: "[Hong Kong Court of Appeal considers whether receipt arising from the disposition of land is chargeable to profits tax](#)") and the practice of the Commissioner in dealing with objections to tax assessments (see our client briefing: "[Hong Kong court challenges long-established practice of Inland Revenue when dealing with an objection to tax assessment](#)".)

In this instance, directors that may have long since ceased to have dealings with companies for which they used to serve as officers will be relieved to know they cannot be made personally liable for tax assessments made against the companies years after their time in office.

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