

Court ruled company directors not personally liable to penalty tax for incorrect profits tax returns filed

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Issue 7

In brief

The Court of Appeal (COA) handed down its judgment on *Koo Ming Kown and Murakami Tadao v. The Commissioner of Inland Revenue (CIR)* on 11 October 2019 and delivered its written judgment on 20 July 2021¹.

The case concerns whether additional (penalty) tax assessments can be issued by the Inland Revenue Department (IRD) to the directors of a company who sign the profits tax return of the company filed with the IRD, when such returns are regarded by the IRD as incorrect.

The COA held in this case that the directors of a company are not required under the Inland Revenue Ordinance (IRO) to make or furnish a profits tax return on behalf of the company, and therefore cannot be made liable to additional (penalty) tax imposed for filing an incorrect return of the company.

In detail

Background of the case

- The two individuals involved in this case (the Applicants) were the directors of a Hong Kong incorporated company. The IRD conducted a tax audit of certain profits tax returns filed by the company that were signed by the Applicants.
- At the conclusion of the audit, additional profits tax assessments were issued to the company to disallow the deduction of certain intercompany fee expenses claimed in the returns, on the basis that they were not deductible under sections 16 and 17 of the IRO or alternatively sections 61 and 61A (the anti-avoidance provisions) of the IRO.
- After unsuccessful appeals, the company did not pay the additional taxes assessed and was wound up by the court on the petition of the CIR.
- The CIR then invoked section 82A(1)(a)² of the IRO and issued additional tax assessments to the Applicants on the basis that they had made incorrect returns on behalf of the company.
- The Applicants appealed against the additional tax assessments firstly to the Board of Review and then to the Court of First Instance (CFI) upon the dismissal of their appeal by the Board.

Judgment of the CFI

- The CFI held in favour of the Applicants and concluded that where a company is required by notice issued by the IRD to it to make a return, it is the company, rather than the individual who signs the document,

that makes the return in compliance with the requirements of the notice. Accordingly, section 82A(1)(a) does not permit a penalty assessment to be made on the Applicants. For a detailed discussion of the CFI's judgment, please refer to our *Hong Kong Tax News Flash* previously issued³.

Judgment of the COA

The CIR lodged an appeal to the COA against the CFI's judgment. The COA dismissed the CIR's appeal and upheld the CFI's judgment that the Applicants were not required to make or furnish the returns on behalf of the company, and thus could not be made liable to the additional tax imposed under section 82A(1)(a). The key points of the COA's decision are summarised below.

Issue 1: Whether the returns were made by the Applicants in their personal capacity as agents for the company?

- The returns of the company were not made by the Applicants in their personal capacity as agents for the company. The Applicants' acts should be regarded as those of the company itself.
- The process of filing a return is triggered by the giving of notice by the assessor to the person who is required to make or furnish the return. As the notices were addressed to the company, it was for the company to furnish the returns. There is no compelling reason to regard the returns to have been made by someone else on its behalf, when it was capable of doing so itself (albeit the physical acts would inevitably have to be done by a human being).
- In respect of the declaration signed by the Applicants in the tax returns, nothing in it expressly indicated that the Applicants were to be regarded as having made the returns on behalf of the company. Even if the declaration were made by them in their personal capacities, it did no more than declare their own belief as to the correctness of the information in the return which was provided by the company itself.
- In signing the returns as directors of the company, the Applicants should be regarded as doing the act as the company instead of doing so as agents for the company.

Issue 2: Whether the Applicants were *required* by the IRO to make the returns on behalf of the company?

- Section 57(1) of the IRO imposes an obligation on directors to be "answerable" for doing the acts which are required to be done by the company (i.e. the directors are under a duty to ensure that the act in question is done by the company). This is different to being under an obligation or requirement to do the act on behalf of the company. The use of the term "answerable" instead of "required" suggests that the obligation imposed on the directors is different to that imposed on the company. This distinction is underlined by the existence of IRO provisions which clearly and explicitly impose a requirement on certain persons to do acts (including the making of returns) on behalf of others, such as the requirement imposed under section 53 on the agent (in Hong Kong) of a non-resident person to do any act that the non-resident person is required by the IRO to do.
- Based on the well-established principle against doubtful penalisation, a person should not be penalised except under clear law. Accordingly, even if it might be arguable that section 57(1) imposes a personal obligation on the directors to make returns on behalf of a company, the said principle should be applied so that section 57(1) should be interpreted in such a way as to avoid penalising the Applicants.

Issue 3: Any liability imposed on answerable directors for failing to ensure the company performs its obligations?

- The IRD has the power under section 51(4) of the IRO to require the answerable directors to provide information or to be examined with regard to the tax liabilities of the company. Failure to comply with such demands in notices without reasonable excuse is an offence under section 51(4B). It is ultimately a question for the legislature to determine what, if any, consequences should flow from such failures on the directors' part.

Application for leave to appeal to the Court of Final Appeal

The case has not yet been finalised as the CIR filed an application for leave to appeal against the COA judgment to the Court of Final Appeal (CFA) on 8 November 2019 soon after the date of the COA judgment.

The takeaway

The COA's judgment, to a certain extent, reinstated the doctrine of separate legal personality of a company in the reading of the punitive provisions and denied the application of section 82A(1)(a) to corporate officers who signed the tax returns of a company. It has yet to be seen what the final outcome of this case will be as the CIR has applied for leave to appeal to the CFA. Meanwhile, it is worth noting that where a person is expressly required to make a return on behalf of another person (such as the agents of non-resident persons under sections 20A and 53), the person making the returns could be liable to punitive actions under section 82A(1)(a).

Endnotes

1. The COA's written judgment in this case can be accessed via this link:
https://legalref.judiciary.hk/lrs/common/ju/ju_frame.jsp?DIS=137263
2. Under section 82A(1)(a), administrative penalty assessment (in the form of additional tax) can be issued to a person if the person, without any reasonable excuse, *makes* an incorrect return in respect of which he is *required* by the IRO to make, either on his behalf or on behalf of another person.
3. The news flash can be accessed via this link:
<https://www.pwchk.com/en/hk-tax-news/2021q3/hongkongtax-news-aug2021-7-section82a1.pdf>

Let's talk

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