IN THE HIGH COURT OF THE COOK ISLANDS
HELD AT RAROTONGA
(CIVIL DIVISION)

OA NO. 3/2001

IN THE MATTER of the Income Tax Act 1972

BETWEEN **ANTHONY MARK MANARANGI** of Rarotonga, Solicitor

Appellant

AND **GEOFFREY COLIN STODDART**, Collector of Inland Revenue

Respondent

Mr MC Mitchell for Appellant
Mr T Clarke for Respondent
Date of Hearing: 26 November 2001
Date of Judgment: 29 November 2001

JUDGMENT OF GREIG CJ

This is a case stated on objection by the taxpayer against the determination of the Collector to charge penal tax of 100% on what was determined by him to be the deficient tax pursuant to s. 224 of the Income Tax Act 1972.

At the opening of the hearing counsel for the taxpayer raised a preliminary point which it was said determined the whole matter. The point is a legal one Shortly put it is that for the relevant years 1995 and 1996 no income tax could lawfully be assessed or levied on the taxpayer and that there being no income tax there could be no deficient tax or penalty. As I said the matter in issue before the Court related to the income year and the years of assessment for the years ended 31 December 1995 and 1996. At that time the 1972 Act was in force.

The point arises out of the application and the construction of ss. 41 and 42 of the Act. S. 41 provides:

> (1) Subject to the provisions of this Act there shall be levied and paid for the use of Her Majesty for the year commencing on the 1st of January in each year a tax herein referred to as income tax.
>
> (2) Subject to the provisions of this Act, income tax shall be payable by every person deriving income on all such income derived by him during the year for which the tax is payable.

Sub-section (3) provides the definitions of the year of assessment and the income year. S. 42 provides:

> 42 Rates to be fixed by annual taxing Act:
>
> (1) Income tax shall be assessed and levied on the taxable income of every taxpayer at such rate or rates as may be fixed from time to time by Acts to be passed for that purpose;
>
> (2) The Act by which the rate of income tax is so fixed for the year is in this Act referred to as the annual taxing Act.

The last time an Annual Taxing Act was passed was on 4 May 1993. That was the Income Tax (Annual 1993) Act 1992-1993. That fixed rates for the year commencing 1 January 1993. The Act validated all assessments and payments made for that year. In the absence of an annual Act there is no rate of tax payable and therefore no power to assess or to levy the tax on taxpayers. S. 19 of the Act permits assessment by the Collector at the basic rates as specified in the First Schedule to the 1972 Act , but that is subject in the end to the rates that are fixed by the annual taxing Act. The basic rate does not continue and is not therefore the tax rate which may be levied against the taxpayer.

S. 224 provides:

> 224. Penal tax in case of evasion

> If any tax payer evades, or attempts to evade, or does any act with intent to evade, or makes default in the performance of any duty imposed upon him by this Act or any regulations thereunder with intent to evade, the assessment or payment of any sum which is or may become chargeable against him by way of tax (which sum is hereinafter referred to as the deficient tax), he shall be chargeable, by way of penalty for that offence, with additional tax (hereinafter called penal tax) not exceeding an amount equal to treble the amount of the deficient tax.

That then provides for a tax or a penalty of an additional charge which is based upon and assessed upon the deficient tax which in turn is based upon the rates fixed by the Annual Taxing Act. So in the absence of an Annual Taxing Act there can be no penal tax chargeable. There was no argument against this submission put forward by the Collector.

In the circumstances that disposes of the matter and means that the determination of the penalty which is the only matter in issue here could not be charged. On that basis and related to the penalty or penal tax the objector must be entitled to an order in his favour.

I note that the Income Tax Act 1997 came into force on 1 July 1997. By s. 230 of that Act it applies to tax for the income year commencing 1 January 1997.

The scheme for taxing a taxpayer is changed under this Act and by section 40 of the 1997 tax is assessed and chargeable on the rates set out in the First Schedule. That then means that these continue and any changes depend on an alteration to the First Schedule. The point that was argued then cannot apply after the 31st of December 1996.

Notwithstanding this determination the taxpayer sought to deal with the matter on the merits and to challenge what was the finding of the Collector that by some act or default there was an intent to evade tax or that by wilful neglect and default in making due and complete returns there was an intent to evade. The taxpayer also sought to object to the quantum of the amount that was assessed.

The onus of proof in this case as in all other objections is on the objector. Part IV of the Act deals with objections. Section 25 makes the assessment conclusive and it is quite clear under s. 31 of the Act that the objector has the onus of proof.

Objections to penal tax are provided for separately under Part XIV of the Act by s. 227. It is therefore treated as a separate matter and is not in the ordinary way an objection under Part IV. S. 227 however provides clearly that the manner of objection to penal tax and the other provisions in relation to objections in the Act are to be applied. That must apply s. 31 and must apply the onus on the objector.

It was argued that because of the penal nature of this tax and the determination that is required to be made by the Collector and the form in which there is a finding of evasion that in fairness or in justice, perhaps, there should be some equitable interpretation or reading of the Act to change the onus. That would require a reading down of the Act or an insertion by implication into the Act of words which alter the onus entirely. That I think cannot be done. It is interesting to note that the comparable legislation in New Zealand specifically provides that on objections to penal tax the onus is on the Commissioner of Taxes. It is interesting to note too that the 1997 Act of the Cook Islands which was a complete consolidation and re-formulation of the tax legislation repeated precisely the provisions of s. 31 and the provisions of s. 227. Clearly the legislature thought fit to repeat these

provisions and they must stand. I am in no doubt that the onus of proof in this case must remain on the objector.

What that means is that the objector has to show that the Collector was wrong. In other words in the circumstances and on the evidence now before the Court the taxpayer did not have the intent to evade or has not acted wilfully or by neglect in such a way as to become chargeable to penal tax. In effect this is a review de novo. It is not just a question whether the Collector has been wrong in law or failed to take into account matters that were relevant or took into account matters that were irrelevant. That is the kind of decision that has to be made on an administrative review. Moreover it is not just a question whether on the evidence then before the Collector at the time he made the determination he was justified or entitled to make it. I have to decide on a complete review of all the circumstances before the Court whether the objector has shown that he is not chargeable with penal tax.

I deal first on this with the facts and with the facts as they appear to have been before the Collector. In the relevant years 1995-1996 the taxpayer was a barrister and solicitor in private practice. He had been in practice for some time and there was before me and before the Collector tax returns by the taxpayer for the years ended 1992,1993 and 1994. The taxpayer instructed an accountant in practice here to prepare the returns. The accountant is not formally qualified but has had considerable experience in commerce and accountancy and has operated a practice in accountancy and in the preparation and filing of returns of income tax for some time. Contrary to the first recollection of the accountant in the witness box he prepared the tax returns for the objector for the years 1992, 1993 and 1994. The last of these was dated 11 September 1995.

The returns in issue were prepared and dated 10 January 1998. They were prepared on a cash basis. That means that there is no provision for bad or doubtful debts or for un-billed work. Each of the relevant returns sets out a

trading profit and loss account for the year. That showed the gross cash receipts less the turnover tax and the provision for that tax. There was shown then the expenses of operating the practice. These include such items as depreciation and an allowance for his office work at home and some vehicle running. These of course are legitimate allowances or deductions. I mention them because they are not cash deductions against receipts.

A barrister and solicitor commonly, as does this taxpayer, pays disbursements, expenses, filing fees and other items on behalf of a client. They are often paid out of the solicitor's own pocket, they are paid in advance of recovery from the client. But they are in due course billed and paid, and there is always a balance of unpaid disbursements which it seems is and has been accepted as a legitimate allowance in that Income Tax year as an expense.

It is noted that in the three earlier returns the amount of that claim for disbursements was $273.32, $2199.54 and $4716.15. That indicates of course a fluctuation in such items and would commonly be expected in the fluctuation of the business and a possible outlay from time to time on a client's business.

In the relevant tax returns in issue the disbursements were not shown as part of the general operating expenses of the practice but as a direct deduction against the gross receipts. The amount for 1995 was $25,597.25 and the amount in 1996 was $37,537.27. That is to say the amount was some six to seven times greater than the amount shown in 1995. In the result, the tax assessable in 1995 was less than 1/10th of the gross receipts, that is to say some 90% of the gross receipts was swallowed by expenses. In the other year the tax as returned as assessable was less than 1/16th of the gross receipts.

I said that the tax returns were dated in January 1998 and were filed on 17 March 1998. It was not until 25 January 1999 that an assessment was made. The Collector's explanation of that delay was that there was a large backlog and this was the reason for that delay.

Following the assessment, there was then an audit of those two returns. As is customary audits are done on a random basis. Here the audit is done by the Collector himself. The explanation is that he has a small staff. None of them have any tertiary or other accounting qualification or overseas experience. He proceeded to do the audit but sent out the letter of enquiry that followed that in a clerk's name. That was done so that he would not have to field the preliminary response. The Collector told me in evidence that his basic view was to look at the return on a point of reasonableness. His conclusion was that the assessable tax at 1/10th or 1/16th of the gross was not reasonable. The first letter that was sent to the taxpayer or the taxpayer's accountant was sent out on 8th February 1999, shortly after the date of the assessment. It sought in particular details of the client's disbursement items. That was followed on the 12th of February 1999 with a further query about the taxpayer's communication expenses.

The accountant unfortunately had no contemporary note of his response to this matter or his responses to the Collector. But there is a note on the letter of 8th February or on the copy in the Collector's possession which is somewhat cryptic but it appears to indicate that the accountant had advised the clerk that some of the disbursements had been received and that there would be a reduction.

Although there is no contemporary record to confirm this I accept entirely that the accountant did make an early enquiry of the taxpayer on receipt of the letters in February. He discovered then that there was or had been an error and that new returns of tax would have to be made.

On 24 February the accountant wrote to the Collector and sought an extension of time for formal response because he was going overseas until 21 March. The Collector's response was to extend the time for an answer to the enquiries on the audit to 16 April. That appeared to have been extended to the 23rd of April following a discussion on the telephone on the 19th of April. As far as the Collector is concerned nothing then happened.

On 27 September the Collector now under his own signature reminded the accountant that he had not had a response. That did not achieve a reply either and in early December the Collector sought a meeting with the taxpayer. That meeting was held on 7th December and following the meeting the Collector wrote to the taxpayer concerning the discussion. A number of matters were discussed but on the personal income tax question the letter from the Collector was as follows:

> *"In relation to your personal income tax and the arrears of annual returns I note you hold the amended returns as compiled by the accountant in your possession and you will present these to us later today after photocopying them for your office copy. We discussed the reasons for the earlier understatement of net income and I will not go into the detail of that again in this correspondence. However, my staff will again consider the items on which written explanations were asked for when examining the amended returns receivable. I record your acknowledgement that your first filed tax returns were materially understated and my office had reasonable cause for enquiry."*

Following a reference to the 1997 and 1998 returns there was this from the Collector:

> *"I record your advice here that there is an amount of taxation calculated on your amended returns as payable*

and it is your intention to offer a term payment proposal. We shall consider this proposal having regard to the quantum of the assessment and other factors in due course."

The amended returns are noted as having been filed in the Collector's office on 11 December 1999. These amended returns were accompanied by amended profit and loss accounts for each year. There were alterations to the gross receipts, one year they were down to some extent, the other year they were up. As between the two years there was an increase overall of some $6,000 to $7,000. The client's disbursements as shown as a deduction for 1995 were now $2,881.25 and for 1996 $1,329.28. The taxable income in each year was just under 50% of the gross. My understanding is that in an ordinary solicitors practice that would not be an unusual or an unreasonable balance between gross and taxable income. Neither the taxpayer or the accountant made any response to the Collector's letter of 7 December.

On 13 July 2000 the Collector wrote to the accountant referring to the tax returns and assuring a minimum tax applying to the returns together with the 10% late payment of additional tax. In the body of that letter the Collector said this:

"Having regard to the material difference in the taxable income originally prepared and the taxable income resulting from enquiries from this office, your client may wish to advise if there is any reason the Collector should not impose penal tax under s. 224 of the 1972 Income Tax Act." He went on to say, " your client is not obliged to respond however in the absence of a reply the Collector will decide accordingly."

He gave notice that he intended amended assessments and invited written submissions by 29 July 2000. There was no reply to that.

On the 13th of September the Collector it seems on his own initiative extended the time for reply to the 29th of September. The Collector was aware that the accountant was overseas. Again there was no reply and on the 16th of January 2001 an assessment was issued which included the tax now assessed, the additional late payment tax and the penal tax at 100% of the deficient tax.

The reasons for the decision of the Collector and his finding and determination of intent to evade was based on the wide discrepancy in the amounts shown as the deduction claimed for client's disbursements and the unreasonably low amount of taxable income as first shown. The Collector understood from his general and particular knowledge of the taxpayer and his business that the taxpayer had a knowledge of his own accounting and billing. It was understood by the Collector that the taxpayer made up or typed his own bills and accounts from time to time. The Collector had made some enquiries and ascertained that the taxpayer had paid in respect of a mortgage over some of his property sums in excess of the amount of the taxable income as returned in the original returns.

The Collector was I think reasonably entitled to take into account the absence of any explanation on behalf of the taxpayer. The delay in the matter could not allay any doubt or suspicion on the part of the Collector.

I have had the advantage of hearing both the taxpayer and the accountant and the Collector in this matter and I have had careful and full submissions from both counsel in the case. The explanation of the original error is that the accountant was given figures in four columns for the relevant years. The columns were for the gross receipts for the year, the client disbursements for the year, the net receipts and the turnover tax. These were shown month by month. In addition the accountant had the general account of the taxpayer from which he was able to extract the other items of expenditure and operating expenses. The accountant did not make any enquiry or

investigation beyond those figures. He did not seek any copies of the bank statements. What he appears to have done is to add up all disbursements and treat them as a total deduction for each of the years. When the tax returns were completed he had a discussion with the taxpayer, that was a relatively short one. The taxpayer as is usual asked how much tax was payable, he was happy that it was a small or very small amount and he signed the tax returns.

It was clear that for some period, I am not sure how long, the tax returns were held by the taxpayer before he handed them over. At the least that gave the taxpayer an opportunity to check them.

When the matter was raised it is clear, as I have already accepted, that the accountant took steps to investigate. He ascertained that there had been an error, clearly a serious one and he undertook to make new returns. The accountant's explanation for the delay was that the accountant and the taxpayer were overseas for some periods but not at the same time. No attempt was made to specify those periods and I am bound to say that in the face of a discrepancy such as this, it behoved the accountant and indeed the taxpayer to take speedy steps to correct the matter.

It is the case that in 1998 when these returns were completed and the taxpayer filed them with the Collector, they were for some years past, some two or three years in the past. I think it is reasonably to conclude that a taxpayer busily involved in his day to day practice would not remember in detail the affairs of his practice and the moneys he might have made in the years past. Clearly there are fluctuations in income in any business, solicitors are peculiarly subject to that. The taxable income as I have already observed is not in a strict relation or does not strictly correspond with the net spending income or the income which was actually spent. There is also some indication that at least for some periods in the relevant times the taxpayer operated on overdraft.

The Collector has been satisfied on all the other items which he queried. These included the mortgage repayments that I have mentioned and some other transactions which were questioned during the earlier part of the enquiry. The Collector furthermore has been satisfied and has accepted the various other items of expenses and deductions although they have in some cases varied. He has accepted too the gross receipts as now returned.

It is important I think to note that this is not a case of hidden income. It is an error in claimed deductions which was in fact glaringly obvious. It was clearly disclosed. It ought to have been obvious and indeed it is accepted that there was an error on the part of both accountant and taxpayer in this matter. It was obvious enough to be noted at the first audit. It is however clearly the accountant's error.

There is not in this case any deliberate intention to evade. It was suggested that of course the making of the return, if accepted by the Collector, would have meant an amount of tax payable on the returns very much less than ought to have been payable. It was by chance perhaps that an audit was conducted on those returns. But I am still not satisfied that this was a deliberate intention to evade. There was carelessness but the question really is whether there was wilful carelessness such as is justified in being treated as an intention or as being the deliberate or wilful closing of one's eyes to the true position.

Looking back, it now seems clear but in ordinary circumstances at the time and having regard to my view of the evidence that is now disclosed I am not prepared to find that the taxpayer was deliberately intending to evade or was so wilfully careless as to amount to an intention to evade.

I believe that the Collector on the information before him and on the lack of any explanation forthcoming from the taxpayer was justified in his

determination. But now having heard the whole matter before me I believe that the objector has satisfied the onus of proof and that he is entitled to an order or a declaration that he did not intend to evade and did not wilfully or carelessly act to amount to such an intent.

As to the quantum if the taxpayer had intended or had the intent or was careless such as to amount to an intent, I believe that the 100% penalty being a 1/3 of the maximum is neither wrong or excessive. This was a substantial amount of tax. If there had been an intent to evade, it was a serious matter and a penalty such as was imposed was by no means unreasonable or excessive.

Finally it was suggested or claimed that the penalty tax or additional tax of 10% was also subject to objection and should be declared excessive.

I am satisfied that on proper reading of the Income Tax Act that form of penalty tax is not subject to objection. It was clearly properly assessed, the assessment or the question of payment of such tax maybe challenged before the taxpayer under particular provisions of the Act. It is outside the ordinary objections provisions under Part IV and is certainly not part of the penal tax provisions in Part XIV.

In the result then on the basis of the preliminary determination the answer to this question in the case stated must be no.

Costs normally follow the event. In this case the objector has won. He has won on a technical ground and also on the merits as they were presented to this Court. The technical ground was raised at the hearing. It was never part of the objection or the answer to the case stated. It is a flaw or a gap in the legislation but it is legislation for which the Collector must have some responsibility. I have found in the course of my finding that the Collector was justified but that on a full hearing there is no intent to evade. For that the

objector taxpayer must bear some responsibility because he did not attempt to satisfy the Collector about the matter or indeed give any real explanation or excuse for what had occurred. This is a highly unusual case and my conclusion is that there should be no order for costs and that costs will lie where they fall.