Preamble

As part of the Society's regular dialogue with the Government to facilitate tax compliance, improve procedural arrangements and to clarify areas of interpretation, representatives of the Society met the Commissioner of Inland Revenue ("CIR") Mr. Wong Ho-sang, and members of his staff in January 1999. As in the past the agenda took on board items received from a circulation to members prior to the meeting. The minutes of the meeting, prepared by the Inland Revenue Department ("IRD") are reproduced in full in this Tax Bulletin and should be of assistance in members' future dealings with the IRD. Part A contains items raised by the Society and Part B, items raised by IRD.

Summary of Discussion Items

Part A Items

A1. Matters Arising from 1998 Meeting:

   (i) A6 (i) & (ii) - Profits on Long-term Building Contracts and Loss Carry back (the Proposed DIPN No. 1 (revised)).
   (ii) A16 - PRC/HK Double Taxation (DIPN No. 32).

A2. Lodgment of Tax Returns:

   (i) The Latest Lodgment Statistics or Patterns.
   (ii) Presentation of the "Tax Representative" Filing Performance Report.

A3. Holdover of Provisional Profits Tax:

   (i) Types of Management Accounts and Certification thereof to Support Holdover Applications.
   (ii) Acceptance of Shorter Period Management Accounts.
   (iii) Acceptance of Late Applications.

A4. Salaries Tax:

   (i) Extending the Block Extension Deadline to End of July.
   (ii) Self-assessment on an Election Basis with Extended Filing Deadline and Fixed Tax Payment Date.


A7. Definition of Life Insurance Business under Section 23 (9) of IRO.

A8. DIPN No. 33 - Applicability of Appendix A to Businesses other than Insurance Agents.


   (i) DIPN No. 21 and Totality of Factors.
   (ii) Entrenching Certain Source Principles in IR Rules.

A10. Extension of Separate Assessment to Personal Assessment.

A11. Individual Cases:

   (i) Statement of Facts.
   (ii) Suspension of Business Registration Fees when Company has Applied for Striking off.

Part B Items

B1. Proper Completion of Returns.

B2. Apportionment of Profits into Onshore and Offshore Components.

B3. Payment by Installments and Waiver of Surcharges.

B4. Electronic Methods of Settling Demand Notes.

B5. Time Required to Make Advance Rulings.

B6. Discrepancies Detected by Field Audits.

B7. Accrual Basis of Accounting.

B8. Record Keeping by Professional Accountants.

Full Minutes

The 1998/99 annual meeting between the Hong Kong Society of Accountants' Taxation Committee and the Commissioner of Inland Revenue was held on Friday, 8 January 1999 at the Inland Revenue Department.

IN ATTENDANCE
CIR welcomed the Society's representatives to the meeting. After introducing the IRD members, he reiterated his support for the annual meeting as a useful forum of communication on practical issues affecting both the Society's members and IRD.

Mr Lui, after thanking CIR for his welcome, re-affirmed the Society's commitment to the meeting as a conduit for constructive dialogue between the Society and IRD. The meeting then commenced discussion of the agenda.
The future. Thus, for corporations, the concession will only apply where the specific project is completed
forward for set-off purposes does not apply. If a corporation ceases a particular business, any unrelieved losses
profits for subsequent years of assessment. The same trade or business requirement for losses to be carried
houses for other owners.

The HKSA wished to clarify two issues relating to the loss carry back. First, it wanted to know the IRD treatment
where the contract had been undertaken by an unincorporated business as a joint venture, partnership, or
individual consultant. Secondly, in accordance with the rules on “combining and segmenting construction
contracts” in paragraphs 6-9 of SSAP 23, it considered there was a case for allowing carry backs of losses on a
contract by contract basis, rather than an overall business basis.

CIR confirmed that the concession is not confined to incorporated businesses. DIPN No. 1 (Revised), in Part B,
paragraph 8, uses the words “a taxpayer” and not “a company”. It applies equally to incorporated and
unincorporated businesses. He also said the concession would be reviewed if it was found to be being abused.

The requirements of SSAP 23 are usually applied separately to each construction contract. However, the SSAP
recognizes that situations will occur where it is necessary to combine or segment construction contracts. The
requirements of the SSAP then apply to the separately identifiable components of the contract. Where a contract
covers a number of assets, the construction of each asset is treated as a separate contract where -

- separate proposals are submitted
- separate negotiations took place
- costs and revenues can be separately identified.

For tax purposes, each separately identifiable component of a contract is regarded as a single contract. Any loss
incurred in respect of one component can only be set off against other profits of the same year or carried
forward for set off against future profits. Other than for one project companies that cease business entirely,
carrying back of losses on individual contracts to prior years is not permitted. Mr Tam said that questions of
cessation were determined on a “taxpayer” basis. For companies and partnerships, cessation is a matter of fact.

[Post-meeting Note]

The CIR has since confirmed that the concession in DIPN No. 1 (Revised), which is intended to give relief for
losses that would otherwise lapse upon the cessation of the trade or business, applies to all taxpayers irrespective
of whether they are individuals, partnerships or corporations. There are, however, different legislative provisions
governing the carrying forward of losses: section 19C(1) for individuals, section 19C(2) for partnerships and
section 19C(4) for corporations.

Sections 19C(1) and (2) provide that the losses incurred by an individual or a partnership can be carried forward
and set off against assessable profits from that trade, profession or business for subsequent years of
assessment. In other words, if an individual or partnership ceases a trade or business and then restarts it in the
future, then provided the recommenced business is only a continuation of the business previously conducted and
not a new business, the losses made in the previous years can be set off against future profits of that trade or
business. It is up to the individual or partnership concerned to establish, as a matter of fact, that the business is a
continuation of the old trade such that the period of inactivity amounts only to a temporary suspension of the
business rather than a cessation. If a new trade has been established by the individual or partnership, the losses of
the previous trade or business cannot be set off against the assessable profits of the new trade or business. For single
project businesses conducted by individuals and partnerships, they have a finite life span which comes to an end upon
the completion of the project. At this point, the business ceases once and for all and the concession in the DIPN can apply. The question of “re-commencing” business therefore does not arise. In the case of an individual (in particular) the question of cessation will very much turn on the facts. The cessation of one of an ongoing series of single projects e.g. construction of village houses for individual owners, would not be taken as cessation of the trade or business if the individual concerned continued to build more such
houses for other owners.

For corporations, section 19C(4) provides that the losses can be carried forward and set off against assessable
profits for subsequent years of assessment. The same trade or business requirement for losses to be carried
forward for set off purposes does not apply. If a corporation ceases a particular business, any unrelieved losses
incurred can be carried forward and set off against its assessable profits of any trade or business it carries on in
the future. Thus, for corporations, the concession will only apply where the specific project is completed and it
has gone into liquidation. In any other situation, the losses will be carried forward for future set off.

Item A1(ii) - PRC/HK Double Taxation (DIPN No. 32)

The HKSA said that the PRC/HK double taxation arrangement provides that a Hong Kong entity which -

(a) has a project in the Mainland that does not last for more than 6 months; or
(b) provides services through employees or other personnel for a period or periods not exceeding 6 months in the aggregate 6 months in any 12 months period

will not be regarded as having a permanent establishment in the Mainland and accordingly will not be subject to
tax there. The Society considered that it was not clear how the provision of after-sale and installation services
would be treated. If it formed part of a project for the sale or installation of plant and equipment, it cited the
situation of a new project lasting for 5 months and after-sales services taking a further period in excess of one
more month. It asked if IRD would consider adopting rules similar to those in paragraphs 6-9 of SSAP 23.

The CIR said DIPN No. 32, in paragraph 15, states that the duration of a project runs from the date the contractor
commences work (including all preparatory activities) up until the date of hand over after completion of the work.
After-sales or installation services provided immediately following completion of the main installation would be
expected to form part and parcel of the project. It is necessary to determine whether the after-sales or installation
work performed constitutes an essential and significant part of the project or post-completion maintenance. If it is
an integral part of the project, the period during which such services are provided would normally be taken into
account in determining the project’s completion date.
The CIR said the SSAP 23 describes the circumstances under which construction contracts should be segmented or combined for the purposes of applying the generally accepted accounting principles to the determination of profits. It has no relevance to deciding the existence of a permanent establishment. The determination of whether a permanent establishment exists is a totally different issue. It is necessary to consider a site or the project as a whole rather than by reference to its individual components. DIPN No. 32, in paragraph 15, states that if two or more sub-projects are contracted for at the same site or as part of the same project, then they are part of a single project. The duration of the respective contracts must be aggregated in calculating the 6-month period when determining whether a permanent establishment exists.

[Post-meeting Note]

The CIR has subsequently reconfirmed that for after-sales service to be taken into account it is necessary to determine whether the after-sales or installation work performed constitutes an essential and significant part of the project or post-completion maintenance. This is determined from the contract documents and the facts of individual cases. Whether the after-sales maintenance work is done on-site or off-site is not, of itself, a material consideration. The essence of the matter is whether the service is provided as part and parcel of the project.
TAX BULLETIN

Annual Meeting between
the Inland Revenue Department and
the Hong Kong Society of Accountants - 1999

PART A - MATTERS RAISED BY HKSA

Item A2 (i) - Lodgment of Returns (latest statistics and patterns)

The HKSA asked to discuss the latest lodgment statistics and patterns.

Mr Tam provided the following lodgment statistics (as at 14 November 1998) for 1997/98 returns -


<table>
<thead>
<tr>
<th>Comparison</th>
<th>1997/98</th>
<th>1996/97</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulk issue (on 1 April)</td>
<td>148,000</td>
<td>139,000</td>
</tr>
<tr>
<td>Cases with a failure to file by due date:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>'N' Code</td>
<td>2,900</td>
<td>2,200</td>
</tr>
<tr>
<td>'D' Code</td>
<td>5,400</td>
<td>5,100</td>
</tr>
<tr>
<td>'M' Code</td>
<td>11,700</td>
<td>10,200</td>
</tr>
<tr>
<td>Total</td>
<td>20,000</td>
<td>17,400</td>
</tr>
<tr>
<td>Compound offers issued</td>
<td>8,200</td>
<td>7,100</td>
</tr>
<tr>
<td>Estimated assessments issued</td>
<td>6,500</td>
<td>6,200</td>
</tr>
</tbody>
</table>

B. 1997/98 Detailed Profits Tax Returns Statistics

<table>
<thead>
<tr>
<th>Cases with a failure to file by due date:</th>
<th>N</th>
<th>D</th>
<th>M</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total returns issued</td>
<td>19,000</td>
<td>42,000</td>
<td>113,000</td>
<td>174,000</td>
</tr>
<tr>
<td>Failure to file on time</td>
<td>2,200</td>
<td>5,100</td>
<td>10,000</td>
<td>17,300</td>
</tr>
<tr>
<td>Compound offer issued</td>
<td>1,000</td>
<td>2,500</td>
<td>3,900</td>
<td>7,400</td>
</tr>
<tr>
<td>Estimated assessments issued</td>
<td>700</td>
<td>1,700</td>
<td>3,000</td>
<td>5,400</td>
</tr>
</tbody>
</table>

C. Represented Corporation and Partnership Returns - Lodgement Patterns

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>D - 31 July</td>
<td>100%</td>
<td>80%</td>
<td>80% *</td>
</tr>
<tr>
<td>M - 31 August</td>
<td>25%</td>
<td>14%</td>
<td>15%</td>
</tr>
<tr>
<td>M - 30 September</td>
<td>55%</td>
<td>21%</td>
<td>23%</td>
</tr>
<tr>
<td>M - 31 October</td>
<td>80%</td>
<td>42%</td>
<td>43%</td>
</tr>
<tr>
<td>M - 14 November</td>
<td>100%</td>
<td>64%</td>
<td>84% **</td>
</tr>
</tbody>
</table>

* 37% lodged within a few days around 31 July 1998 (44% for 1996/97)
** 28% lodged within the period 1 - 14 November 1998 (34% for 1996/97)

The CIR said that on the whole, the lodgment position was still far from satisfactory. The progressive lodgment as at 31 August, 30 September and 31 October 1998 respectively all remained significantly below the lodgement standard. On 16 October 1998, a letter highlighting IRD's concern at the likely shortfall in 14 November lodgments, was sent to some 1,200 tax representatives whose actual lodgments of 'M' coded cases as at 30 September 1998 were below the standard by 50% or more. Notwithstanding the letter, there was effectively no improvement in the overall lodgment rates at either 31 October or 14 November. The CIR asked the Society's representatives for suggestions on how firms could improve lodgment performance. Mr Lui responded that all practitioners maximize efforts to lodge returns. Mr Smith pointed out that a frequent cause of delays was the finalisation of accounts. Mr Lui suggested that taxpayer education may also be necessary. Notwithstanding the considerable shortfall in meeting the lodgment standard, there was a marginal improvement in progressive lodgments achieved in August, September and October. However, as the position as at 14 November 1998 remained unchanged, the CIR said that he could not say that there had been any improvement. The CIR reminded members that the block extension programme is a "two-way street" designed to assist both IRD and tax representatives manage their respective workloads. If IRD is to achieve its revenue objectives, tax representatives must submit their returns in accordance with the agreed schedule. Tax representatives who have again failed to meet their lodgment targets this year must achieve higher lodgment rates next year if the block extension programme is to be retained in its present format.

Item A2 (ii) - Tax Representative Filing Performance Report

D. Tax Representatives with Lodgment of 84% or Less of 'M' code Returns as at 14.11.1998

The CIR said that 1,320 tax representatives have 'M' code clients. Of these, 618 firms were below the average performance of 84%. The analysis of the firms, based on size, is:-

<p>| Current Year's Performance | Previous Year's Performance |</p>
<table>
<thead>
<tr>
<th>Firm size</th>
<th>Total no. of firms</th>
<th>Total no. of clients represented</th>
<th>No. of firms below the average of 84%</th>
<th>No. of non-compliance cases</th>
<th>% of total non-compliance cases</th>
<th>Total no. of firms</th>
<th>No. of firms below the average of 84%</th>
<th>No. of non-compliance cases</th>
<th>% of total non-compliance cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small size</td>
<td>1,128</td>
<td>556</td>
<td>3,711</td>
<td>62%</td>
<td>1,091</td>
<td>567</td>
<td>4,017</td>
<td>71%</td>
<td></td>
</tr>
<tr>
<td>Medium size</td>
<td>174</td>
<td>58</td>
<td>1,822</td>
<td>31%</td>
<td>123</td>
<td>34</td>
<td>1,283</td>
<td>23%</td>
<td></td>
</tr>
<tr>
<td>Large size</td>
<td>18</td>
<td>4</td>
<td>446</td>
<td>7%</td>
<td>13</td>
<td>4</td>
<td>324</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>1,320</td>
<td>618</td>
<td>5,979</td>
<td>100%</td>
<td>1,227</td>
<td>605</td>
<td>5,634</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

The CIR explained that the objective of the report is to provide an analysis, by reference to firm size, of tax representatives with lodgement rates below the performance standard.

[Post-meeting Note]

The CIR has now advised that 1,320 firms mentioned above are tax representatives to which the annual block extension scheme arrangements are made available. However, not all of them are CPA firms. He further confirmed that no statistics are maintained with respect to how many of the 618 firms are CPAs or CPA firms.

The Society suggested a revised presentation of the "tax Representative" filing performance report, along the format shown below. The Society thought that the addition of columns (a), (b) & (e) in each category of firms to the report would give a better view of the number of non-compliance cases by showing the percentage as a % of total firms in each category and as a % of total cases handled by each category.

HKSA proposed revised "Tax Representative" Filing Performance Report

<table>
<thead>
<tr>
<th></th>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
<th>(e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm size</td>
<td>Total no. of firms</td>
<td>Total no. of client represented</td>
<td>No. of firms below the average of 84%</td>
<td>No. of non-compliance cases</td>
<td>Non-compliance cases as a % of total cases handled (d) (b)</td>
</tr>
<tr>
<td>Small (100 or less clients)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medium (101-300 clients)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Large (Over 300 clients)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The CIR said that he had no objection to adding the proposed column (a), showing the total number of firms in each of the "size" categories, to the report (This has been added to table D.). There were reservations, however, as regards the addition of proposed columns (b) and (e). He said that the comparisons in the illustration provided drew information from different statistical bases. Since the information was not directly related, the statistics deduced by combining columns (b) and (d) would present a distorted picture of the position. In addition, as the information for column (b) is not readily available within IRD, obtaining it would involve enhancements to computer programs. In coming years, programming enhancements with a higher priority would take precedence.
The Society said that there is no published statement of what constitutes the required documentation to support a holdover application. It said that according to its understanding, the requirements are:

1. Management accounts for a specified period duly certified as true and correct;
2. A projection of the results for the remainder of the basis period; and
3. A Profits Tax Computation based on items (1) and (2) preferably calculating the amount of tax to be held over.

As it had been advised of different requirements by different assessors, it wished to clarify the Departmental policy. In particular, clarification was requested on the required format and certification of the supporting accounts.

The CIR confirmed that this proposal is acceptable for taxpayers with "M" code accounts.

Item A3(ii) - Acceptance of Shorter Period Management Accounts

The HKSA said that at present time IRD only accepted management accounts containing at least 8 months’ operating results for the relevant tax year. This created significant practical difficulties as the deadline for lodging holdover is often less than 3 weeks after the end of the 8 months period. It requested IRD to accept management accounts drawn up either to a date within 7 weeks of the due date for the making of the holdover claim or for an 8-month period, whichever is shorter.

The CIR confirmed that this proposal is acceptable for taxpayers with "M" code accounts.

Item A3(iii) - Acceptance of Late Holdover Applications

The Society said that it understood that IRD's practice was to accept late applications for holdovers if the estimated final tax plus the following year's provisional tax is significantly less than half of the amount provisionally assessed. Clarification of this practice was requested.

There is no provision in the IRO dealing with the acceptance of late claims for the holding over of provisional profits tax, the CIR said. The onus is on taxpayers to monitor their trading results so that timely applications are lodged.

In exceptional circumstances, late applications may be considered. Taxpayers must demonstrate why they were prevented from lodging an application in time. Acceptance of late applications lacking a reasonable justification could not be assumed.

Item A4(i) - Extending the Salaries Tax Block Extension Deadline to End of July

For represented salaries tax cases, most of the taxpayers are expatriates, the Society said. In preparing the employer's returns, full details of their remuneration including option gains, pensions and shares grants etc. had to be obtained from employers resident outside Hong Kong. In most of the cases, due to the need for overseas correspondence, such employer's returns may only become available in late June. This may cause difficulty in meeting the block extension filing deadline at the end of June for such taxpayers- individual tax returns. It was suggested that the Department extend the time allowed under the block extension to the end of July.

The filing deadline for CTRs with business income is already extended until the end of September. A block extension until the end of June is granted to taxpayers to file CTRs reporting non-business income.

The CIR said some two million CTRs were issued this year and it is estimated that about 1% (or 20,000 only) are represented taxpayers who do not have business-sourced income. On an individual tax representative basis, this number is not particularly large and it is not envisaged that applying for individual extensions causes major operational problems for tax representatives, especially as this was in practitioners' quieter months of April, May and June. CIR also said that with modern communications, it was difficult to see the reason for delay in receiving information from overseas.

Extending the deadline to July would require IRD computer programs to be enhanced to encompass applications lodged on a taxpayer by taxpayer basis. The current priority for allocation of programming resources is the Y2K project and it is not possible to consider the enhancement this year.

Item A4(ii) - Self-Assessment on an Election Basis.

The HKSA said that currently practitioners and the IRD incur much time and resources on filing extensions, particularly for expatriates who are on foreign payrolls. It also said that once the return is filed, the IRD spend valuable time raising assessments. It thought that it would be more efficient for all parties if taxpayers are allowed to elect for self assessment and have their filing deadline extended, to say 30 November with a fixed payment dates on 31 January (provisional tax also being due on 31 January and 30 April).

The Society was thanked by the CIR for the suggestion. He said that, on a no commitment basis, it will be taken into account in future planning.

Item A5 - Dating of IRD letters
The Society said that there have been incidences where the post-mark is a day or two later than the date of the letter. IRD was requested to give allowance for delays in transit when dating documents such as Notice of Assessment or Letter of Determination such that the taxpayer is not deprived of valuable time to lodge objection, appeal etc.

Problems with mail dispatch are rare. Without more detailed information, the CIR said that it was not possible to follow up on the particular issue. He considered the reported problem to be an isolated incident.

CIR said that if a taxpayer was able to demonstrate that he was prejudiced by a delay in transmission of an assessment notice, the matter would be sympathetically considered. The benefit of any doubt, he said, is always given to the taxpayer.

**Item A6 - Exemption from Profits Tax (Interest Income) Order 1998**

The Society referred to its earlier representation on this issue suggesting that there are potential pitfalls for the unwise with respect to the drafting of the Order. It was concerned that it may result in depositors who return deposits to Hong Kong not gaining the benefit of the exemption. This, it thought, may lead depositors to conclude that it is safer to leave their deposits in offshore accounts where the interest on them is not taxable, which would of course undermine the intention of the policy change which led to the introduction of the Order. The HKSA had suggested that section 2(2) of the Order needs to be reviewed because at present any deposits that are being used to secure a loan, however much larger the deposit may be than the loan, appear to lose the entitlement of the tax exemption on interest income. At the very least, it believed that it should be made clear that the exemption will only cease to apply in relation to that portion of any deposit that is needed to secure the relevant loan.

To date, the CIR said, no problems had been encountered with the implementation of the Order. In addition, a Practice Note (in English and Chinese) was in the course of preparation to explain the basis of application of the Order. He expected the Practice Note to be issued in the foreseeable future.

The CIR said that at the time that the Exemption Order was introduced, the Society's representations as regards the anti-avoidance provisions had been fully considered. After consultation between the Hong Kong Monetary Authority and some banks, it had been determined that the banks consulted were willing to assist their customers obtain the benefit of the concession by only taking security over customers' deposits to the extent necessary to secure the banking facilities granted. It now appears that not all banks were willing to assist their customers in a similar manner.

The CIR said that both the test for exemption and the solution to the problem were simple. To be exempt from the payment of tax on the interest income, taxpayers may hold the funds concerned in a separate account - either with the same bank as they have other banking business or another bank. He also said that because the funds are presently deposited outside of Hong Kong, it is probable that no bank in Hong Kong currently holds a lien over them. The funds can therefore be re-patriated to any bank of the taxpayer's choice. Mr Smith said that if the deposits were re-patriated to Hong Kong and placed with the same institution as grants the overdraft or borrowing, the set-off arrangements would typically be required by that institution not for security reasons but for their own capital adequacy management reasons. While this could be avoided by placing the deposit with a different institution than that granting the overdraft or borrowing, this would not usually be commercially desirable.

The CIR said that permitting interest income on individual deposits to be apportioned on the basis of the amount used to secure a loan vis-a-vis the excess of the deposit that is not, on a day by day basis, used to secure credit facilities was a totally unsatisfactory solution to the problem. As the apportionment calculations would need to be done daily, it would be unwieldy and cumbersome for taxpayers and IRD alike. However, to abandon the provision, as was suggested, would open the door to unacceptable levels of avoidance opportunities, he said. As regards the CIR's concern that the HKSA proposal would be difficult to implement because of the need to carry out cumbersome apportionment calculations, Mr Smith said that a similar result could be achieved by simply denying the exemption on an amount of interest income equal to the interest deduction claimed.

The CIR reiterated that there must be simple, certain, easily understood and easily administered anti-avoidance provisions if Hong Kong is to contain avoidance and retain the underlying simplicity of our taxation system. Mr Smith asked whether, where the overdraft interest was small in relation to the interest income, the overdraft interest expense could be disallowed. Mrs Law said that if the deposit was exempt from tax, then the interest expense should be disallowed. The CIR said that taxpayers could not elect to take the exemption. Under the law it automatically applied.

The CIR said that treatment of interest in various situations could be expanded upon in the Practice Note. The Society undertook to make written representations together with examples of the way they proposed the exemption should be dealt with in the assessment.

[Post-meeting Note]

The Society subsequently provided IRD with examples of the various scenarios under which the exemption from payment of tax on the interest would be lost and suggestions of ways in which the exemption could be preserved for taxpayers - net interest income. The Society's submission and its various suggestions were considered by IRD but, having regard to the specific conditions for exemption imposed by the Exemption from Profits Tax (Interest Income) Order, it was not possible to adopt any of the proposed solutions.

**Item A7 - Definition of Life Insurance Business under Section 23(9) of IRO**

The Insurance Companies (Amendment) Ordinance 1993 introduced three new classes of long term business i.e. Classes G, H and I. Group life insurance business, the Society said, had been reclassified as Class I business from Class A business since then. However, no corresponding amendment has been made to section 23(9) of the IRO, which specified classes A, B, C and E only as "life insurance business". The HKSA said that some assessors had concluded that group life insurance belongs to non-life insurance category. It asked that the apparent mismatch between the IRO and the Insurance Companies Ordinance be reviewed and clarified.

Under the Insurance Companies Ordinance (ICO), Class I business refers to the provident fund and retirement scheme business that contains an element of life insurance. Class I business, not being "pure" life insurance business, falls outside the scope of the definition of "life insurance business" in section 23(9) of the IRO.

The CIR said that to the extent that part of the premium paid relates to life insurance, it could be argued that there is a minor mismatch between IRO and the ICO. A legislative amendment to the IRO will be necessary to remove this. The matter is being reviewed to determine the extent of the "life" element of Class I premiums.

**Item A8 - DIPN No. 33 - The applicability of Appendix A to businesses other than insurance agents**

The Society asked the CIR to clarify the applicability of Appendix A of DIPN No. 33 to businesses other than insurance agents.
The CIR said that the provisions of the IRO governing the deductibility of expenses for profits tax purposes are sections 16 and 17. Although DI PN No. 33 has been issued to specifically deal with insurance agents, the underlying principles upon which Appendix A is based are certainly not confined to insurance agents.

He said that materiality is an issue that is considered by assessors. The questions, suitably modified to reflect the particular trade, business or profession concerned could equally be raised, where appropriate, with other taxpayers.
**TAX BULLETIN**

**Annual Meeting between**
the Inland Revenue Department and
the Hong Kong Society of Accountants - 1999

**PART A - MATTERS RAISED BY HKSA**

**Item A9(i) - Source of profits - DIPN No. 21 and Totality of factors**

The HKSA noted that the system of Departmental Interpretation and Practice Notes had served Hong Kong well in that successive CIRs had used them to clarify their interpretation of existing legislation. This brought a greater degree of predictability to the Hong Kong tax system. It felt, however, that successive changes to them can also sometimes reintroduce elements of uncertainty.

It cited the introduction by the Court of Appeal, in the "Magna" case, of a totality of factors test in relation to the locality of profits as an example. There was no dispute that the Magna decision had, quite correctly, been incorporated into DIPN No. 21. Nevertheless, the Society believed that a greater degree of certainty should now be achieved. It suggested that the provision of guidance by CIR as to the factors that he believes should be given significant weight and those that he considers should be largely ignored in applying the "totality of factors test" to the determination of the source of trading profits.

The ascertainment of the source of a given income is a hard, practical matter of fact that will vary with the facts on a case by case basis, the CIR said. As it is unlikely that the relevant facts in different cases will be identical, the weighting to be given to each will also vary as between cases. The issue is addressed in some detail in paragraphs 6, 8 and 9 of the DIPN No. 21 but it is difficult to draw up rules of the weighting. If any, to be given to each factor in a multitude of different circumstances.

DIPN No. 21 was revised in March 1998 at the request of the Society and tax practitioners. The revised DIPN takes into account the latest court decisions on source and is a definitive statement of IRD's current interpretation and practice on the question of source of profits. The so-called source principles are dynamic in that they are capable of adapting to changing circumstances. Entrenching the principles for determining the source of profits into rigid rules would remove the ability of the IRO to keep abreast of the times. To the extent that the judicial interpretation of "source" evolves over time, updating the DIPN provides the best solution for disseminating IRD's practice.

He added that in recent times, the question of source had not been a cause of concern. In particular, there had been only a few requests for advance rulings on "source". The Society's representatives said that they did not consider the lack of cases going forward for advance rulings as proof that the issue of "source" was not causing problems for practitioners. They said that most practitioners would prefer to have any uncertainties tested in court rather than seek an IRD ruling unless certainty of the tax position was more important than a favourable reply.

**Item A9(ii) - Source of Profits - Entrenching Certain Source Principles in IR Rules**

The HKSA thought that because of the importance of the question of source in a territorial tax system, consideration should be given to incorporating certain elements of the question into the tax legislation. It suggested entrenching certain basic principles in the Inland Revenue Rules. In particular, the Society was considering the "totality of factor" test and the "provision of credit" test.

To support its view, it cited the case of CIR v Orion Caribbean Ltd where the Privy Council rejected the taxpayer's proposition that the interest arose in the place where the credit was provided. The Society said that if this is now to be the test to determine the source of interest income, then an area of relative certainty relating to source will have been eliminated. In this context, and for greater certainty in Hong Kong tax code, it suggested that statutory recognition be given to the provision of credit test as the true test for determining the source of interest income.

The CIR said that in the day to day application of the law, the IRO, IR Rules and decided case law are all relevant in determining a person's tax liability. Although fulfilling different roles, each is nevertheless complementary to the other two.

The "provision of credit" test, although simple, can be easily worked around by arranging for the provision of credit to take place outside Hong Kong. In cases such as the Orion Caribbean case, the interest income is not passive income because the recipient has to find, or source, the funds in the first instance.

The CIR said that IRD's stance on the "provision of credit" test, as it applied to passive interest income, has not changed. It is only in cases similar to Orion Caribbean that the "provision of credit" test is not the relevant test of source.

**Item A10 - Extension of Separate Assessment to Personal Assessment**

The Society contended that when separate salaries taxation was introduced in 1989, the law recognized the financial independence of spouses and their right to maintain a degree of confidentiality about their own financial affairs. It said that compulsory joint assessment for married couples who wish to elect for personal assessment is inconsistent with this approach and wished to discuss allowing separate assessment for married couples if they wish to elect for personal assessment.

The CIR said that this issue is a taxation policy issue. He also noted that it was included in the Society's 1999 Budget submission to the FS. Prior to the handing down of the 1999 Budget, he thought that it would not be appropriate to comment.

**Item A11(i) - Statement of Facts**

A member of the Society was concerned about two recent cases where he considered the Statement of Facts was incomplete because the facts produced were selective and very few appendices were attached. He further commented that a number of points he had raised in reviewing the draft had not been included in the final version. A further request to the appeals officer for the issue of a revised Statement of Facts prior to the determination being made was not complied with.

The member's principal concern was protecting his client's interests. He felt that it was inappropriate for assessors to rely on the Commissioner having access to all the files at the time of making the determination and but not including any relevant facts in the Statement of Facts. The member was concerned that as the documentation presented to the Board of Review at the time of the appeal is limited to the Statement of Facts, with all other facts having to be admitted in evidence, the Board of Review would not have access to the Department's files to review all the relevant facts that were considered by the Commissioner. He thought it important that as full and complete as possible Statement of Facts be prepared at the time of the determination.
The CIR said that in the determination of objection, it is for the Commissioner to decide, first, what particulars are facts (as opposed to mere assertions and opinions) and, secondly, which facts are relevant to the issue in dispute. If a point is admitted in the Statement of Facts as such, it is unnecessary to attach additional documentary evidence as an appendix unless the attachment has additional evidential value.

Appeals Section generally issues a Statement of Facts to the tax representative for comment prior to submitting the case to the Commissioner for decision. Relevant suggestions, corrections and additional facts submitted by the tax representative are incorporated into the final draft that is placed before the Commissioner for determination. Generally, the revised Statement of Facts is not forwarded to the taxpayer for agreement before the Commissioner’s determination.

Suggested amendments to Statements of Facts will be made where they are -

- not repetition of what has already been included in the statement
- factually correct and relevant to the issue to be determined
- not in contradiction with information already provided, or available to the assessor from independent sources.

Suggested amendments that are self-serving statements of opinion rather than verifiable fact are not incorporated into the revised Statement of Facts.

The Board of Review requires the taxpayer (or his tax representative) and IRD to submit an agreed bundle of documents and to agree, as far as is possible, the facts of the case before the hearing of the appeal. Appeals Section assessors will work with taxpayers and their representatives to ensure that the Board’s requirements in this regard are met.

The Board of Review is a fact-finding tribunal. It is not limited to the facts as considered by the Commissioner as set out in the Statement of Facts. Appellants are free to adduce before the Board any additional facts that they consider are relevant to the determination of their appeal.

**Item A11 (ii) - Business Registration Fees when Company has Applied for Striking-off**

The Society understood there is an administrative arrangement between the Companies Registry and the IRD such that once a company had applied for striking off under section 291 of the Companies Ordinance and had copied the documentation to the IRD, business registration fees would no longer be charged. A member had encountered a case where all the relevant procedures for a waiver of further business registration fees had been complied with but the company was prosecuted for non-payment of fees. Winding up procedures were commenced some months after the application under section 291 was lodged.

The CIR said that there has not been any change to the extra-statutory concession. Business Registration fees will not be charged on companies which had applied for striking off. In practice, once a company submits an application for striking off under section 291 of the Companies Ordinance or the Companies Registry initiates striking-off proceedings under either section 291 or section 290A, no Business Registration fees for subsequent years will be demanded.

In the case of a members- voluntary winding up or Creditors- Voluntary winding up, Business Registration fees will only be demanded up to the date of commencement of the winding up proceedings.

When striking off or winding up proceedings are aborted (or rejected) the position is reviewed. As a general rule, both outstanding back year fees plus the current year fee will be demanded as if the proceedings had never commenced.

In the particular case cited, the company, pending striking off under section 291, opted for a members' voluntary winding up some months after the submission of the striking-off application. In processing the winding up notices, the Business Registration Office, in the absence of any information to the contrary, treated the section 291 application as if it had never been made. The company was only exempted from the payment of business registration fees as from the date that winding up proceedings commenced. When payment of the fee was not received as demanded, penalties were added and, ultimately, a writ of summons issued.

Had the full facts been known, the fees would not have been charged nor payment subsequently pursued through the Courts. This case provides an example of where a dialogue between the tax representative and the Business Registration Office could have averted a considerable amount of trouble and inconvenience for all concerned.

The BRO is instituting procedures to try and identify such cases in the future. However, advice of changed circumstances from tax representatives will be of assistance.
Item B1 - Proper Completion of Returns

Mr Tam said that many instances occur where profits tax returns are not fully completed. He asked the Society's members to note that -

- Every item on the return must be completed
- The amount of any income claimed to be sourced outside of Hong Kong must be disclosed in Part A of the return
- Any amounts claimed to be capital gains must be disclosed in Part A of the return
- It is essential for the smooth processing of returns that the statistical data in Part D of the return be completed
- Transactions for, or with, non-residents be shown at Part B of the return.

If attention is given to these items at the time the return is prepared, speedier processing of taxpayers-assessments will result.

Item B2 - Apportionment of Profits into Onshore and Offshore Components

Mr Tam explained that in situations where taxpayers manufacture goods partly in Hong Kong and partly outside of Hong Kong, IRD's existing practice is to apportion the assessable profits on a 50:50 basis.

He said that cases have been noted where the gross profits, rather than the assessable profits, have been apportioned and then the total general and administrative expenses wholly charged against the Hong Kong-sourced portion of the profits. Members were requested to note that the net profit (after deduction of all expenses) is the profit to be apportioned into Hong Kong and ex-Hong Kong components.

Item B3 - Payment by Installments and Waiver of Surcharges

The CIR said that with the slowing economy, the number of requests for payment by instalments had increased a little. He explained that IRD is mindful of its duty to collect public revenue on schedule and, equally, believes it should be fair to those taxpayers settling their tax on time. IRD's long-standing policy is to impose the 5% surcharge for all outstanding taxes. Notwithstanding an instalment payment plan may be approved, the 5% surcharge will not be waived.

Mr Shing said that for investigation cases which were exceptionally granted instalment payments, a 5% surcharge would be imposed on tax and penalties outstanding for more than 6 months. The additional 10% surcharge is imposed on amounts still outstanding after 9 months. Mr Tse confirmed the same criteria applied to tax due as a result of field audit action i.e. for those cases exceptionally granted payment by instalments.

Item B4 - Electronic Methods of Settling Demand Notes

The CIR advised the meeting that electronic payment facilities for settlement of tax assessments are now available via JETCO and ETC ATMs. For ATM payments, the machine printed bank advice serves as a temporary receipt. An official IRD receipt would be posted to the taxpayer within 3-5 days.

Item B5 - Time Required to Make Advance Rulings

As noted in paragraph 36 of DIPN No. 31, provided all information is furnished with the request and further consultation with the applicant is unnecessary, IRD endeavors to respond with six weeks.

On a number of occasions, IRD has received requests for advance rulings very shortly prior to the intended implementation date. Invariably, they are accompanied by a request that the ruling be issued urgently. IRD is conscious of the needs of business and the fact that, at times, transactions do arise at short notice.

The issuance of an early ruling is dependent on workloads. IRD does its best to accommodate urgent requests but cannot guarantee to meet the time frames for the implementation of such transactions. Up until now, most rulings have been issued in about one month.

Item B6 - Discrepancies Detected by Field Audits

Mr Tse distributed two tables of field audit statistic to demonstrate specific types of discrepancies detected by Field Audit between 1 January and 30 November 1998. Table 1 shows some of the more prevalent discrepancies detected in corporation cases.

Table 1

<table>
<thead>
<tr>
<th>Unqualified Auditor's Report Nature of Discrepancy</th>
<th>No. of Cases</th>
<th>Discrepancy Amount</th>
<th>Tax Undercharged</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales omitted</td>
<td>25</td>
<td>$24,975,592</td>
<td>$4,062,234</td>
</tr>
<tr>
<td>Purchases overstated</td>
<td>14</td>
<td>$19,633,406</td>
<td>$2,635,540</td>
</tr>
<tr>
<td>Closing stock understated</td>
<td>9</td>
<td>$6,494,859</td>
<td>$1,113,866</td>
</tr>
<tr>
<td>Gross profit understated</td>
<td>26</td>
<td>$36,103,575</td>
<td>$5,656,827</td>
</tr>
<tr>
<td>Expenses over-claimed</td>
<td>32</td>
<td>$32,237,676</td>
<td>$5,295,577</td>
</tr>
<tr>
<td>Technical adjustments</td>
<td>41</td>
<td>$42,876,157</td>
<td>$6,153,718</td>
</tr>
<tr>
<td>Other</td>
<td>63</td>
<td>$54,493,216</td>
<td>$9,110,331</td>
</tr>
<tr>
<td>TOTAL</td>
<td>135*</td>
<td>$216,814,481</td>
<td>$34,048,093</td>
</tr>
</tbody>
</table>
In one case there may be more than one type of discrepancy

### Qualified Auditor's Report

<table>
<thead>
<tr>
<th>Nature of Discrepancy</th>
<th>No. of Cases</th>
<th>Discrepancy Amount</th>
<th>Tax Undercharged</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales omitted</td>
<td>18</td>
<td>$13,608,118</td>
<td>$2,224,388</td>
</tr>
<tr>
<td>Purchases overstated</td>
<td>9</td>
<td>$8,848,897</td>
<td>$1,369,862</td>
</tr>
<tr>
<td>Closing stock understated</td>
<td>3</td>
<td>$2,945,568</td>
<td>$488,953</td>
</tr>
<tr>
<td>Gross profit understated</td>
<td>20</td>
<td>$52,196,652</td>
<td>$7,446,950</td>
</tr>
<tr>
<td>Expenses over-claimed</td>
<td>17</td>
<td>$7,227,635</td>
<td>$1,011,543</td>
</tr>
<tr>
<td>Technical adjustments</td>
<td>18</td>
<td>$8,214,002</td>
<td>$1,196,624</td>
</tr>
<tr>
<td>Other</td>
<td>19</td>
<td>$7,811,021</td>
<td>$1,249,940</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>57</strong></td>
<td><strong>$100,851,893</strong></td>
<td><strong>$14,988,060</strong></td>
</tr>
</tbody>
</table>

* in one case there may be more than one type of discrepancy

### Additional Statistics for Above Cases

<table>
<thead>
<tr>
<th>Total Discrepancy for All Years</th>
<th>Total Tax Undercharged for All Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>135</td>
<td>$583,418,397</td>
</tr>
<tr>
<td></td>
<td>$91,288,603</td>
</tr>
</tbody>
</table>

### Additional Statistics for Above Cases

<table>
<thead>
<tr>
<th>Total Discrepancy for All Years</th>
<th>Total Tax Undercharged for All Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>57</td>
<td>$290,409,489</td>
</tr>
<tr>
<td></td>
<td>$43,652,806</td>
</tr>
</tbody>
</table>

Table 2 sets out examples of the nature of some of the discrepancies uncovered by IRD auditors during the year in field audits of corporation. This information may be of assistance to members in identifying potential problem areas within accounts.

**Table 2**

<table>
<thead>
<tr>
<th>Nature of discrepancy</th>
<th>Amount reported for year audited ($)</th>
<th>How discrepancy detected</th>
<th>Discrepancy for year audited ($)</th>
<th>Tax Undercharged ($)</th>
<th>Total Discrepancy (all years) ($)</th>
<th>Tax Undercharged (all years) ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales omitted</td>
<td>1,886,735</td>
<td>Director's current account examined. Numerous credits recorded as cash advances from him but determined to be sales of the business</td>
<td>2,032,415</td>
<td>335,349</td>
<td>6,001,525</td>
<td>1,001,329</td>
</tr>
<tr>
<td>and expenses over-claimed</td>
<td>145,680</td>
<td>Year-end adjustments examined. A year-end adjustment was shown as an entertainment allowance but there were no vouchers to support any expenses being actually incurred</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases overstated</td>
<td>3,308,344</td>
<td>Audit of related company transactions, verification of inter-company balances and settlements (especially at cessation of business of related company)</td>
<td>3,509,344</td>
<td>579,041</td>
<td>3,509,344</td>
<td>579,041</td>
</tr>
<tr>
<td>Closing stock understated</td>
<td>1,446,826</td>
<td>Strike-taking and end of year cut-off tested</td>
<td>2,006,735</td>
<td>387,308</td>
<td>8,726,541</td>
<td>1,449,974</td>
</tr>
<tr>
<td>Compensation received</td>
<td>1,285,019</td>
<td>Compensation cheques deposited into business bank account but no record of transactions in business accounts</td>
<td>2,170,121</td>
<td>358,070</td>
<td>11,022,865</td>
<td>1,853,586</td>
</tr>
<tr>
<td>Expenses over-claimed</td>
<td>334,992</td>
<td>Documentation checked. No supporting documents for amounts charged as expenses in accounts</td>
<td>382,139</td>
<td>63,053</td>
<td>1,960,390</td>
<td>331,805</td>
</tr>
<tr>
<td>and exchange gain understated</td>
<td>47,147</td>
<td>Cut-off error only</td>
<td>47,147</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Item B7 - Accrual Basis of Accounting**

The CIR said that during the field audit of an established audit-based CPA firm, the firm was found to have adopted cash basis accounting rather than an accrual basis for its own accounts. This practice is not acceptable as accounting firms are not engaged in a cash trade business. IRD has previously expressed the view that cash basis accounting is not acceptable for any profession engaged in the provision of services, except barristers.

In their defence, firms using cash basis accounting have said that the fee for the job is not always collected in one sum but by instalments, the final payments may take some time to collect and, in a few cases, the final payments were not collectible. The CIR said that this situation is no different to other trades, businesses and
professions which are also required to recognize income and prepare accounts on an accrual basis. The CIR also said that section 51C makes it clear that the accrual basis of accounting is the appropriate method.

In the coming year, IRD assessors will be looking to identify more cases where accounts receivable and work in progress are not included in the accounts as at balance sheet date.

**Item B8 - Record Keeping by Professional Accountants**

The CIR said that during a review of non-compliance by a few professional accountants failing to file their own profits tax returns on time, it had been detected that some had also failed to comply with the record keeping obligations in respect of their own firms. This, he said, was inexcusable.

He reminded professional accountants that they too are bound by section 51C. Accounting firms providing professional advice to taxpayers should never fail to maintain the statutory business records required by the Companies Ordinance and the IRO. The usual excuse given (priority to filing clients' tax returns in time) is totally devoid of any merit as "a reasonable excuse" - irrespective of whether the non-compliance applied occurred in only one year or on a continuing basis.

IRD is committed to enforcement of the record keeping requirements of section 51C. All offenders will be penalized and, in more serious cases, prosecuted. Professional accounting firms are expected to keep their own tax affairs above reproach. Any professional accountants found not to be maintaining the business records prescribed under section 51C should expect to have their default viewed very seriously.

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**Articles in the Tax Bulletins reflect the views of the Taxation Committee. Questions on the Bulletins should be made in writing in the first instance to Ms Winnie Cheung, Director of Professional Practices, at the Hong Kong Society of Accountants, 4th Floor, Tower Two, Lippo Centre, 89 Queensway, Hong Kong. Fax no. 2865 6776**