

# TAX BULLETIN

ANNUAL MEETING BETWEEN  
THE INLAND REVENUE DEPARTMENT AND  
THE HONG KONG SOCIETY OF ACCOUNTANTS — 2001



HONG KONG  
SOCIETY OF  
ACCOUNTANTS

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## *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"), and members of his staff on 23 February 2001.

As in the past, the agenda took on board items received from a circulation to members of the Society 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.

## *List of Discussion Items*

### *Part A – MATTERS RAISED BY HKSA*

- A1. *Issue of further guidance to taxpayers*
  - A1(a) Pre-packed software and the question of withholding tax
  - A1(b) Guidance on electronic transactions
  - A1(c) DIPN 31 – Publication of advance rulings
  - A1(d) List of "major financial centres" under section 16(2)(f) of the Inland Revenue Ordinance
  
- A2. *Lodgement of tax returns*
  - Lodgement statistics
  - Tax representatives' filing performance
  
- A3. *Tax filing deadlines*
  
- A4. *Tax deduction for the cost of permanent textile quotas*
  
- A5. *Treatment of furnished letting by individual property owners*
  
- A6. *Charging of provisional tax to individuals who elect for personal assessment*
  
- A7. *Reminders of taxpaying deadlines*

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- A8. *Re-opening settled cases*
    - A8(a) Finalisation of cases
    - A8(b) Guidelines on use of section 60
  - A9. *Penalties under section 82A*
  - A10. *Minimising the requirement to produce extraneous information*
    - A10(a) Guidelines to produce information
    - A10(b) Channel of complaint
  - A11. *Publication of Assessors' Manual*
  - A12. *Hong Kong – Mainland Double Taxation Arrangement*
  - A13. *50:50 Apportionment on profits tax*
  - A14. *Electronic filing*
  - A15. *Feedback on new BIR 51*
    - A15(a) Audit of small corporations
    - A15(b) Amendment to the HK\$500,000 threshold
    - A15(c) Box 4.10 of the profits tax returns
  - A16. *Position on self-assessment*

#### *PART B – MATTERS RAISED BY IRD*

- B1. *Discrepancies detected by field audit*
- B2. *Electronic payments*
- B3. *“Assess First Audit Later” programme*
- B4. *Letters of Objection attached with returns/accounts*
- B5. *Cross-reference of schedules to accounts*

*Any Other Business*

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## *Full Minutes*

The 2000/2001 annual meeting between the Hong Kong Society of Accountants' Taxation Committee and the Commissioner of Inland Revenue was held on Friday, 23 February 2001 at the Inland Revenue Department.

### IN ATTENDANCE

#### *Hong Kong Society of Accountants (HKSA)*

Mr Tim Lui	Chairman, Taxation Committee
Ms Yvonne Law	Deputy Chairman, Taxation Committee
Ms Elizabeth Law	Member, Taxation Committee
Mr John Reid	Member, Taxation Committee
Mr W Ping Leung	Member, Taxation Committee
Mr Peter Tisman	Deputy Director of Professional Practices

#### *Inland Revenue Department (IRD)*

Mr Elmo D'Souza	Commissioner of Inland Revenue [CIR]
Mrs Alice Lau	Deputy Commissioner of Inland Revenue (Technical)
Mr Luk Nai-man	Deputy Commissioner of Inland Revenue (Operations)
Mr Tam Kuen-chong	Assistant Commissioner of Inland Revenue
Mr Tse Hon-kin	Assistant Commissioner of Inland Revenue
Mr So Chau-chuen	Chief Assessor (Profits Tax)
Mr Wong Ching-ping	Senior Assessor (Special Duties)

Mr D'Souza welcomed the Society's representatives to the meeting and introduced 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 the IRD. Mr Lui thanked CIR for his words of welcome. The meeting then commenced discussion of the agenda items.

AGENDA ITEM A1 – ISSUE OF FURTHER GUIDANCE TO TAXPAYERS

*A1(a) Pre-packed software and the question of withholding tax*

*HKSA pointed out that the position of pre-packed software was currently somewhat ambiguous under section 15 of the Inland Revenue Ordinance (IRO). If standard, unmodifiable software has been purchased from an overseas supplier it was questionable whether the purchase should be regarded as the right to use intellectual property in Hong Kong rather than the simple purchase of a product. It asked whether the Commissioner would consider issuing a Departmental Interpretation and Practice Note (DIPN) on the issue of pre-packed software and withholding tax.*

CIR advised that for pre-packed software, the use of the copyrighted right would be limited to such rights as were necessary to enable downloading, storage and operation on the customer's computer. As such, the payment for the software would not generally be regarded as a payment for the use of or the right to use the copyright since the customer would not be allowed to make copies of the software for commercial exploitation purpose. This issue would be covered in the DIPN being prepared on the taxation of e-commerce.

*A1(b) Guidance on electronic transactions*

*HKSA noted that information was being sought by IRD through profits tax returns on business transactions conducted over the Internet. It questioned whether CIR would consider issuing guidance on the taxation of e-business. While the question of the determination of the source of profits should be a question of fact, and case law and DIPN No 21 set out various tests, it was not entirely clear how the existing operations test would apply to e-commerce transactions carried out under different e-business set-ups. A computer server may, for example, be an "intelligent" server which can perform sales order processing, approval and fulfilment, invoicing and collection functions in respect of goods sold by a non-Hong Kong enterprise. Alternatively, it may be relatively easy to restrict the functions of the server to lesser activities (eg sales promotion and data storing). HKSA suggested that guidance would be desirable on how the issue of source would be dealt with under various business models, including:*

- Businesses with operations in Hong Kong and a website in another country.*
- Businesses with operations in Hong Kong and a website in Hong Kong and an overseas establishment.*
- Businesses with operations outside Hong Kong and a website in Hong Kong.*
- Businesses with operations outside Hong Kong and a website and establishment in Hong Kong.*

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*HKSA further suggested that guidelines could also cover the treatment of the supply of intangible goods, such as on-line books, games and software.*

Mrs Lau replied that an ad hoc committee had been set up within IRD to study the taxation aspects of e-commerce. At the same time IRD maintained close contact with OECD, which was cultivating a common understanding among countries, to update itself with OECD's view on this subject. OECD shared the IRD view that the existing legislation was equally applicable to e-commerce. To clarify its stance on e-commerce, IRD would before long issue a DIPN. Among other issues, it would specifically address the locality of profits and characterisation of income. For complex e-commerce transactions, Mrs Lau suggested that taxpayers could seek advance rulings if certainty was required.

CIR added that IRD applies the "neutrality" principle in taxing e-commerce. By and large, there would be no difference in the taxation of conventional and e-commerce transactions on application of the existing tax principles. However, the Society was invited to provide detailed examples and/or specific models of e-commerce transactions for IRD to consider addressing them in its proposed DIPN. As the DIPN was to be issued shortly, Mrs Lau said it would be much appreciated if the Society could provide such detailed examples or specific models within a month's time.

In response to an enquiry from Mr Reid on the possibility of apportioning profits generated by e-commerce transactions, given the wider geographical basis, CIR said that there was no question of apportioning trading profits for the reasons given in DIPN 21. As regards services income, there might be some scope for apportionment in accordance with the guidance given in DIPN 21.

#### *A1(c) DIPN 31 – Publication of advance rulings*

*Paragraphs 38-39 of DIPN No 31 suggest that the Commissioner will publish advance rulings that may be of general interest. In this regard, the Society wished to know if any such rulings had been published.*

Mrs Lau informed the Society that at the moment there were hardly many cases of advance rulings issued by the IRD that were worth publication. Most cases were related to special categories of businesses and such cases turned on their own facts. IRD would continue to scrutinize advance rulings made in the future. Once there was sufficient number of cases of general interest, they would be published. Mr Reid indicated that publication of a ruling on securitisation structures for example would be useful. In response to a question on the proportion of favourable rulings, CIR said the majority of rulings were favourable.

#### *A1(d) List of "major financial centres" under section 16(2)(f) of the Inland Revenue Ordinance*

*The Society would like to ascertain whether there was a list of major financial centres approved by CIR for the purposes of section 16(2)(f)(ii)(A) of the IRO and, if so, whether this would be made public.*

Mrs Lau confirmed that there was a list of “major financial centres” based on approvals made by CIR. As the list was only based on rulings so far given, it was not exhaustive and would be expanded in the light of further rulings granted. The list, with date of last update, would be uploaded to the IRD Home Page for tax representatives’ reference.

Mrs Lau stated that, in essence, those centres listed in the Securities (Recognition of Stock Markets) (Consolidation) Notice (Cap 333) had been recognised by CIR as major financial centres outside HK for the purposes of S.16(2)(f)(ii)(A). There was no absolute requirement for an instrument to be listed on a recognised stock exchange in order to fall within the ambit of S.16(2)(f)(ii)(A) of the IRO. However, it would be up to the issuer to establish that the instrument was marketable, in other words, that a market existed.

## AGENDA ITEM A2 – LODGEMENT OF TAX RETURNS

*The Society asked to discuss the latest lodgement statistics and patterns.*

Mr. Tam provided the following lodgement statistics [as at 15 November 2000] for 1999-2000 profits tax returns.

### A. *Lodgement Comparison for Corporations and Partnerships – 1997/98 to 1999/2000*

	<u>Y/A</u> <u>1997/98</u>	<u>Y/A</u> <u>1998/99</u>	<u>Y/A</u> <u>1999/2000</u>	Comparison 1998/99 and <u>1999/2000</u>
1. Bulk issue (on 1 April)	153,000	151,000	144,000	-5%
2. Cases with a failure to file by due date:-				
‘N’ Code	2,200	2,000	2,000	-
‘D’ Code	5,100	5,000	4,500	-10%
‘M’ Code	<u>10,000</u>	<u>9,000</u>	<u>8,600</u>	-4%
	17,300	16,000	15,100	-6%
3. Compound offers issued	7,400	6,900	7,200	4%
4. Estimated assessments issued	5,400	4,600	3,900	-15%

B. 1999/2000 Detailed Profits Tax Returns Statistics

	<u>'N'</u>	<u>'D'</u>	<u>'M'</u>	<u>Total</u>
Total returns issued	19,000	40,000	100,000	159,000
Failure to file on time	2,000	4,500	8,600	15,100
Compound offers issued	900	2,500	3,800	7,200
Estimated assessments issued	600	1,200	2,100	3,900

C. Represented Corporation and Partnership Returns – Lodgement Patterns

<u>Code</u>	<u>Lodgement Standard</u>	<u>Actual Performance</u>	
		<u>1998/99 PTRs</u>	<u>1999/2000 PTRs</u>
D – 31 July	100%	80%	79% *
M – 31 August	25%	15%	13%
M – 30 September	55%	23%	20%
M – 31 October	80%	43%	39%
M – 15 November	100%	85%	83% **

\* 45% lodged within a few days around 31 July 2000 (41% for 1998/99)

\*\* 35% lodged within the period 1 - 15 November 2000 (31% for 1998/99)

D. Tax Representatives with Lodgement of 83% or less of 'M' code Returns as at 15.11.2000

1,403 Tax Representatives have 'M' Code clients. Of these, 637 firms were below the average performance rate of 83%. An analysis of the firms, based on size, is:

	<u>Current Years Performance</u>					<u>Late Years Performance</u>			
	<u>No. of clients per firm</u>	<u>Total No. of firms</u>	<u>No. of firms below the average of 83%</u>	<u>No. of non-compliance cases</u>	<u>% of total non-compliance rate</u>	<u>Total No. of firms</u>	<u>No. of firms below the average of 85%</u>	<u>No. of non-compliance cases</u>	<u>% of total non-compliance rate</u>
Small size firms	100 or less	1,245	592	4,157	73%	1,178	525	3,434	63%
Medium size firms	101-300	143	43	1,401	25%	176	62	1,705	32%
Large size firms	over 300	15	2	105	2%	14	3	299	5%
		<u>1,403</u>	<u>637</u>	<u>5,663</u>	<u>100%</u>	<u>1,368</u>	<u>590</u>	<u>5,438</u>	<u>100%</u>



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Mr Tam commented that, on the whole, the lodgement position was still far from satisfactory. Referring to table (A), Mr Tam pointed out that the lodgement performance for 'D' code and 'M' code returns remained disappointing. Overall, returns issued on 1 April 2000 and failed to file by due dates were down 5% in comparison with the preceding year of assessment. The lodgement performance of returns with 'D' code accounts slipped 10% in comparison with the year of assessment 1998-1999 and was particularly worrying.

Turning to table (C), Mr Tam stated that the both returns with 'D' code and 'M' code accounts not only failed to reach the lodgement standard, but they also fell short of the actual performance made in the preceding year of assessment. In respect of returns with 'M' code accounts received by the due date on 15 November 2000, there was a shortfall of 2% compared with the year of assessment 1998-1999. Ms E Law commented that for smaller clients, their accounting systems tended to be weaker and due to the economic downturn, some clients had cut back on accounting staff.

On the performance of tax representatives by reference to the average performance rate of 83% and the sizes of firms, Mr Tam stressed the deteriorating performance of small practitioners. There was a significant increase of non-compliance rate of small size firms from 63% to 73%, as shown in table (D). However, Mr Tam noted that the rates for medium size firms and large size firms had improved.

Mr Tam urged tax representatives to take measures to improve their lodgement performance. Otherwise, the Block Extension Scheme would not serve its purpose.

(Post meeting note: HKSA pointed out that in considering the non-compliance rates the significant increase in the number of small firms and the similar decline in the number of medium-sized firms should be taken into account.)

## AGENDA ITEM A3 – TAX FILING DEADLINES

*The Society pointed out that from 2001 onwards, listed companies had to announce their annual financial results within 4 months after their financial year end dates. In this connection, listed companies with their financial year ending 31 March 2001 would have to finalise their audit reports prior to 31 July 2001. This would clash with the tax filing deadline of D-code companies. To facilitate an even allocation of resources, the Society suggested that the tax filing deadline of D-code companies be extended to 31 August 2001.*

Mr Tam explained that deferring the extended due dates from 31 July to 31 August for "D" code returns under the Block Extension Scheme would have implications on revenue collection and assessment output performance. Having said that, IRD would try to accommodate the difficulties raised by the Society. On a trial basis, there was no objection to accede to the request for an extension of return due date to 31 August for "D" code cases under the Block Extension Scheme. However, taking into account the number of "D" code returns involved and as a quid pro quo, IRD would set a progressive lodgement level,



similar to that of "M" code returns, for lodging "D" code returns – say 60% to file by 31 July and 40% by 31 August (60:40 lodgement pattern). This was introduced so that the impact on the IRDs assessing program and output performance would be minimised whilst tax representatives were able to prioritise audit of listed companies with 31 March accounting date. Details of the programme would be announced in the Block Extension Letter to be issued next month.

Mr Tam stressed that the proposed extension would be on a trial basis subject to review on a yearly basis, taking into account the lodgement performance of the tax representatives. This was in particular necessary given the disappointing "D" code returns lodgement performance shown under Agenda item A2. In respect of those tax representatives who could not meet the proposed 60:40 lodgement pattern for lodgement of "D" code returns this year, IRD might consider not granting similar extension to those firms in the following year.

Ms E Law said that for some unincorporated businesses, tax representatives might not know if they would be retained for the coming year of assessment. She asked whether IRD could supply information in this regard. IRD explained that such information was not available and suggested tax representatives approach their clients direct.

#### AGENDA ITEM A4 – TAX DEDUCTION FOR THE COST OF PERMANENT TEXTILE QUOTAS

*The Society noted that all permanent textile quotas would be phased out after 31 December 2004. Hence, such quotas should no longer be classified as capital assets since there would be no enduring benefits. Accordingly, the Society suggested that taxpayers should be allowed to claim a tax deduction in respect of the cost of obtaining such quotas. The deduction might be allowed to spread over the period from acquisition to 31 December 2004.*

Mr Tam responded that the short answer to the Society's suggestion was 'no', on the ground that the phasing out of permanent textile quotas did not alter the capital nature of such quotas.

#### AGENDA ITEM A5 – TREATMENT OF FURNISHED LETTING BY INDIVIDUAL PROPERTY OWNERS

*The Society said that furnished letting by individual property owners had been generally accepted as a business carried out by such individuals and, as such, subject to profits tax instead of property tax. However, there had been recent cases in which the Department had assessed the individual property owners under property tax and not profits tax, even though the profits tax filing position had been previously agreed. The Society wished to clarify the current practice.*

Mr Luk stated that whether property letting by an individual amounted to a business was a matter of fact and degree to be determined on the facts of the individual cases. In the generality of cases, individual property owners would not be regarded as carrying on a business. Therefore the majority of individual property owners would be chargeable to property tax.

Mr Luk further clarified that furnished letting by individual property owners could be accepted as a business but what constituted "furnished letting" would depend on the facts of each case. A person could hardly be said to be carrying on a business simply because he allowed his tenant to use a few pieces of furniture in the premises, such as electronic appliances and fittings installed by the developer at the time of acquisition of the property. In respect of cases where the number of properties let was substantial and the owners engaged some staff to handle tenancies and to deal with tenants, or that the properties were of a special class such as cinemas or restaurant, or that additional services were provided such as in the form of the landlord continuing to hold the licence of the cinema or restaurant establishment, it would then be possible that the owners were carrying on a business chargeable to profits tax. Mr Luk added that assessors were entitled to review the tax basis and, where justified, assessed a case on a different basis different from preceding years of assessment.

CIR summed up by saying that the basis had not been changed.

## AGENDA ITEM A6 – CHARGING OF PROVISIONAL TAX TO INDIVIDUALS WHO ELECT FOR PERSONAL ASSESSMENT

*The Society said it understood from the last year's Annual Meeting that with effect from 1 April 2000 provisional profits and property tax would be levied on taxpayers where in the preceding year taxpayer's assessable income was substantial. In this regard the Society would like to know (a) the criteria for levying provisional tax, and (b) whether account would be taken of situations in which the preceding year was exceptional in terms of the level of a taxpayer's income.*

Mr Luk first made it clear that the law did not exempt the levy of provisional profits and property tax on individuals who elected personal assessment. Election for personal assessment generally reduced a person's tax liability by way of allowances, concessionary deductions and marginal tax rate. In order to avoid inconvenience to taxpayers and its administrative work, IRD did not charge provisional profits and property tax in cases where personal assessment had been elected and the assessable income was not substantial. This concessionary treatment did not apply to large income taxpayers. In determining large income taxpayers, IRD would take into account various factors including the prevailing economic conditions and the threshold for a large income taxpayer might be adjusted from time to time. As such and given this measure was for taken for administrative convenience, IRD considered it inappropriate to disclose the threshold. As to the second question of the Society, CIR advised that if a taxpayer's assessable profit or net assessable value was, or was likely to be, less than 90% of those charged for provisional tax, or that personal assessment

was likely to reduce the taxpayers liability to tax, the taxpayer could apply for holding over of the provisional tax under Sections 63J or 63O of the IRO.

## AGENDA ITEM A7 – REMINDERS OF TAXPAYING DEADLINES

*The Society said it raised the question of issuing reminders to taxpayers about their due dates for payment some years ago. The then Commissioner pointed out quite reasonably that there would be significant cost implications, and that taxpayers should in any event be reminded by the proliferation of advertisements about tax loans at around that time. The Society enquired whether IRD would also consider commissioning some government Announcements of Public Interest (API) on the television as it understood that a quota of time-slots could be available free of charge to government departments for such purposes.*

Mrs Lau suggested that the simple solution to the problem would be one single fixed due date for all taxpayers, rather than the various due dates now being set, as it would be much easier to remember. She went on to confirm that IRD had already exhausted all time-slots available free to the Government and would continue to explore other means of communication in this regard. As a matter of fact, IRD from time to time paid for commercial advertisements to get the message across but this was subject to budget constraint.

Mrs Lau was of the view that advertisements would not be particularly helpful in serving the purpose. This was because most taxpayers settled their tax payments late as they forgot the exact due dates rather than it was tax payment season. To help taxpayers, Mrs Lau recommended the electronic tax reserve certificates (electronic TRCs) offered by IRD. The Electronic TRCs scheme provided “Auto Tax Payment Service” to TRC account-holders in that the electronic TRCs held in their accounts would be automatically redeemed, with interest accrued, for payment of their tax. It therefore ensured on-time tax payment. Where a taxpayer did not have sufficient fund in his TRC account, a redemption statement showing, amongst other things, the balance of tax payable on the due date and sent to him before the tax due date, would serve as a reminder.

## AGENDA ITEM A8 – RE-OPENING SETTLED CASES

### *A8(a) Finalisation of cases*

*The Society wished to know to what extent a taxpayer could treat a case as having been finalised once it had been settled and agreed by an assessor after detailed enquiries and whether a taxpayer was entitled to assume that settled issues would not be re-opened on IRD's side in a situation where the taxpayer raised objections on aspects outside of the original points of enquiry.*

Mr Tam explained that where the issue had been agreed by an assessor after detailed enquiries, it would normally not be re-opened. There were, however, the following exceptions:

- The presence of an obvious mistake e.g. an arithmetical error;
- The agreement being based on incorrect information supplied by the taxpayer;
- Discovery of additional facts;
- The existence of a gross error of law; and
- Other very exceptional situations depending on the merits of the case.

In the case of an objection, Mr Tam further clarified that the assessment itself remained open and CIR had the duty to look at the *whole* assessment. Therefore, it was possible that matters previously considered settled would be re-opened, in particular when new facts came to light. Normally, on determining an objection, CIR would deal with the grounds of objection only. Settled issues in general would not be reopened where the taxpayer raised objections to aspects outside the original points of enquiry. Having said that and as a matter of law, CIR was not bound by the grounds of objection specified by the taxpayer or decisions of the Assessor. In appropriate cases, as explained above, CIR would consider further issues. However, it could be confirmed that IRD would not re-open a case simply to find off-setting liabilities for the purpose of covering any refund resulting from the settlement of an objection.

Mr Tse quoted an example of a case settled by way of the Assets Betterment Statement (ABS) Method. He said if new assets were subsequently found after the settlement, the ABS would need to be revised, and an additional assessment issued. This was equally applicable to other methods of settlement such as the discovery of a new bank account subsequent to the settlement of a case by the bank deposits method.

#### *A8(b) Guidelines on use of section 60*

*The Society would like to know if there were any guidelines issued to assessors on the use of section 60 of the IRO.*

CIR answered that assessors had been given specific instructions to follow the aforesaid practice. In some cases such as where there was a change of opinion, the approval of an Assistant Commissioner would be required before invoking section 60 but he assured the Society that such cases were rare.

#### **AGENDA ITEM A9 – PENALTIES UNDER SECTION 82A**

*The Society noted that IRD had recently published on its Home Page details of penalties under section 82A of the IRO. It would like to clarify the position where a taxpayer who*

*carried on a business, and was therefore subject to profits tax, had been late in lodging his profits tax return for a number of years. His file had been transferred to the investigation and field audit section, where it was subsequently ascertained that there was no discrepancy in the quantum of profits declared in the return. In such case, the Society questioned whether the taxpayer would be subject to additional tax in accordance with Part II of the document or be subject to the more severe penalties set out in Part I of the document as a result of his case having been referred to the investigation and field audit section.*

CIR advised that details of section 82A penalty policy had been uploaded to IRDs homepage to give greater transparency. Regarding the case quoted by the Society, he commented that what had been described seemed to be a hypothetical case which could hardly be found. In any event if no discrepancy had been found in the quantum of profits in the returns by investigation or field audit sections, the taxpayer would not be put at a worse-off position than any other taxpayers who had submitted their returns late, i.e. where the lateness was not a result of investigation or field audit action taken. Consequently, the taxpayer should be subject to additional tax in accordance with Part II of the document for profits tax rather than Part I for back duty cases if the late returns were submitted before referral for investigation or field audit.

CIR suggested that a more realistic situation would be that a case was referred for investigation or field audit because the taxpayer failed to file tax returns persistently for a number of years but had paid tax on the estimated assessments. Upon investigation or audit it was found that due to specific reasons (eg poor management), the taxpayer just paid the tax but did not file tax returns. On the advice of the field audit and investigation officer the taxpayer filed the back year returns and provided its records for verification. If no discrepancy had been found in the quantum of profits in the returns by investigation or field audit sections, and the estimated assessments (long become final and conclusive) were adequate, the field audit and investigation officer would normally recommend the penalty to be based on tax on the actual profits rather than the over-estimated profits. The penalty would be computed in accordance with Part I for back duty cases.

## AGENDA ITEM A10 – MINIMISING THE REQUIREMENT TO PRODUCE EXTRANEOUS INFORMATION

### *A10(a) Guidelines to produce information*

*The Society raised the concern that in cases handled by field audit and investigation officers, requests were sometimes made for huge volumes and detail of back information, much of which appeared to have, at best, a tenuous connection with the issue under consideration. As such, the Society wished to know if there existed any guidelines issued internally within IRD in relation to minimising the burden on taxpayers to produce information that was not strictly necessary to establish a particular point.*

Mr Tse assured the Society that IRD's present practice being normally field audit officers asked for necessary current year records, and investigation officers asked for records covering the period under investigation. They rarely asked for books and records of all years of assessment. Sometimes back years' books and records could be asked for when the officer needed a further probe to establish his findings, such as for consideration of offshore claims and the like or applying his findings to back years. Taking this opportunity, Mr Tse said officers would be reminded not to ask for voluminous past records indiscriminately.

CIR supplemented that for the sake of effective communication and case settlement, taxpayers were invited to have a dialogue with case officers to agree upon on what sorts of records and information had to be provided at their mutual convenience. He stressed that the assessor has the delegated authority to request for information and records which he considered relevant in ascertaining the amount of assessable profits or income of the taxpayers.

#### *A10(b) Channel of complaint*

*The Society asked what was the recourse should a taxpayer believe that he had been treated unfairly in this respect.*

CIR advised that if a taxpayer felt being unfairly treated, he could approach the Senior Assessor or even the Chief Assessor. There were exceptional instances where the Deputy Commissioner had been approached. In all of these cases information and records were ultimately provided in the manner agreed by both sides.

#### AGENDA ITEM A11 – PUBLICATION OF ASSESSORS' MANUAL

*The Society said some years ago, it reflected concerns that assessors were increasingly tending to rely on unpublished practices and procedures. The suggestion was therefore made that it would be useful if the Assessor's Manual could be published. The then Commissioner had no objection in principle although he expressed doubt as to whether it could be done on a commercial basis. The Society asked what was the present position on this matter.*

CIR expressed that in principle he has no objection to the publication of the Assessors Manual in a suitable format. Nonetheless, IRD had over the years increased its transparency by publishing quite a number of DIPNs and other documents to explain the Departments views on issues of concern to the taxpayers and practitioners. IRD would continue to update existing DIPNs and issue new ones as and when necessary. The Assessors Manual was initially drawn up for internal reference. It was still being updated and in its present format, was not yet suitable for publication. Having said that, CIR noted the Assessors Manual contained some internal guidelines and procedures which might not be appropriate for publication. In fact most information therein, if of interest to taxpayers and tax practitioners, could now be found in the much expanded DIPN series.

Mrs Lau said the publication of the Assessor's Manual should move hand in hand with the decision to migrate to a self-assessment regime. This was because of the need for greater transparency of the Department's operation. At that time, there might be a need to merge the Assessor's Manual with the issued DIPNs.

## AGENDA ITEM A12 – HONG KONG – MAINLAND DOUBLE TAXATION ARRANGEMENT

*The Society first enquired the progress regarding the discussions with the Mainland on the extension of the arrangements for the avoidance of double taxation to cover passive income – withholding tax, capital gains on securities, etc. Secondly, as the Mainland's impending entry to the World Trade Organization would mean that many more foreign enterprises would be competing with Hong Kong companies to do business in the Mainland and many such foreign enterprises would be from jurisdictions with double taxation treaties with the PRC, the Society was interested in knowing if IRD had any particular plans to ensure, through the Hong Kong – Mainland double taxation arrangements ("DTA"), that Hong Kong taxpayers were not at a competitive disadvantage as compared with foreign taxpayers when they were doing business in the Mainland.*

Mrs Lau informed the Society that the DTA concluded in February 1998 had covered the major concerns, except passive income, brought up by the business community. Further items, such as passive income (including interest, dividend and royalties), had yet to be included in the DTA. The stance of the Hong Kong in relation to the mentioned passive income had been conveyed to the State Administration of Taxation (SAT), and they proposed to hold the discussion until they had finalised their tax reform on interest income by the Mainland. If the Arrangement was to be expanded, SAT would not agree to a piecemeal extension of the DTA. Therefore it could be expected that most of the terms in the OECD Model Convention had to be incorporated. It was understood that the "exchange of information" article would be of concern to taxpayers.

## AGENDA ITEM A 13 – 50:50 APPORTIONMENT ON PROFITS TAX

*The Society noted that the 50:50 apportionment concession for processing arrangements in the Mainland was a useful facility when it was first introduced. At that time, however, whilst production was carried out in the Mainland, most of the back office operations were carried out in Hong Kong. Nowadays, this was increasingly not the case and often the purchasing, transportation, research and development, etc. functions would also be based in the Mainland. The Society asked IRD to consider if it was now time for the Department to be more flexible about the strict application of the 50:50 apportionment arrangement.*

Mr So said the short answer was no. He went on to explain that when DIPN 21 was issued, the 50:50 apportionment was offered in order not to get into protracted arguments of other bases such as 20:80 and the like. He referred to the example quoted by the Society and pointed out that should the activities in the Mainland mentioned were carried

out by a company there, there was no question of apportioning the profits derived by the Hong Kong company. At the end of the day, Mr So said it was a matter of who actually carried out the processing activities in the Mainland.

Mr Tam supplemented that “contract processing” (來料加工), involving the execution of a processing agreement between a HK entity and a PRC entity, was to be distinguished from “import processing (manufacturing)”, (進料加工) where a PRC entity (whether an FIE, or a PRC domestic production enterprise, with the rights to import and export) was allowed to import raw materials to manufacture goods for export. Under the latter type of arrangement the PRC entity took title to both the raw materials and finished goods and its relationship with a HK entity would be on a principal to principal basis and the 50:50 apportionment as applicable to the “contract processing” arrangements would not apply.

CIR concluded that 50:50 apportionment basis would be the norm for contract processing cases. Only in very exceptional cases where taxpayers could prove otherwise would IRD consider a basis departing from the norm.

## AGENDA ITEM A14 – ELECTRONIC FILING

*The Society understood its representatives had held an initial meeting with IRD on the issue of electronic filing of tax returns. The Society asked how this issue was progressing and what was IRD's view on the estimated timing for the various stages of its introduction as well as what was the current thinking on the scope of the proposal.*

Mr So advised that at the end of September 2000 profits tax officers of the IRD invited the Society's representatives to a meeting for discussion of general issues such as benefits and difficulties in filing profits tax returns through the Internet. HKSA representatives were aware of the digital signature requirement and difficulties with accounts, auditors reports, directors' reports etc. filed as attachments, which could be voluminous, to profits tax Returns. They would meet IRD officers again in March 2001 to discuss their progress. As such, there was no time frame for introducing electronic filing of profits tax returns.

Regarding the filing of composite tax and property tax returns, Mr So said it could now be made through Internet or kiosks provided by the Government. IRD was going to launch a publicity campaign on electronic filing in coming May, following the bulk issue of composite tax returns. Mr So further disclosed that IRD was planning to implement telefiling of simple tax returns in April 2002.

## AGENDA ITEM A15 – FEEDBACK ON NEW BIR 51

### *A15(a) Audit of small corporations*

*The Society said it understood some concern had been expressed that certain small corporation callers to the IRD could have been given the impression that IRD no longer expected an audit to be carried out. These may have been “one-off” incidents but the*

*Society was interested to hear what kind of feedback IRD had been receiving about the revised forms and whether many taxpayers were actually seeking confirmation from the Department as to whether or not an audit was expected to be carried out for all companies. In addition, the Society asked if there were plans to amend the returns in this respect.*

Mrs Lau said that since the issue of last year's profits tax returns, IRD had solicited the views of the Society and other professional bodies on the changes made in the returns. As a result, there were improvements in the design of the profits tax return forms BIR 51 & 52 for the year of assessment 2000/01. Briefly, the current year's returns further emphasised the audit requirement of the "small corporations" in both the main body and notes to the return form. They also required taxpayer to state (i) the total gross income; (ii) the name of the Auditor; and (iii) date of the audit report to ensure that proper audit had been carried out before the completion of the return. A User Acceptance Test on such improvements had been carried out by IRD and the response was positive. Mrs Lau further informed the meeting that in a sample check conducted, only one case was found to have the return submitted before the audit was conducted.

#### *A15(b) Amendment to the HK\$500,000 threshold*

*The Society would like to know whether there were plans to change the HK\$500,000 turnover threshold.*

Mrs Lau expressed that there did not seem to have a need to change the threshold turnover of \$500,000. This was because no matter how the threshold was set, the same problems would be faced by taxpayers whose total gross profits were below the threshold.

#### *A15(c) Box 4.10 of the profits tax returns*

*The Society would like to request some clarification regarding the question on the profits tax return – '4.10 Did you use the Internet to accept any orders for goods or services within the basis period?' It asked if the question was interpreted broadly, most businesses that used computers would have to answer 'yes', as most businesses used email these days as a form of communication in which offers could be made and accepted. For example, if a firm of accountants submitted a proposal to a client by email and the client replied by accepting the proposal, then it appeared that the accountants should indicate 'yes' on the return form. However, there was a distinction between the use of the Internet primarily as a medium of communication and its use to conduct business transactions in a more substantive way, as where e.g. Amazon.com effected transactions for books and CDs over the Internet.*

*The Society asked whether IRD would consider clarifying the position for taxpayers by giving some examples in the notes to the return of situations in which IRD would expect a 'yes' answer (and situations where they would not).*

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Mrs Lau pointed out that on the IRD website ([www.info.gov.hk/ird](http://www.info.gov.hk/ird)), there was a list of common questions and answers on the completion of profits tax returns (BIR51 & BIR52) issued after 1 April 2000. The list had been uploaded on 9 May 2000 and it served to help the taxpayers and/or tax representatives to complete the tax returns. She went on to say that in respect of the Society's question on Box 4.10 of BIR51, the following clarifications had been made therein:

Q1. Does "Internet" used here include "intranet" and "e-mail"?

A1. Yes. However, "fax" is excluded.

Q2. If the acceptance of the orders through Internet is only a minor part of the whole income-earning process, should I put in "Y" or "N"?

A2. Irrespective of whether the acceptance of the orders is a major or minor part of the whole income earning process, you should put in "Y".

Mrs Lau urged the Society to remind its members to visit the IRD website regularly for obtaining up to date information. She added that in order to provide better service to the public, IRD was in the course of improving its index system on the website.

## AGENDA ITEM A16 – POSITION ON SELF-ASSESSMENT

*The Society enquired whether there had been any further developments on the issue of self-assessment and asked IRD's current thinking on this.*

Mrs Lau stated that up to the present moment there was no timeframe for the introduction of self-assessment by IRD.

She revealed that with the implementation of the second IRD Information System Strategy Programme, an assessment programme known as "Assess First Audit Later" (AFAL) would be introduced in April 2001. Under the AFAL environment, returns filed by taxpayers would be accepted as correct in the first instance with demand notes issued according to the returned profits. Basing on certain pre-set criteria, selected cases would then be identified by the computer for desk audit which normally involved the raising of queries on doubtful claims. The first computer run would be carried out in November 2001. Following desk audit, cases suspected of tax evasion or avoidance would be referred to the Field Audit and Investigation Unit for field audit or investigation. While this initiative was essentially an enhancement to IRD's current process, it was also recognised as a preparatory step in the event that self-assessment was to be implemented.

CIR pointed out that this new approach would be more scientific, for example audit on a project basis could be easily carried out in respect of a certain trade where specific irregularities had been found. In reply to a question raised by the Society, Mr So said the percentage of enquiries to be raised under the AFAL environment was expected to be about the same as for the time being. He further disclosed that under the new system selection for desk audit in one year did not automatically exclude a taxpayer from being selected again in the following years. At present, in the absence of objection or queries raised by IRD, an assessment would be regarded as final and conclusive one month after the issue of the assessment subject to any additional assessment being raised under section 60 within six years after the end of the year of assessment. Under the AFAL environment, the assessment would similarly become final and conclusive one month after the issue of the assessment in the absence of objection but would similarly be subject to the operation of section 60. The AFAL programme would not change the legal position.

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## PART B – MATTERS RAISED BY IRD

### AGENDA ITEM B1 – DISCREPANCIES DETECTED BY FIELD AUDIT

As previously, Mr Tse presented two tables to demonstrate the specific problem areas detected in the tax audit of corporations between 1 January 2000 and 31 December 2000. Table 1 is on the common types of discrepancies detected. Table 2 shows how the discrepancies were uncovered. Mr Tse drew the attention of the Society to a new item in respect of "IBA Overclaimed" in Table 2. Referring to Table 1, Mr Tse commented that though the average amount of discrepancy per case detected from unqualified auditors' reports compared favorably with the average for qualified auditors' reports, the quality of unqualified auditors' reports remained an area of concern.

Mrs E Law referred to Table 1 and asked the nature of issues classified under "gross profit understated" if it did not fall under the previous three categories of 'sales omitted', 'purchases overstated' and 'closing stock understated'. It was explained to her that for these cases, the audit was focused on gross profits. Therefore a detailed breakdown into the one of the three categories mentioned was impossible.

### AGENDA ITEM B2 – ELECTRONIC PAYMENTS

Mr Luk informed the Society that a continuous growth had been recorded for electronic payments - by phone, ATM and via the Internet. The number of such transactions made in the month of January 2001 increased by 20.9% over the same month last year. CIR further informed that with effect from October 2001, taxpayers would be able to pay tax at post offices.

### AGENDA ITEM B3 – "ASSESS FIRST AUDIT LATER" PROGRAMME

Mr Tam referred the Society to Agenda Item A16 where this new programme had been discussed.

### AGENDA ITEM B4 – LETTERS OF OBJECTION ATTACHED WITH RETURNS/ACCOUNTS

Mr Tam said it was sometimes found that notices of objection or of section 70A claims were attached to tax returns or inserted inside accounts or supporting schedules. They came to the attention of the assessing officers only when the tax returns were examined. To get prompt attention, he asked the Society to remind its members to send in such notices by separate cover.

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## AGENDA ITEM B5 – CROSS-REFERENCE OF SCHEDULES TO ACCOUNTS

In order to facilitate assessing officers' examination work, Mr Tam urged tax practitioners to cross reference items in the supporting schedules with those in the accounts and in the notes to the accounts.

## ANY OTHER BUSINESS

As this was the HKSA's last meeting with Mr D'Souza before his retirement, Mr Lui thanked him on behalf of HKSA for his help and co-operation during his time with IRD.

Table 1

Analysis of Completed FA Corporation Cases for the year ended 31 December 2000

Auditor's Report = Unqualified	No. of Cases	Discrepancy Amount by Nature	Tax Undercharged by Nature
Sales omitted	30	\$33,373,609	\$4,730,949
Purchases overstated	13	\$14,085,843	\$2,368,631
Closing stock understated	4	\$5,201,522	\$822,487
Gross profit understated	32	\$54,789,996	\$7,521,584
Expenses over-claimed	49	\$36,561,665	\$4,892,986
Technical adjustments	30	\$36,196,302	\$5,228,338
Other	79	\$47,256,576	\$8,081,024
<b>TOTAL</b>	<b>148*</b>	<b>\$227,465,513</b>	<b>\$33,645,999</b>
* in one case there may be more than one type of discrepancy			
Total Discrepancy for All Years		Total Tax Undercharged for All Years	
\$783,430,212		\$114,929,799	
Other statistics for the above cases:			

FOR  
AUDIT  
YEAR  
ONLY

Auditor's Report = Qualified	No. of Cases	Discrepancy Amount by Nature	Tax Undercharged by Nature
Sales omitted	21	\$24,232,872	\$3,718,591
Purchases overstated	11	\$31,873,266	\$4,777,056
Closing stock understated	7	\$7,368,220	\$1,118,398
Gross profit understated	19	\$41,119,703	\$5,586,544
Expenses over-claimed	25	\$17,919,295	\$2,403,076
Technical adjustments	6	\$1,163,399	\$122,183
Other	21	\$27,382,176	\$4,547,975
<b>TOTAL</b>	<b>54*</b>	<b>\$151,058,931</b>	<b>\$22,273,823</b>
* in one case there may be more than one type of discrepancy			
Total Discrepancy for All Years		Total Tax Undercharged for All Years	
\$497,714,938		\$75,643,667	
Other statistics for the above cases:			

FOR  
AUDIT  
YEAR  
ONLY

Table 2

*Field Audit Cases with some items of discrepancy considered detectable through statutory audit for the year ended 31.12.2000*

Name of Auditor	Items that should be detected by Auditor	Amount of item(s) for audited year that should be detected	Reasons why the item should be detected	Auditors Report	Disc Amt for Audited Year	Tax Undercharged for Audited Year	Total Discrepancy Amount	Total Tax Undercharged
Auditor 1	Sales Omitted	7,600,867	T/R should detect the omission from examining the source document	Unqualified Report	7,600,867	1,128,729	17,154,241	2,672,350
Auditor 2	Sales Omitted	898,331	T/R should detect the omission from examining the source document	Unqualified Report	998,299	194,256	6,725,421	1,113,688
Auditor 3	Sales Omitted	2,506,524	T/R should detect the omission from examining the source document	Unqualified Report	2,792,899	446,864	12,027,739	1,886,398
Auditor 4	Expenses Overclaimed	599,742	T/R should detect the omission from examining the source document	Unqualified Report	599,742	95,958	3,458,178	555,535
Auditor 5	Expenses Overclaimed	473,139	T/R should detect the omission through examining the source document	Unqualified Report	473,139	88,773	818,871	127,043
Auditor 6	Expenses Overclaimed	553,258	Expenses of private in nature should be detected by auditor when examining the relevant supporting documents	Unqualified Report	3,260,788	484,227	6,052,191	944,809
Auditor 7	Purchases Overstated	300,000	An audit adjustment has been made to record unsupported purchases	Unqualified Report	908,552	126,460	2,758,310	344,661
Auditor 8	Expenses Overclaimed	541,390	Commission paid to a non-resident without documentary evidence should be detected by the auditor	Qualified Report	1,389,819	206,388	1,760,647	267,574
Auditor 9	Closing Stock Understated	618,727	The understatement was attributable to goods-in-transit which should have been easily detected	Qualified Report	2,005,829	297,866	7,767,200	1,261,823
	IBA Overclaimed	34,927	T/R should have noticed that premises was used as an office					
	Total	14,126,905			20,029,934	3,069,521	58,522,798	9,173,881