



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Annual Meeting

The Inland Revenue Department

and

The Hong Kong Institute of Certified Public Accountants

2005
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS –

Preamble

As part of the Institute's regular dialogue with the government to facilitate tax compliance, improve procedural arrangements and to clarify areas of interpretation, representatives of the Institute met the Commissioner of Inland Revenue ("CIR"), and members of her staff in January 2005.

As in the past, the agenda took on board items received from a circulation to members of the Institute 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 Institute and Part B, items raised by IRD.

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For Members' Note

In the process of finalising the minutes, the Institute sought clarification from the IRD on the following issues:

(1) *Agenda item A1(c)(iii) – DIPN 21: Locality of Profits*

- the IRD's comments, which referred to "commission income/spread derived by a re-invoicing centre", seemed to suggest that certain re-invoiced trading transactions would be re-characterised as transactions of a service nature. The Institute asked whether this was in fact the case and, if so, for some guidelines as to when a trading transaction might be re-characterised as a service transaction for tax purposes.

(2) *Agenda Item A8(ii) – Penalty policy – application of section 82A to section 61A cases*

- further clarification was sought on the IRD's view that if a taxpayer had accepted an assessment under section 61A, it would be difficult for him to argue that in his own opinion his return was correct. The Institute pointed out that the profits tax return states, inter alia, that assessable profits are the net profits...calculated in accordance with the provisions of Part IV of the IRO. Section 61A, on the other hand, falls under Part X of the IRO and is a restorative rather than a charging provision.

The IRD responded that, in respect of items (1) and (2) above, the department will endeavour to address the issues before finalising the redrafting of DIPNs 21 and 15, which is currently taking place.

(3) *Agenda Item A11 – Interest payable under section 71(10) of the IRO*

- the IRD indicated that the imposition of interest under section 71(1) of the IRO is mandatory in objection cases with tax in dispute held over unconditionally. The Institute sought further clarification as to whether interest would be imposed under section 71(10) *as a matter of law* in cases where the issue in dispute was settled in favour of the taxpayer,

although the assessable profits were adjusted upwards in relation to other matters that were not the subject of the objection or appeal.

The IRD replied that DIPN 6 will be revised after the final outcome of the appeals in a number of court cases concerning interest and standover of taxes are known. The IRD will endeavour to address the issue before finalising the redrafting of DIPN 6.

Full Minutes

The 2004/05 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Commissioner of Inland Revenue was held on 21 January 2005 at the Inland Revenue Department.

IN ATTENDANCE

Hong Kong Institute of Certified Public Accountants (the Institute)

Mr Paul Chan	Chairman, Taxation Committee
Ms Yvonne Law	Deputy Chairman, Taxation Committee
Ms Florence Chan	Member, Taxation Committee
Mr David Cho	Member, Taxation Committee
Ms Elizabeth Law	Member, Taxation Committee
Mr Tim Lui	Member, Taxation Committee
Mr Peter Tisman	Technical Director (Business Members & Specialist Practices)
Mr John Tang	Assistant Director (Business Members & Specialist Practices)

Inland Revenue Department (IRD)

Mrs Alice Lau	Commissioner of Inland Revenue
Mr Tam Kuen-chong	Deputy Commissioner of Inland Revenue (Technical)
Mr Luk Nai-man	Deputy Commissioner of Inland Revenue (Operations)
Mr Chiu Kwok-kit	Assistant Commissioner of Inland Revenue
Mrs Jennifer Chan	Assistant Commissioner of Inland Revenue
Mr Chan Cheong-tat	Assistant Commissioner of Inland Revenue
Mr Yim Kwok-cheong	Senior Assessor (Research)

Mrs Alice Lau (CIR) welcomed the Institute's representatives, in particular Mr Paul Chan who attended the meeting as Chairman of the Taxation Committee for the first time. She reiterated that the annual meeting had provided a precious forum for the Institute and the IRD to exchange views on issues of common concern. If the Institute's representatives had any good suggestions in mind, they in fact could contact the IRD through various channels at any time without waiting for the annual meeting. The IRD always advocated effective communication to resolve issues on a day-to-day basis. To convene the annual meeting in a more efficient manner, CIR suggested that discussion should focus on broad issues rather than specific cases or incidents. Mr Paul Chan agreed that this was the proper approach. The meeting then proceeded to discussion of the agenda items raised by both sides.

PART A - MATTERS RAISED BY THE INSTITUTE

AGENDA ITEM A1 - INTERPRETATIONAL ISSUES

Departmental Interpretation and Practice Notes ("DIPNs")

A1(a) DIPN 10 : Time apportionment claims

- (i) The Institute referred to the confirmation by the IRD at the 2004 Annual Meeting that there had no change in policy and that the IRD had all along been using the three tests mentioned in DIPN No. 10 in its fact-finding process. Notwithstanding this confirmation, our members were indicating to the Institute again this year that it seemed to be increasingly difficult to succeed in time apportionment claims, and that the IRD continued to (a) request information beyond the three tests, in the majority of cases (contrary to the stated practice) and (b) to adopt practices not covered in DIPN No. 10. For this reason the Institute felt the need to reflect the concern once more to the IRD and to seek further assurances that DIPN No. 10 remained relevant. The Institute should also like to enquire about any internal guidelines given to Assessors and, generally, about the measures that had been taken to ensure consistency in approach.

CIR confirmed that *CIR v Goepfert* was still the authority in considering non-Hong Kong employment claims. The relevant factors mentioned in DIPN No. 10 were consistent with the Goepfert case. Briefly stated, if the facts of a case were the same as those in the Goepfert case, there was no reason why the non-Hong Kong claim should not succeed. The internal guideline was the same as that in DIPN No. 10.

With regard to the Institute's impression that it was more difficult to succeed in time apportionment claims, CIR pointed out that time apportionment claims involved factual issues and not just a pure interpretation of legal statute. Whether a case would succeed would depend on the facts of the case. Usually, a taxpayer would not hesitate to exercise his objection and appeal right if the facts of his case were in support of his time apportionment claim.

CIR further pointed out that there were not too many appeal cases at the Board of Review on this issue. For example, of the total 112 decisions published under the 2003 series, there were only 4 cases on the issue of source of employment. All of them were found to be of Hong Kong source. Such statistics tended to indicate that most claimants were in agreement with IRD's decisions; otherwise there should have been more cases at the Board of Review.

As regards the Institute's view that IRD continued to request information beyond the 3 factors mentioned in the DIPN No. 10, CIR explained that each of the factors mentioned in the DIPN No. 10 was stated in very broad terms. For example, the question of whether a contract was concluded and enforceable in Hong Kong could only be answered when the full circumstances leading up to the conclusion of contract, how the terms of the contracts were negotiated and carried out, etc. were known. IRD officers might need to raise relevant questions to ascertain the full facts in processing time apportionment claims. CIR mentioned that DIPN No. 10 was being redrafted in response to the submission from the Joint Liaison Committee on Taxation ["JLCT"] on bringing DIPN No. 10 up-to-date. Although the DIPN was not legally binding, IRD staff would adhere to it. IRD would avoid any ambiguities during redrafting.

- (ii) Would the IRD usually asked for overseas tax receipts when a taxpayer claimed not to have rendered any services in Hong Kong and in what circumstances might such information be requested?

CIR explained that if a taxpayer claimed not to have rendered any services in Hong Kong, it was likely that the taxpayer would claim to exclude income from assessment to Hong Kong salaries tax. Such claim could be made either under s.8(1A)(b)(ii) as read together with s.8(1B) of the Inland Revenue Ordinance [“IRO”], i.e., no services rendered in Hong Kong and if some services, less than 60 days in Hong Kong, or under s. 8(1A)(c), i.e., services rendered outside Hong Kong and tax paid in respect of the income. In the first situation, tax receipts would not be required. However, tax receipts would be required in the second situation.

Ms Yvonne Law said that the IRD appeared to have a tendency to ask for foreign tax receipts for non-tax credit cases, e.g. offshore claims. She queried the relevance of foreign tax receipts in such cases as the law did not require that an offshore claim could only be accepted if foreign tax had been paid. CIR replied that it would be unlikely for IRD officers to request for foreign tax receipts only and the existence or otherwise of such receipts should not be a decisive factor. For relevance, the cases concerned had to be looked at, and this would be done upon receiving particulars of the cases. Mr Chiu explained that the requests might be made in response to tax representatives’ advice that foreign tax had been paid in support of offshore claims.

A1(b) DIPN 38 : Employee share option benefits

The Institute would like an update on the progress of revisions to DIPN No. 38 to address the uncertainties arising from the wording in the current version.

CIR advised that DIPN No. 38 was being revised, and the revised version would be ready for release soon. The revision had broadly taken into account views of the accounting profession. Mrs Chan said that, in the revised version, the paragraphs had been rearranged to make it more readable and examples added on conditional grants. Ms Florence Chan asked if the revised version would also deal with stock awards. Mrs Chan replied that DIPN No. 38 was on taxation of share option benefits. However, a paragraph had been added on stock awards. [Note – Revised DIPN No. 38 was issued in March 2005 and JLCT will set up a sub-committee to study the taxation matters relating to stock awards.]

A1(c) DIPN 21 : Locality of profits

- (i) The Institute would like to know if the IRD was updating DIPN No. 21, in light of recent developments such as the Consco case, to clarify its position on 50:50 apportionment claims.

CIR replied that JLCT intended to form a subcommittee to review DIPN No. 21, which would send a submission to IRD. The Institute's members could either pass their views to their representative in the JLCT for consolidation or the Institute could convey its views directly. Whilst IRD was waiting for the judgement of three court cases involving source of profits issues, it had set up an internal committee to oversee the matter. As the issue was quite complex, the exercise would take some time and, as usual, the updated DIPN No. 21 would be uploaded to IRD's website after completion. At present, the broad guiding principle was clear i.e. to see what were the operations which gave rise to the profits and where these operations were carried out. The real issue was how the principle was to be applied to the facts of each individual case.

- (ii) The Institute requested the IRD to clarify the basis on which it reviewed claims for the 50:50 apportionment concession in relation to processing arrangements in the Mainland, in particular the measures that had been taken to ensure consistency in approach with respect to the application of DIPN No. 21 – Locality of Profits.

Mr Chiu replied that the matter was raised at the 2000/2001 Annual Meeting [see paragraph A13 of the 2000/2001 Minutes]. It was made clear that strict application of the 50:50 apportionment would continue and the 50:50 apportionment would only apply to “contract processing” cases but not “import processing” cases. Paragraphs 16 and 17 of DIPN No. 21 remained relevant, which had set out the bases for accepting or rejecting the 50:50 apportionment. Mr Chiu further advised that as “import processing” had become more prevalent in the Mainland of China, fewer cases might be entitled to the 50:50 apportionment. In response to the “substance over form” argument put forward by tax representatives in support of the apportionment claims, Mr Chiu pointed out that the argument was rejected by the Board of Review in its decision in *D111/03*.

- (iii) On offshore claims on “booked-profit”, some members indicated to the Institute that the IRD treated the company which had booked the profits as an administrative company that had derived the profit by performing administrative functions. Even though the contracts of purchase and sale might have been effected by the Hong Kong company's associated company overseas, the profits were still treated by the IRD as having a Hong Kong source, as the administrative functions were performed in HK.

The Institute requested the IRD to clarify its position on allowing offshore claims on “booked-profit”.

Mr Chiu explained that IRD had not changed its position. If a profit was derived from services rendered in Hong Kong, the profit was clearly taxable. Thus the commission income/spread derived by a re-invoicing centre was chargeable. A profit derived from the buying and selling of goods was not service income and involved commercial risks [inventory risks, credit risks, exchange risks, capital risks etc.] different from those attached to a service. Confirmation of sales and issue of purchase orders were indications that it was a trading transaction. The source of trading profits depended on the locality of the trading operations [e.g. place where the goods were bought or sold, the place of arranging trade finance, the place of storage and shipment, the place of getting paid etc.] Paragraphs 9 and 29 of DIPN No. 21 remained relevant.

Ms Yvonne Law asked, as the 50:50 apportionment was allowed as a concession rather than by law, if the IRD was prepared to expand the concession to cover “import processing”. CIR pointed out that the legal basis of allowing the 50:50 apportionment had been confirmed by a recent court case. [Note – The court case was subsequently confirmed to be *CIR v. Indosuez Carr Securities Ltd.* HCIA 5/2001.] Hence, the current view was that the apportionment was allowed by law rather than as a concession. In response to Ms Yvonne Law’s further question as to whether the IRD would consider introducing a concession in the case of import processing, CIR confirmed IRD’s view that there was no offshore element found in “import processing” cases so far. Mr. Tam explained that the nature of import processing was quite different, for example, the ownership of goods and the accounting treatment, etc. 50/50 apportionment would be considered where, basically, the profit was generated by the same entity with manufacturing operations undertaken inside and outside Hong Kong. This was not the case with import processing arrangements, which involved trading profits.

A1(d) DIPN 40 : Head office expenses allocation to branches of financial institutions

A member firm had come across a number of cases in which a Hong Kong bank branch’s claims for deductions for head office expenses, which had not been charged to its profit and loss account, had been queried by the IRD.

The Institute believed that:

- i) it had long been the IRD's practice to allow head office expenses allocated to the branches to be deducted, even though the expenses might not be recorded in the branches' accounts, provided that these expenses were incurred in producing the relevant branches' assessable income;
- ii) previously, there had been an agreement between the IRD and Japanese financial institutions on the allocation of these head office expenses, which was subject to an agreed formula.

The Institute understood that the above-mentioned IRD queries were raised following the Court of Final Appeal decision of *CIR v Secan Ltd & Ranon Ltd* ("Secan"). It was held in Secan that assessable profits were to be ascertained on the basis of a taxpayer's financial statements, as modified to conform with the IRO and that a taxpayer was effectively bound by his own financial statements. DIPN No. 40 was issued by the IRD to clarify the treatment of prepaid or deferred revenue expenses in line with the Secan decision. However, DIPN No. 40 (and Secan) went on to say that "the tax treatment should follow the accounting treatment of such expenses, provided that the treatment in the accounts is in accordance with the prevailing generally accepted principles of commercial accounting and is not inconsistent with any provision in the Inland Revenue Ordinance".

Given that branches were not required to prepare audited accounts (but only management accounts for tax filing purposes) and the IRD had accepted such deduction claims in prior years, the Institute requested the IRD's clarification on its practice in this regard.

Mr Chiu replied that, in the cases mentioned, head office expenses were claimed for deduction in the profits tax computations even though they were not charged in the branch accounts. As a rule, the branch account formed the basis of computing the assessable profits chargeable to Hong Kong profits tax. Under Rule 3(2) of the Inland Revenue Rules, the branch account must disclose the true profits of the Hong Kong branch. Enquiries were made to ascertain the expenses that should be attributed to the Hong Kong branch. One firm of accountants representing a number of clients so far had not given any response. The matter was under examination and no head office expenses had been disallowed yet.

Mr Chiu said that as a rule of practice, expenses incurred in the production of the chargeable profits of the Hong Kong branch were expected to be charged in the branch accounts. The critical issue was whether the nexus between the head office expenses claimed for deduction and the Hong Kong branch could be firmly established. If head office expenses not charged in the branch account were claimed for deduction, it was logical for the Assessor to make enquiries relating to the nature and the quantum of the relevant expenses. Further, any allocation basis should be subject to review because the nature of the Hong Kong and the headquarters' operations could have changed over the years.

CIR confirmed that there was in fact no change in practice and said that the Inland Revenue Rules were more relevant than *Secan* to such cases.

A1(e) DIPN on recent amendments to the IRO

The Institute would like to know when the IRD would issue a DIPN on the recent amendments to the provisions of the IRO, made by the Inland Revenue (Amendment) Ordinance 2004 (for example, in relation to section 15(1)(b) and 16(2))?

Mr Tam said that in December 2004, DIPN Nos. 13, 13A and 34 were published which dealt with: the taxation of interest income received, the deductibility of interest expenses and Exemption from Profits Tax (Interest Income) Order 1998. DIPN No. 13A related to the new legislative provisions laid down in the Inland Revenue (Amendment) Ordinance 2004. DIPN Nos. 17 [The Taxation of Persons Chargeable to Profits on behalf of Non-Residents] and 22 [Computation of Assessable Profits from Cinematograph Films, Patents, Trademarks, etc.] which included paragraphs about section 15(1)(b) and (ba) had been updated. They had just been published on 19 January 2005. The DIPN on commercial and industrial building allowances were being updated. Information on the self-education expenses and home loan interest mortgage had been posted on the IRD website.

AGENDA ITEM A2 - IMPROVING THE LEVEL OF CERTAINTY

A2(a) The impact of the Secan case and the application of international accounting standards

(i) The Secan case

As explained in the Institute's Budget Proposals 2005/06, which was submitted to the Financial Secretary in early December 2004, according to the IRD interpretation, the Secan decision required taxpayers to recognise their income or losses for tax purposes on the same basis as set out in their statutory accounts, including the recognition of unrealised profits and losses. While the adoption of international accounting standards in Hong Kong was to be supported, Secan created an unwelcome area of uncertainty in the tax regime and it meant that, in practice, the government was deferring to the International Accounting Standards Board to make decisions affecting an important aspect of tax policy in Hong Kong. The Institute believed that it was necessary for the government to consider the impact of Secan and the impact of new accounting standards (e.g. International Accounting Standards ("IAS") 39 and 40) on the assessment and collection of taxes in Hong Kong.

The Institute would like to know whether:

- (a) the Secan principle was being applied to the taxation of income or deduction of expenses as a universal rule; and
- (b) the government would consider introducing legislative amendments, on a case-by-case basis, as IAS/International Financial Reporting Standards (IFRS) were introduced in Hong Kong?

Mr Tam explained that Secan created certainty and not uncertainty in the timing of assessment or the measurement of taxable profits [i.e. the timing of assessment or the measurement of taxable profits should follow the accounting treatment]. Secan had reaffirmed that profits or losses recognized in the accounts should be assessed or allowed, unless they conflicted with the provisions laid down in the IRO. There was no tax policy issue involved because “profit” had always been a commercial/accounting concept. The IRD had a committee to monitor the impact of new accounting standards on the assessment of profits tax. Subject to provisions laid down in the IRO, the timing of assessment of profits and losses for taxation purposes and for accounting purposes would be the same.

Mr Tam further advised that members of the Institute were welcome to express their views on IFRSs to IRD which would be studied in detail. Incidentally, IRD had sent a draft DIPN on Financial Instruments to the JLCT for comments. Members could also offer their views through their representative in the JLCT.

Mr. Paul Chan said that, if appropriate, the Institute could arrange for the chairman of the Financial Accounting Standards committee to meet the IRD committee.

CIR said that once new IFRSs had been in effect for a period, their impact would become clearer. A number of issues had, for example, been raised in relation to the draft DIPN on Financial Instruments. As regards the question of changing the law, CIR explained that the IRD administered the law as it was. The profession was at liberty to lobby for legislative changes to provide for special treatment for particular items, if it considered this to be appropriate.

(ii) HKFRS 2 “Share-based Payment”

Hong Kong companies would have to adopt HKFRS 2 “Share-based Payment” for accounting periods beginning on or after 1 January 2005. As a result, companies would have to reflect in its profit and loss account the effect of share-based payment transaction, including expenses associated with transactions in which stock options were granted to employees. The Institute would like to seek the IRD’s view on the deductibility of these expenses.

Mr Chiu replied that as a rule, expenses incurred in the production of chargeable profits were deductible. Share based payments, if they were found to have been so incurred, would be given the same treatment. The subject matter was not simple and the IRD would form a committee to study the proper tax treatment. Input from members was welcome and it could be sent to Assistant Commissioner (Unit 1).

(iii) SSAP 34 – Employee benefits

Prior to the adoption of SSAP 34, the amount charged or credited by a company to the profit and loss account in any particular period in respect of its pension obligations for that period would normally equal the contributions actually paid or payable for that period. For tax purposes, the tax relief claimed in respect of the company’s pension obligations would typically follow the accounting treatment, subject to relief for any “special contributions” being spread over 5 years rather than being claimed in the period paid.

Following the adoption of SSAP 34, for companies with a defined benefit pension scheme, the pension expense charged or credited to the profit and loss accounts consists of broadly the sum of the following:

- the increase in the present value of the pension obligation arising from employee service in the year, referred to as “current service cost”, plus
- the increase in the cost of meeting the scheme’s pension obligation because the benefits are closer to settlement, referred to as “interest cost”, plus
- net actuarial losses recognised, less the total of
- the expected return on scheme assets, and
- net actuarial gains recognised, and will rarely equal to the contributions paid in that period.

What was the IRD’s position on the tax relief available to the company? Should it be based on the pension expense charged to the profit and loss account or the contributions actually paid or payable in the period?

Mr Chiu explained that the allowable deduction was based on the pension expense recognized in accordance with SSAP 34 and charged in the profit and loss account, rather than the contribution actually paid or payable in the period.

(iv) Tax treatments of a prior year’s adjustment

In the minutes of last year’s Annual Meeting (Item A4 – SSAP 34 - Employee benefits), in relation to a prior year adjustment arising from the first time adoption of SSAP 34 in Hong Kong, it was stated that “...the negative adjustment made to the opening retained earnings was not deductible as the adjustment was made through the equity account. According to the principle laid down in *CIR v Secan Ltd* the tax treatment should follow the accounting treatment provided that the latter was in accordance with the prevailing generally accepted principles. As the provision was not charged to the Profit and Loss account and was not treated as an operating expense of a company, the adjustment was not deductible.”

Following the same reasoning, did this mean that a transitional liability made as a prior year's adjustment in an equity account, resulting from a taxpayer's change from adopting one valid accounting basis to another valid accounting basis, would not be tax deductible in the year of change? Also under these circumstances, the taxpayer might not be able to invoke section 70A, IRO, to re-open prior years' assessments that had become final and conclusive, as it could not be said that there was an error or omission in the original tax returns.

If so, unlike retirement benefits which have specific tax provisions in section 16A, IRO, to allow tax deductions when contributions were actually made, the additional accrual of prior years' liability, assuming that it was on revenue account, would not get any tax relief. In this situation would the IRD accept that the principle established in the case *Pearce v Woodall-Duckham Ltd.* (51 TC 271), referred to in paragraph 7 (vii) of Part A of DIPN 1, applied not only to a prior year's adjustment relating to a change of stock valuation from one valid accounting basis to another accounting basis?

That would mean, when dealing with particular items of assessable income or allowable expenditure, where there had been a change from one valid accounting policy to another, and as a result a prior year's adjustment was made (so far as it related to taxable/deductible items), the prior year's adjustment was taxable or deductible, as the case might be, in the year of the first adoption of the new accounting policy. This seemed to be the UK Revenue's position, as stated in its Inspector's Manual IM 545.

Would the IRD advise the Institute of its stance on this point?

Mr Tam explained that after the 2003/2004 Annual Meeting, legal advice has been sought from the Department of Justice, which advised that the fact that an item was not reflected in the profit and loss account [e.g. reflected in the equity account] was not decisive for establishing its taxability or deductibility. For expenses, the item would be deductible if it satisfied the requirements of section 16(1) and was not disallowable under section 17 or other statutory provisions. For profits tax purposes, an increase or a decrease in retained profits, which satisfied the taxability and deductibility conditions, would be assessable or deductible in the year of assessment in which the prior period adjustment was recognized. DIPN No. 42, in draft form, sent to JLCT for comment had adopted this interpretation.

(v) Deductibility of provision for unutilised annual leave entitlement

The Institute was informed that, recently, some Assessors had been questioning the deductibility of the provision for unutilised annual leave entitlement. It appeared that some Assessors took the view that, in light of the Secan decision, a deduction would be granted only where the company had to pay the employee upon termination in cash, but not where the company had a choice to compensate by cash payment or by way of early termination. The Institute requested clarification of the IRD's position on this matter.

CIR replied that there was no specific information about the actual situation of the case(s) mentioned. As a general rule, the deduction of unutilised leave entitlement was not determined by whether there was a choice to compensate the employee upon termination in cash or by way of early termination. The relevant consideration was whether it could be established that an expense was incurred during the basis period in the production of the assessable profits. Any over-provision of leave entitlement previously allowed should be assessable upon writing back. CIR further pointed out that in the commercial sector, it was more likely that the staff would be required to clear his/her leave annually and the impact would not be large.

A2(b) The need for earlier finalisation of tax positions

(i) “Assess First Audit Later” programme

Under the “Assess First, Audit Later (“AFAL”)” programme, an IRD Assessor would issue either an assessment or a statement of loss based on the assessable profit or allowable loss contained in the taxpayer’s tax return, without undertaking any review of the tax return. Under this approach, the IRD stated that it reserved the right to review the relevant tax return at a later date and to ask questions and/or make amendments to the assessment or statement of loss at any time up to six years from the end of the basis period for which the assessment or statement of loss was issued.

Consequently, taxpayers were more likely to be in a position where they could not confirm that their tax affairs had been finalised for any particular year of assessment until the expiry of the statutory time limit of six years from the end of the year of assessment in question. Meanwhile, after a period of years, the responsible person at the taxpayer organisation, tax representative firm and the IRD, or even the tax representative might have changed. As indicated in our Budget Proposals 2005/06, this lack of certainty was seen as a significant disadvantage and might have an adverse impact on Hong Kong’s reputation, not only as a low tax jurisdiction, but one that offered certainty in the interpretation of its tax laws.

The Institute would suggest that consideration be given to limiting the period for review of tax returns, and to raise questions and/or make amendments to the assessment or statement of loss by the IRD, to one year after issuing the assessment, or two years after submitting the return, whichever was the later.

Moreover, the Institute was not clear that the AFAL approach adopted by the IRD was supported by the provisions of the IRO, and would like to know more precisely the legal justification for the approach.

CIR explained that the proposed reduction of the six-year limitation period would constitute a significant departure from the existing framework [e.g. error or omission claims under section 70A has a six-year time limit, repayment of excess tax paid under section 79 has a six-year time limit, power to compound offences under section 80 has a six-year time limit etc.]. It would also impose tremendous constraint upon the field audit and investigation functions, resulting in a substantial reduction in back duty collected.

CIR further explained that the power of the Assessor to raise additional assessment under section 60 had been confirmed in two recent decisions by the Court of First Instance [i.e. *Lam Soon Trademark v CIR* [2004] 3 HKLR 258 and *International Bag Manufacturers Limited v CIR* [HCAL 98/2003]. The Australian High Court in *Industrial Equity Limited v DCT* 21 ATR 934, confirmed that the Australian Taxation Office had the power to conduct a “tax audit” where it was directed towards the ascertainment of the taxable income of a taxpayer.

CIR said that on the issue concerning the legal authority for the implementation of the AFAL programme had been raised and answered at the 2002/2003 Annual Meeting. See paragraph A3(a) of the 2002/2003 Minutes. The legal authority could be found in section 59(2)(a) of the IRO which provides that where a person has furnished a return under section 51, the Assessor may “accept the return and make an assessment accordingly”. The purpose of assessment review was to identify possible unassessed or under-assessed cases. The selection of cases was either based on risk areas or by random checking. It was necessary in some of these cases that additional assessments had to be issued after clarifying with the taxpayers. In warranted cases, all in-time years would be considered.

Regarding the Institute's suggestion that the period to raise question/make amendments to assessment be limited to one year after issuing the assessment or two years after submitting the return, CIR pointed out that this issue was discussed in the 2001/2002 Annual Meeting. IRD's response then was that assessments would be subject to review within the time limit laid down in section 60 of the IRO. In practice, IRD aimed at reviewing most assessments within 2 years after the date of issue otherwise a backlog would build up. Generally, only difficult cases might take more time. There was no change in IRD's stand.

(ii) Re-opening of prior years' assessments by IRD

Practitioners had noted that the IRD had been re-opening prior years' assessments, which the taxpayer believed to have been settled. The Institute requested the IRD to clarify its practice in respect of the re-opening of prior years' assessments.

Mr Luk replied that the same issue had been raised and answered in the 2002/2003 Annual Meeting. See paragraph A3(b) of the 2002/2003 Minutes. In most cases, assessments were re-opened because of additional information coming to light. Reopening a back year assessment due to a change of opinion, which was rare, would require the approval of an Assistant Commissioner. Mr Luk further explained that in *International Bag Manufacturers Limited v CIR* [HCAL 98/2003], Hartmann J. at the Court of First Instance concurred that assessments were subject to the power of CIR to review because CIR had a duty to collect taxes and the power to issue additional assessments under section 60. It was not usual to re-open a settled case to reconsider "days in / days out" basis.

(iii) Issuing return/statement of loss every year

It was stated in the notification IR1812 that a company should notify the Commissioner of Inland Revenue ("CIR") where assessable profits (before the set-off of any losses brought forward) were earned for a year of assessment. It was also stated that any loss would be agreed once the

company commenced or recommenced earning assessable profits. However practitioners were being informed by the IRD that no return would be issued when they notified the CIR of a company having earned assessable profits (before set-off of losses brought forward), and no losses were ever agreed. The Institute suggested that IRD should issue a return (and statement of loss) to all companies for every year. This would be in line with the self-assessment principle.

Mr Luk replied that in an IR1812, a company was asked to notify the Assessor if it earned assessable profits (before the set-off of any losses brought forward). This requirement catered for the situation where losses in prior years had not been agreed [e.g. no losses were accepted]. If the quantum of the losses brought forward could not be agreed but the quantum was substantial enough to wipe out completely the current year profit, then the issue of a return remained unnecessary. The issue of a return and a statement of loss for each and every company had resource implications because the number of review files was even greater than the number of permanent files.

In relation to new companies, Ms. Florence Chan asked, given the deadline for notifying the IRD of chargeability to tax, in a case where the IRD had never agreed losses, whether there would be any culpability on the part of a taxpayer, which had not notified the IRD, but had not received a return or an IR1812 and believed that its offsetting losses would result in no overall tax liability.

Mr. Tam believed that, in principle, there might be culpability in relation to section 51(2), but if the company had genuine grounds for believing that it was in an overall net loss position, this might constitute “reasonable excuse”. The CIR said that, in practice, this would be a rare scenario.

Ms. Elizabeth Law asked whether, generally, a company that had accumulated considerable losses, but which, upon earning assessable profits, had overlooked informing the IRD within the required four-month period, would automatically be penalised. Mr. Tam advised that the company would not necessarily be penalised if there was a reasonable excuse, but if it had received a return and had not completed it, then it would be.

(iv) Loss cases

Some of the Institute's members had the experience that when profits tax returns were filed by taxpayers under Cat 22 Review category, Assessors would not generally issue queries or statements of loss if the returns showed tax losses. Increasingly the same treatment was also accorded to many other permanent file cases. In this sort of case when taxpayers ultimately returned profits in subsequent years, they would have the burden of having to retrieve a large volume of old records in order to substantiate the losses claimed in previous years. However, some of these records might not have been retained as they might be more than 7 years old.

The Institute's members were of the view that the ascertainment of tax losses at the earliest possible time benefited both taxpayers and the IRD alike.

The Institute requested the IRD's view on the above.

In this connection, the Institute should also like to know whether the IRD would support legislative changes to accord to a loss statement the same status as a tax assessment in terms of objection rights, conclusiveness and finality of assessment after 6 years - in view of the Board of Review decision in case *D13/03* that, "in the absence of fraud, there is finality in tax matters after six years" (although the Institute understood that the IRD was appealing against the decision).

CIR replied that all cases were assessed similarly regardless of whether they were profit or loss cases. Losses in many current year returns had been disallowed. There was a need to raise queries on back year returns, in particular permanent files which had been recently converted from category 22 review files. The contentious items must be resolved before the back-year losses could be agreed. Under the AFAL programme, the Assessor had the duty to check the back-year returns to ensure that they were in order. In the generality of cases, officers would not go back to more than 7 years [i.e. statutory time period for keeping the business records]. Before having the court's judgments, CIR considered that it would be too early to conclude whether legislative changes should be made to accord a loss statement with the status of an assessment or to make the loss statement subject to a limitation period of 6 years.

(v) Submitting information after cessation of business

Concerns had been raised about cases where sole proprietorships that had ceased business for over four years were still receiving notices from the IRD under sections 51(4)(a) and 51(4A), IRO, to submit accounting and business records. The Institute would appreciate clarification from the IRD as to its practice with respect to such cases.

Mr Chan Cheong-tat explained that the Department could confirm that request for accounting books and records after cessation of a taxpayer's business often occurred, especially in field audit and investigation cases. Section 51C requires taxpayers to retain business records for a period of not less than 7 years and section 60 allows an Assessor to raise assessment or additional assessment within 6 years after the end of a year of assessment. If it appeared to the Assessor that a taxpayer had not been properly assessed to tax, the Assessor was obliged to review the taxpayer's affairs, even if the taxpayer's business had ceased. In some tax evasion cases, it was found that the taxpayer started up a new business after cessation of the previous business where profits had not been reported for assessments.

A2(c) Issuing of provisional profits tax assessment/demand without a return

Under section 63H(5) of the IRO:

“If a person is liable to pay provisional profits tax, an Assessor shall, as soon as may be after the expiration of the time limited by the notice requiring that person to furnish a return under section 51(1), assess or estimate the amount of provisional profits tax which he is liable to pay.”

The Institute would like to know whether IRD had the practice of raising a provisional profits tax demand without issuing a provisional profits tax return, and if section 63H(6) was relied on, the reasons for using the provision.

CIR said that for commencement cases, section 63H(4) permits the Assessor to estimate the amount of provisional tax for the year of commencement and the succeeding year of assessment. Section 63H(6) further permits the Assessor to assess or estimate the provisional tax where it is expedient to do so. Issue of return is not a prerequisite for the exercise of the powers under section 63H(4) and section 63H(6).

A2(d) Companies in members' voluntary liquidation

IRD in the 2003 Annual Meeting (Agenda item A5 – companies in members' voluntary liquidation) had indicated that IRD's policy was not to insist on the submission of audited accounts provided that the accounts were signed by a responsible person (i.e. the liquidator). The Institute would like the CIR to clarify, where the liquidators refrained from signing the return, whether unaudited accounts would be acceptable in members' voluntary winding ups for the period before the appointment of the liquidator.

CIR clarified that since all the powers of the directors ceased on the appointment of a liquidator [section 244(2) of the Companies Ordinance], the returns or accounts would not be signed by the directors after the date of appointment of liquidator. The practice mentioned in the 2002/2003 Annual Meeting would be followed. The Assessor would not insist on the submission of audited accounts provided that the unaudited accounts had been signed by the liquidator. See paragraph A5 of the 2002/2003 Minutes.

A2(e) Stock awards benefits vesting to employees/expatriates after cessation of employment or relocation out of Hong Kong, where the employees/expatriates worked in Hong Kong during part of the vesting period

Stock award benefits were not covered by DIPN No. 38, as they were not option schemes. The Institute would like to know, for conditional stock award benefits granted to an expatriate before or during his Hong Kong assignment but vesting only after he had been relocated out of Hong Kong, whether the employer had an obligation to subsequently file IR 56B or IR 56G in respect of the benefits (assuming that the expatriate was entitled to the time-apportionment claim and did not render any services in Hong Kong during visits of more than 60 days in the year of vesting)?

There was a view that the stock award benefits only accrued to the expatriate in the year of vesting and, since in that year he did not render any services in Hong Kong, the benefits should not be chargeable to tax in Hong Kong. Would the IRD advise the Institute of its view on the matter?

Mrs Chan replied that stock awards received by employees as part of their remuneration package should be regarded as income within the definition of the term in section 9 of the IRO. The bringing of stock awards into charge for salaries tax raised a few technical issues. The most difficult issue was at what point in time was the stock award derived by the employees, particularly when the shares were not distributed to the employees outright, or the so-called conditional awards. Restrictions on e.g., disposal, voting and dividend rights, gave rise to questions of valuation and the timing of chargeability.

Mrs Chan clarified that in most conditional stock award cases, employees would write to the IRD at the initial stage when the stock award schemes were set up, to clarify how the stock awards should be reported and taxed. In dealing with such enquiries, the Assessors would have to examine details in stock or share award schemes, the rights and obligations of the employees, etc. before advising the employers. The Institute's members were urged to advise their clients to take advantage of the Advance Ruling system [see Schedule 10 of the IRO] to seek an advance ruling before implementing such award schemes.

In response to the question raised by the Institute, Mrs Chan said that unless there had been an agreement between the employer and the IRD on reporting of stock awards, the employer had an obligation to report shares awarded during the taxpayer's assignment in Hong Kong but vested after his departure, notwithstanding that the employee did not come to Hong Kong for more than 60 days during the year of vesting. As mentioned earlier, the question of accrual of share awards could only be determined by reference to details of individual schemes, IRD could not agree with the general statement that the benefits must accrue in the year of vesting. Ms. Florence Chan asked whether the IRD would consider giving guidance on e.g., issues of the timing of accrual and the basis of valuation of the restrictive stock awards, etc., for tax assessment purposes. Mr. Tam said that the IRD would go through the decided advance ruling cases and publish ones that were suitable. The CIR added that if any common ground emerged, the IRD could consider issuing guidance.

A2(f) Compensation for loss of office

In the judgment handed down on 7 September 2004 by the High Court in *CIR v Board of Review (Inland Revenue Ordinance), Lam Chi Kwong*, judicial review was granted in favour of the IRD to compel the Board of Review to state a case on

whether or not it had erred on a question of law to have ruled that certain “severance payments” were non-taxable.

The Institute requested the IRD’s confirmation that ongoing salaries tax cases that involved an exemption from salaries tax on the basis that certain payments were compensation in nature rather than income, would not be delayed pending the outcome of the above case.

CIR explained that it was not normal to put cases on hold pending outcome of court decisions. Different employers offer different terms for compensating their employees. Decisions relevant to one group of employees might be totally irrelevant to another group. Hence, there was no practice to hold all compensation for loss of office cases pending the court decision involving similar claims. However, in some circumstances, for examples, employees working for the same employer receiving the same compensation package, it might be to the benefit of both the IRD and the group of employees to wait for the result of a test case. In this particular case, similar claims by colleagues of Mr. Lam are handled simultaneously without waiting for the Court decision. CIR said that if the Institute was aware of delay in processing such cases, it could provide the file references for IRD’s further review.

CIR further explained that severance pay, if it was properly so described, did not attract salaries tax. However, if the sum was payment for remaining at work and performing one’s duties satisfactorily, the sum would constitute a reward connected with one’s work and would become liable to tax.

AGENDA ITEM A3 - PERMANENT ESTABLISHMENT UNDER DOUBLE TAXATION AGREEMENT

The Institute would like to have the IRD’s clarification of the meaning of a “permanent establishment (“PE”)” under the Double Tax Arrangement between the Hong Kong SAR and the Mainland, and the entitlement to double tax relief, in the situation where the Hong Kong taxpayer did not have any physical establishment in the PRC, but had paid PRC income taxes. The Institute would like to know in particular whether, in such cases, the IRD would disallow the double tax relief on the basis that the Hong Kong taxpayer had no PE in the PRC.

CIR advised that the Arrangement only covered business profits of an enterprise which carried on business through a PE. Only tax on profits attributable to a PE in Mainland China was creditable for double tax relief purposes in Hong Kong. Where the Hong Kong resident company or person did not have any PE in the Mainland but had paid income tax there, the income tax paid was not creditable in Hong Kong. The Arrangement defined PE to include services provided by an enterprise through its employees or other personnel in the Mainland for a period or periods exceeding in the aggregate 6 months in any 12-month period. As IRD had no tax jurisdiction in the Mainland, it would be the privilege of the Mainland tax authority to decide whether a PE existed in the Mainland in a particular case. CIR further explained that, while the PE's definition was wide under Article 1 of the Arrangement, the fact that a withholding tax had been charged under Article 19 of FEITL suggested that the income was derived in the absence of a PE in the Mainland or was not effectively connected with the PE, if any.

AGENDA ITEM A4 - PROCEDURE UNDER SECTION 50, IRO

Tax credit relief from double taxation under section 50 of the IRO

A member of the Institute noted that in respect of how to make a section 50, IRO, tax credit claim in relation to salaries tax, little guidance was provided to practitioners on how such a claim could be made. A separate tax credit relief claim was usually lodged following section 8(1A)(c) – given the time limit of filing section 50 tax credit claims.

Would the IRD consider providing more guidance to practitioners and/or taxpayers how they might make better use of section 50 claim procedures for the avoidance of double taxation.

CIR pointed out that an example of how tax credit under section 50 was calculated in relation to salaries tax could be found in DIPN No. 32, paragraph 50. Normally, relief under section 8(1A)(c) was more advantageous to taxpayers than the tax credit relief under section 50. Once relief under section 8(1A)(c) had been given in an assessment, there was no double taxation, hence section 50 had no application. If a taxpayer was of the view that less tax was payable under section 50, he/she could always object to the assessment in which section 8(1A)(c) was applied. Alternatively, section 50(9) provides for a right of objection and appeal in the event of any dispute as to the amount of tax credit allowable. If the Institute wanted to follow up on a particular case, it should provide the file reference.

AGENDA ITEM A5 - GUOSHUIFA [2004] NO.143

According to the Guoshuifa [2004] No. 143 (issued in around October 2004), the State Administration of Taxation allows the corresponding transfer pricing adjustments for both intra-China and cross border transactions.

The Institute would like to know, (a) how the IRD intended to deal with this unilateral adjustment, for example, in the accounts of a Hong Kong company that had entered into a trading transaction with its affiliated company in China, subject to transfer pricing adjustment in China and (b) whether the IRD would look at the possibility of providing for corresponding transfer pricing adjustments under the Double Tax Arrangement between Hong Kong and the Mainland.

CIR explained that if taxpayers followed the arm's length principle, the problem was unlikely to arise. Deduction of the unilateral adjustment, in the form of an appropriate adjustment, could only be permitted in the context of a CDTA. Various sectors of the business community had urged the HKSAR Government to expand the limited arrangement into a CDTA and the IRD was working towards this direction. CIR hoped that a second CDTA, with a country in the region, would soon be signed. However, some countries were insisting on the inclusion of extensive exchange of information provisions as part of the CDTA.

AGENDA ITEM A6 - THE BASIS OF CALCULATING COMMERCIAL BUILDING AND INDUSTRIAL BUILDING ALLOWANCES

Concerns had been raised over the complexity involved in calculating commercial building allowance (“CBA”) and industrial building allowance (“IBA”) on the basis of the first construction cost or the first assignment price under the current system. Some practitioners had suggested calculating IBA and CBA using “market price” or some other commercially-acceptable formula instead, to better reflect the real cost of doing business.

The Institute should be grateful for IRD’s views on those suggestions.

CIR said that the objective of allowing CBA and IBA was to allow deduction of construction cost of a commercial or industrial building in a phased manner throughout its useful life. The consideration passed in subsequent purchases did not reflect the construction cost only. The consideration included an element of land cost as well as a profit (or loss) of the seller. Also, with inflation and a buoyant property market, the cost of purchase would be substantially higher than the original construction costs over the years. Allowing deduction of IBA or CBA on market price would result in a substantial revenue loss when compared to the existing scheme. In addition, the IRD’s research into the practice overseas had not found any jurisdictions that adopted market value or other similar bases.

AGENDA ITEM A7 - AVAILABILITY OF INDIVIDUAL TAXPAYER’S RETURN FILING PERFORMANCE

Practitioners had found that the individual return filing performance of each tax representative, which was previously provided to the taxpayer/tax representative automatically for “D” and “M” code cases, had not been released as from 2003/04. The Institute would like to suggest that such information, if available, should be provided to the taxpayer/tax representative as before. The Institute would like to know whether such information was still being kept by the IRD, and if so, the purposes for which such information would be used (in addition to showing the individual taxpayer’s filing performance).

CIR explained that the Department had ceased to prepare this report because of resource constraints. The industry performance would continue to be published. The reports were now in electronic form only. Members could compare their performance with the industry average to know whether they were above or below the industry average.

AGENDA ITEM A8 - APPLICATION OF SECTION 61A, IRO

(i) Application of the seven factors under section 61A

Concerns had been raised over the application of section 61A, IRO. Section 61A, IRO requires an assistant commissioner to review a transaction in the light of the seven factors listed in section 61A(1), IRO and apply the section if,

"it would be concluded that the person, or one of the persons, who entered into or carried out the transaction, did so for the sole or dominant purpose of enabling the relevant person.....to obtain a tax benefit."

DIPN No. 15, paragraph 25, states the IRD's view that because the words of section 61A are "would be concluded" and not "could be concluded", or "might reasonably be concluded", the provision would only be applied in cases where the sole or dominant tax purpose was clearly evident.

The Institute would like IRD to clarify its practice on requesting information needed to consider the seven factors for raising an assessment under section 61A, IRO.

Mr Chan Cheong-tat clarified that there was no change of practice with regard to the operation of section 61A and the mechanics for issue of section 61A assessments as stated in paragraphs 20-29 of DIPN No. 15. Suspected tax avoidance cases involved complicated facts. IRD officers would as far as possible raise enquiries for all relevant information and documents, including the seven factors specified in section 61A(1), before seeking an Assistant Commissioner's approval to issue an assessment under section 61A. Only in very exceptional circumstances would an Assistant Commissioner authorize the issue of an assessment under section 61A before ascertaining the full relevant facts, e.g. protective assessment for an impending time-barred year, the taxpayer failed to supply information after repeated enquiries, etc. In the circumstance, the Assistant Commissioner would analyze the seven factors on the basis of the information on hand.

CIR added that all section 61A assessments would be approved by an Assistant Commissioner and the reports would address all the seven factors.

Mr Chan also said that taxpayers were always protected by the objection right under the IRO. In accordance with section 64(2), it was a routine procedure for the Assessor to make enquiry and to invite the taxpayer to provide further facts and information to enable the Commissioner to discharge her function under the IRO. The request for information after the lodgement of an objection should not therefore be a matter of concern to taxpayers or tax representatives.

(ii) Penalty policy - application of section 82A to section 61A cases

The CIR has the power to impose additional tax under section 82A as a penalty when a person, without reasonable excuse, commits the following offences which affect anyone's tax liability:

- omissions or incorrect disclosures in his tax returns or computations arising from non-compliance with the provisions of Part IV of the IRO; or

- failure to comply with the requirements relating to the lodgement of profits tax returns or the provision of information as required under Part IX of the IRO.

However, section 82A, IRO is silent on whether the IRD has the technical basis to apply these penalty provisions to section 61A cases that fall under Part X and not Parts IV or IX of the IRO. In the 2003 Annual Meeting, the IRD indicated that (under Agenda item A7(b) – Penalty on anti-avoidance (section 61A) cases) legal advice was obtained from the Department of Justice for invoking section 82A for section 61A cases. The Institute would therefore request the IRD to clarify its technical or legal basis for invoking section 82A in relation to section 61A cases where, in the taxpayers’ opinion, they:

- had genuine commercial reasons for undertaking the transactions in question (which were subsequently rejected by the IRD under the “sole or dominant” test); and
- submitted correct and complete profits tax returns, computations, accounts, etc. and satisfied the necessary reporting obligations, as imposed under Parts IV and IX of the IRO.

CIR pointed out that IRD’s penalty policy was very transparent. Mr Luk elaborated that there were three key elements for section 82A to apply:

- (i) The taxpayer had committed one of the offences specified in section 82A, which include submitting incorrect returns.
- (ii) No prosecution under section 80(2) or 82(1) had been instituted in respect of the same facts.
- (iii) There was no reasonable excuse.

Apparently, it did not matter whether the assessment was made under section 59, 60, 61 or 61A. For section 61A to be applied, the transaction must be one that was entered into or carried out for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit.

Mr Luk explained that if a taxpayer had accepted an assessment under section 61A, it would be difficult for him to argue that in his own opinion his return was correct. The Board of Review had from time to time reminded that a taxpayer could not approbate and reprobate. The Department's practice was to impose section 82A penalty if there was no reasonable excuse as advised in the 2002/2003 Annual Meeting [Agenda Item A7(b)].

Mr Tam said that to make the position clear, the Department wished to reiterate the following practice recorded in the Minutes for the 1999/2000 Annual Meeting [Agenda Item B3]:

“Mr D’Souza [then DCIR(O)] explained that for tax avoidance cases dealt with by the Investigation Unit and Field Audit Group, tax representatives inevitably claim that no penalties should apply because the adjustments made are technical in nature. The usual claim is that the arrangements are commercially realistic and are properly structured, documented and implemented.

He said that if arrangements are struck down under section 61A, penalty action will be instituted where tax planning is –

- ◆ commercially unrealistic and involves elements of dishonesty etc.
- ◆ involves the use of artificial devices or arrangements; or
- ◆ employs tax avoidance arrangements to conceal taxable transactions (including the supply of incomplete or incorrect information).

Further, criminal prosecution will be considered for more serious cases involving fraud where schemes are implemented dishonestly or rely on misrepresentation, deception or concealment of the full facts.”

Ms. Law asked the number of section 61A cases over the past 12 months that were completed without penalty imposed. Mr. Chan said that there might be a few field audit/ investigation cases where penalty was not imposed because a “reasonable excuse” was found. Ms. Law said that there appeared to be an increasing number of cases in which penalties were imposed. CIR pointed out that it depended on the facts of each case, but she and her deputies would consider the representations before imposing a penalty. CIR said that the process of evaluation of facts was important. The three key elements, and the three factors previously mentioned by Mr. D’Souza, were important considerations.

AGENDA ITEM A9 - APPROACH ADOPTED BY ASSESSORS AND QUESTIONS OF MATERIALITY

A9(a) Assessors’ enquiries - materiality

The Institute should be grateful for clarification whether the IRD had issued any guidance on materiality to Assessors for application in salaries tax cases.

Mrs Chan explained that there was no hard and fast rule on what was considered material or immaterial. Assessors were to exercise their professional judgement. In salaries tax cases, deductions invariably involve small amounts, e.g. subscription to professional associations, contribution to MPF [currently the ceiling is \$12,000 per annum], donation with a minimum of \$100, etc. Small amounts would continue to be allowed if provisions in the IRO are satisfied. On the other hand, if it was shown that a person did not make any payment, he would not be allowed deduction, no matter how small the amount. The Department would not hesitate to prosecute taxpayers for fictitious claims.

A9(b) Field audit and investigation

The Institute had received comments from some of its members regarding the conduct of field audits and investigations, which suggested that there might be reluctance on the part of some case officers to accept documents and evidence produced by taxpayers and their representatives at face value. This in turn might

give rise to a perception that some officers might be predisposed towards a particular view of matters.

The Institute should be grateful for the IRD's views on how this perception might be addressed and what procedures could be followed if taxpayers and their representatives had such concerns in a particular case.

Mr Chan Cheong-tat explained that as a matter of law, Assessors must act on evidence. More often than not, the evidence adduced by tax representatives on behalf of their clients is mere assertion of facts. In the Board of Review Decision *D20/89*, 43 IRBRD 285, the Board clearly stated that assertion of a fact in a submission was not evidence [paragraph 5.3.7 at page 303]. If a taxpayer had kept complete books and accounts, it would not be difficult to convince the IRD officers. Very often, documents produced by tax representatives were rejected because they were not contemporaneous records.

Mr Chan further pointed out that in another Board Decision *D6/92*, 7 IRBRD 88, the Board rejected a computer printout produced by the tax representatives as evidence and said [paragraph 6.2.4 at page 104] "A submission by a taxpayer's representative is not evidence". The taxpayers' affairs were peculiar to themselves and they were in a better position to provide evidence to support their assertion of facts. The Board had also given the following guidelines in respect of documentary evidence:

- ◆ It was not for the Board to advise those taxpayers who were represented as to what was required of them. (*D20/89*, paragraph 5.3.9 at page 303)
- ◆ It was for the taxpayer to produce all the documents. (*D6/92*, paragraph 6.2.2. at page 104)

Mr Chan also pointed out that the fact that most field audit and investigation cases were settled by compromise clearly showed that IRD officers were open-minded. In the event that taxpayers and members of the Institute considered that they received any unfair treatment, they were encouraged to first communicate with the case officer and the supervising Senior Assessor. If the problem could not be resolved, they might reflect their grievance through the complaint channel. After all, taxpayers' interest was well protected by their rights to object and appeal.

AGENDA ITEM A10 - LODGEMENT OF TAX RETURNS

The Institute requested the latest lodgement figures and should be happy to discuss them.

Referring to Table A-D in Appendix A, Mr Chiu pointed out in the year of assessment 2003/04, more profits tax returns, compound offers and estimated assessments were issued. Performance for “D” code returns did not match up to the results of the previous year. Progressive lodgement performances as well as the overall performance of “M” code returns deteriorated slightly. Tax representatives were encouraged to seek ways to improve their performances.

Mr Chiu advised that extended due dates for submitting profits tax returns for the year of assessment 2004/05 were as follows-

<u>Accounting Date Code</u>	<u>Extended Due Date</u>
“N” code	3 May 2005 (no extension)
“D” code	15 August 2005 (no change)
“M” code	15 November 2005 (no change)
“M” code – current year loss cases	13 February 2006 (changed)

For “M” code current year loss cases, the usual practice was to allow an extension to 31 January. Since the first day of the next Chinese New Year would fall on 29 January 2006, 2 days before the usual due date for submitting returns for “M” code current year loss cases, a longer due date for the “M” code current year loss cases would be given. Members should not expect any further extension and should adhere to the timetable.

AGENDA ITEM A11 - INTEREST PAYABLE UNDER S71 (10) OF THE IRO

In objection cases with tax in dispute held over unconditionally, the objection might be settled on the basis that the substantive issue was allowed but with the assessable profits adjusted upwards due to fresh adjustments of some other items. For such cases, the Institute requested clarification of IRD’s practice on imposition of interest payable under section 71(10) and whether IRD would accept a partial waiver reduction of the interest payable.

CIR replied that the request for a waiver of the interest computed under section 71(10) would be rejected. The imposition of this interest was mandatory and there was no provision for waivers or remissions. The Revenue's position had been set out in paragraph 8(vi) of DIPN No. 6. For objections involving complex issues of law and/or fact, which might take a longer time to finalize, the taxpayers were free to approach the IRD to substitute the unconditional standover orders by TRCs.

AGENDA ITEM A12 - ACKNOWLEDGEMENT OF RECEIPT AT THE IRD MAILING COUNTER

When a taxpayer submitted a tax return to the IRD mailing counter, a chop was stamped on the photocopy of the tax return provided. However, IRD would not stamp the tax return if the tax return was accompanied by a covering letter. The Institute would like to know whether the IRD would accept requests for stamping copies of both the cover letter and the tax return.

Mr Luk said that when a taxpayer handed in a tax return accompanied by a covering letter, the IRD's existing practice was to put an acknowledgment stamp on the photocopy of the covering letter provided, but not on the photocopy of the tax return. The stamp put on the copy letter would serve as prima facie evidence of receipt of the enclosures mentioned in the letter. Stamping on the copy of any other documents attached to the covering letter would be unnecessary. Mr Luk added that if IRD were to change its existing practice and stamp both the copy of the covering letters and the copy tax returns, that would increase the time for acknowledging receipt of tax returns and the manpower resources at the Receipt and Despatch Counter by at least two-fold. Hence, the status quo would be maintained. Such demand for stamping service would be even higher on the due dates for filing the D code and M code profits tax returns.

AGENDA ITEM A13 - ANNOUNCEMENT TO MEMBERS OF URGENT AND RELEVANT MATTERS PRIOR TO FINALISATION OF THE MINUTES

In recent years, the CIR had agreed to the Institute's proposal to release information on some of the more urgent and relevant matters prior to finalisation of the minutes.

For example, the tax deadlines for 2004/05 were announced in the Institute's TechWatch publication, within a month after the Annual Meeting.

Given the importance of making members aware of any significant changes in a timely manner, and given that some issues might be more time-sensitive than others, the Institute also requested this year to be able to provide its general membership with information on certain more urgent and relevant matters discussed at the Annual Meeting, in advance of publication of the minutes.

Mr Luk expressed that this was a good practice and Mr Tisman could liaise with Mr Yim for any relevant items.

PART B - MATTERS RAISED BY IRD

AGENDA ITEM B1 - SUBMISSION OF PROFITS TAX RETURNS / DOCUMENTS ON "D" CODE AND "M" CODE DUE DATES AFTER OFFICE HOURS

Mr Luk advised that presently, all profits tax returns handed in during office hours were received by the Receipt and Despatch Counter at the 1/F of the Revenue Tower. For control purposes, the chopping service for profits tax returns was centrally provided at the Receipt and Despatch Counters during office hours. The IRD would like to seek the co-operation of the Institute's members to submit their clients' tax returns as early as possible to avoid the last minute rush, especially on the due dates of the "D" code and "M" code cases. As usual, our Receipt and Despatch Counter would close at 5:00 p.m. on both dates. Tax representatives' delivery staff arriving after that time should drop the tax returns into the mailbox on the G/F of Revenue Tower. These returns would be treated as having been received on the same day. There was no need to rush to beat the office closing hour on both dates.

AGENDA ITEM B2 - DISCREPANCIES DETECTED BY FIELD AUDIT

As in the past, the IRD prepared Table 1 in Appendix B to demonstrate the specific problem areas detected in tax audit of corporations for the year ended 31 December 2004 with comparative figures for the years 2002 and 2003. Table 2 was also prepared on specific cases with apparent discrepancies detectable through statutory audits.

Referring to Table 1, Mr Chan Cheong-tat pointed out that Field Audit teams uncovered discrepancies in 160 corporation cases, 115 of which carried clean auditors' reports. During the year, the IRD had spent more resources on anti-avoidance cases, which were more complicated and time consuming. The amount of discrepancies detected in the clean report cases accounted for 75% (80% for 2003) of the total discrepancies detected in corporation cases completed during the year and a total of \$129M tax was recovered from these cases. There was slight improvement in the average amount of discrepancy and tax per case. The average understatement per case was reduced from \$9.6M to \$8.3M and the tax undercharged per case was reduced from \$1.4M to \$1.1M.

Mr Chan also said that overstatement of purchases, understatement of sales and closing stock remained to be items of concern. Like previous years, majority of the discrepancies were detected by examining the business ledgers and source documents. Adjustments were always needed for unsubstantiated purchases. It was IRD's view that bogus purchases should be detected through statutory audit by vouching the payments for the purchases. There was no significant improvement with respect to "technical adjustments". The IRD wished to reiterate that penalty would be imposed on failing to make adjustments in tax computations for apparently disallowable items in accordance with the notes and instructions on completion of the tax return.

Mr Chan further pointed out that Table 2 had highlighted 2 cases in which items of discrepancy the IRD considered detectable through statutory audit-

- In the first case, a transportation company substantially overcharged ship-hiring charges paid to an associated company (Company A). Company A was a PRC company. There was no invoice from Company A to support the entries in the ledgers. The submitted accounts only showed the “Direct Cost” without breakdown showing the ship-hiring charges. IRD’s field auditors found that the payments for the hiring charges were not made to Company A but to another company, also owned by the director, and eventually transferred to the director’s personal bank account. The amount involved was very substantial (\$10M each year). The statutory auditors did not notice the irregularity and gave a clean report.
- The second case involved a CPA operating a secretarial company through a nominee company. The secretarial company did not maintain complete books and records and returned small amount of fees income. IRD’s field auditors uncovered that the deposits to the company’s bank accounts substantially exceeded the returned fees income. The statutory auditors did not notice the irregularity and gave a clean report.

AGENDA ITEM B3 - DATE OF NEXT ANNUAL MEETING

CIR suggested fixing the date for the 2006 annual meeting. After discussion, the date was fixed at 20 January 2006. CIR reminded the Institute to submit their proposed agenda according to schedule so that the IRD could have sufficient time for preparing responses.

January 2005

Lodgement of Corporations and Partnerships Profits Tax Returns

A. Lodgement Comparison from 2001/02 to 2003/04

	<u>Y/A</u> <u>2001/02</u>	<u>Y/A</u> <u>2002/03</u>	<u>Y/A</u> <u>2003/04</u>	Comparison 2002/03 and <u>2003/04</u>
1. Bulk issue (on 1 April)	149,000	143,000	149,000	4%
2. Cases with a failure to file by due date:-				
'N' Code	1,700	1,600	1,600	-
'D' Code	4,400	3,300	4,500	36%
'M' Code	8,100	7,800	8,300	6%
	<u>14,200</u>	<u>12,700</u>	<u>14,400</u>	13%
3. Compound offers issued	7,200	6,000	6,800	13%
4. Estimated assessments issued	3,500	3,300	4,100	24%

B. 2003/04 Detailed Profits Tax Returns Statistics

	<u>'N'</u>	<u>'D'</u>	<u>'M'</u>	<u>Total</u>
Total returns issued	18,000	44,000	102,000	164,000
Failure to file on time	1,600	4,500	8,300	14,400
Compound offers issued	800	2,400	3,600	6,800
Estimated assessments issued	500	1,300	2,300	4,100

C. Represented Profits Tax Returns - Lodgement Patterns

<u>Code</u>	<u>Lodgement Standard</u>	<u>Actual Performance</u>	
		<u>2003/04 PTRs</u>	<u>2002/03 PTRs</u>
D - 16 August	100%	81% ⁽¹⁾	-
D - 1 September	100%	-	86%
M - 31 August	25%	13%	14%
M - 30 September	55%	19%	20%
M - 31 October	80%	34%	39%
M - 15 November	100%	82% ⁽²⁾	84%

(1) 35% lodged within a few days around 16 August 2004 (26% lodged within a few days around 1 September 2003 for 2002/03 PTRs)

(2) 26% lodged within a few days around 15 November 2004 (32% for 2002/03 PTRs)

D. Tax Representatives with Lodgement Rate of less than 82% of 'M' code Returns as at 15.11.2004

1,620 T/Rs have 'M' Code clients. Of these, 729 firms were below the average performance rate of 82%. An analysis of the firms, based on size, is:-

	<u>No. of clients per firm</u>	<u>Current Year Performance</u>				<u>Last Year Performance</u>			
		<u>Total No. of firms</u>	<u>No. of firms below the average of 82%</u>	<u>No. of non-compliance cases</u>	<u>% of total non-compliance cases</u>	<u>Total No. of firms</u>	<u>No. of firms below the average of 84%</u>	<u>No. of non-compliance cases</u>	<u>% of total non-compliance cases</u>
Small size firms	100 or less	1,483	684	4,915	75%	1,469	697	4,435	77%
Medium size firms	101 - 300	124	43	1,546	23%	122	37	1,306	22%
Large size firms	over 300	13	2	117	2%	11	1	50	1%
		<u>1,620</u>	<u>729</u>	<u>6,578</u>	<u>100%</u>	<u>1,602</u>	<u>735</u>	<u>5,791</u>	<u>100%</u>

Table 1

Analysis of Completed FA Corporation Cases for the years ended 31 December 2002, 2003 and 2004

Appendix B

Auditor's Report = Unqualified	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2002	2003	2004	2002	2003	2004	2002	2003	2004
Sales omitted	17	32	21	18,813,616	16,892,243	29,188,511	2,423,898	2,561,569	4,520,540
Purchases overstated	5	7	10	5,993,825	19,936,197	33,730,413	1,018,809	3,119,654	5,449,859
Closing stock understated	3	1	3	7,927,960	298,503	4,107,878	1,289,435	69,838	657,261
Gross profit understated	33	45	27	106,396,797	130,484,373	53,783,583	17,024,166	17,600,635	8,552,421
Expenses over-claimed	42	46	32	39,091,650	20,994,539	14,253,326	6,040,345	2,940,470	2,303,064
Technical adjustments	26	41	40	11,211,149	25,385,266	23,741,968	1,820,124	3,153,671	3,329,950
Other	56	53	50	35,284,856	47,891,513	26,015,167	5,823,082	6,606,954	4,059,847
TOTAL	182*	225*	183*	\$224,719,853	\$261,882,634	\$184,820,846	\$35,439,859	\$36,052,791	\$28,872,942
TOTAL NUMBER OF CASES	129*	145*	115*						
AVERAGE AMOUNT PER CASE				\$1,742,014	\$1,806,087	\$1,607,138	\$274,728	\$248,640	\$251,069
	* in one case there may be more than one type of discrepancy								
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2002	2003	2004	2002	2003	2004
Other statistics for the above cases: TOTAL AMOUNT				\$995,828,266	\$1,391,729,119	\$956,004,128	\$159,513,970	\$212,999,802	\$128,527,858
AVERAGE AMOUNT PER CASE				\$7,719,599	\$9,598,132	\$8,313,079	\$1,236,542	\$1,468,964	\$1,117,634

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Auditor's Report = Qualified	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2002	2003	2004	2002	2003	2004	2002	2003	2004
Sales omitted	5	6	11	1,857,111	8,152,108	8,479,097	300,966	1,250,459	1,017,664
Purchases overstated	5	2	5	3,452,760	2,566,865	15,543,940	564,737	410,699	2,587,502
Closing stock understated	2	2	1	5,574,913	288,327	3,485,370	887,060	46,132	557,659
Gross profit understated	5	7	13	13,228,053	20,839,244	29,320,487	2,137,019	3,495,251	4,232,930
Expenses over-claimed	8	13	20	4,999,188	5,826,223	11,993,085	763,867	828,407	1,774,074
Technical adjustments	5	8	11	1,729,746	1,243,841	13,490,940	430,995	160,684	2,226,380
Other	17	20	14	3,419,966	49,970,477	2,903,870	554,621	7,887,255	459,775
TOTAL	47*	58*	75*	\$34,261,737	\$88,887,085	\$85,216,789	\$5,639,265	\$14,078,887	\$12,855,984
TOTAL NUMBER OF CASES	26*	38*	45*						
AVERAGE AMOUNT PER CASE				\$1,317,759	\$2,339,134	\$1,893,706	\$216,895	\$370,497	\$285,689
	* in one case there may be more than one type of discrepancy								
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2002	2003	2004	2002	2003	2004
Other statistics for the above cases: TOTAL AMOUNT				\$135,392,518	\$356,418,294	\$330,797,269	\$22,242,599	\$54,438,501	\$47,298,081
AVERAGE AMOUNT PER CASE				\$5,207,405	\$9,379,429	\$7,351,050	\$855,485	\$1,432,592	\$1,051,068

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TOTAL NUMBER OF CASES 155 183 160

	Total Discrepancy for All Years			Total Tax Undercharged for All Years		
	2002	2003	2004	2002	2003	2004
Other statistics for the above cases: TOTAL AMOUNT	\$1,131,220,784	\$1,748,147,413	\$1,286,801,397	\$181,756,569	\$267,438,303	\$175,825,939
AVERAGE AMOUNT PER CASE	\$7,298,199	\$9,552,718	\$8,042,509	\$1,172,623	\$1,461,411	\$1,098,912

Table 2

List of FA Cases with some items of discrepancy considered detectable through statutory audit for Period from 1/1/2004 to 31/12/2004

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	Auditor's Report	Disc Amt for Audited Year	Tax Undercharged for Audited Year	Total Discrepancy Amount	Total Tax Undercharged
Ship Hiring charges overstated	9,693,554	The taxpayer is a transportation company; a company owned by a director (Company A) charged ship hiring charges on the taxpayer; the charges were not supported by invoices from Company A; payments were not made to Company A but to another company (also owned by the director) and eventually transferred to the director's personal bank accounts.	Unqualified report	9,982,926	1,597,268	39,996,728	6,430,131
Secretarial fees income understated	264,577	The taxpayer is a secretarial company of a CPA; it did not maintain complete accounting books and records; deposits to the business bank account substantially exceeded the returned secretarial fees income.	Unqualified report	264,577	41,472	1,555,207	245,852
	9,958,131					41,551,935	6,675,983