



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

2006
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 2006.

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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Full Minutes

The 2005/06 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 20 January 2006 at the Inland Revenue Department.

IN ATTENDANCE

Hong Kong Institute of Certified Public Accountants (the Institute)

Mr Paul Chan	President of the Institute and Chairman, Taxation Committee
Ms Yvonne Law	Deputy Chairman, Taxation Committee
Mr David Southwood	Deputy Chairman, Taxation Committee
Ms Florence Chan	Member, Taxation Committee
Ms Elizabeth Law	Member, Taxation Committee
Ms Ayesha Macpherson	Member, Taxation Committee
Mr Gary Poon	Member, Taxation Committee
Mr Peter Tisman	Director, Specialist Practices

Inland Revenue Department (IRD)

Mrs Alice Lau	Commissioner of Inland Revenue
Mr Chu Yam-yuen	Deputy Commissioner of Inland Revenue (Technical)
Mr Tam Kuen-chong	Deputy Commissioner of Inland Revenue (Operations)
Ms Doris Lee	Assistant Commissioner of Inland Revenue
Mrs Jennifer Chan	Assistant Commissioner of Inland Revenue
Mr Chiu Kwok-kit	Assistant Commissioner of Inland Revenue
Mr Yim Kwok-cheong	Senior Assessor (Research)

Mrs Alice Lau (CIR) welcomed the delegation from the Institute to the meeting. CIR expressed that the Institute and the IRD had always been working partners. CIR in her letter dated 6 June 2005 sent to Mr Chan clearly stated that the IRD always treasured the annual meeting between the Institute and the IRD, which provided a forum to discuss issues of common concern and resolve practical problems that had arisen in dealings between practitioners and the IRD. Through the annual meeting, the IRD was able to look into problems of an administrative nature from the tax practitioners' point of view and to improve the IRD's practice and procedures by taking the necessary follow-up actions. Minutes published after the annual meeting would provide useful and up-to-date tax information not only to practitioners but also to the IRD officers. Occasionally, there were calls that the small and medium practitioners did not have sufficient representation to reflect their views in communication between the accounting profession and the IRD. In the letter, CIR suggested to the Institute that, in deciding the number and composition of its representatives in the annual meeting, the Institute should ensure that the interests of small, medium and big firms were fairly represented. CIR appreciated that the Institute, in preparing the agenda for the annual meeting, had made great effort to alert all members and to invite their views.

Mr Chan said that, as regards the representatives of the Institute who would attend the annual meeting, the Institute always endeavoured to have a good balance of tax practitioners from small, medium and big firms. For this year's meeting, the Institute specifically asked a number of small and medium practitioners to provide feedback on their concerns and, as a result, quite a number of the agenda items were issues raised by them. In compiling the agenda, the Institute had consulted members of the Taxation Interest Group and sent emails to all members, both practising and non-practising, to invite views.

PART A - MATTERS RAISED BY THE INSTITUTE

Agenda Item A1 – Profits Tax Issues

A1(a) DIPN 21 – Locality of Profits

(i) Group service companies

Under paragraph 25 of DIPN 21, where a Hong Kong company, usually a member of a multinational group, rendered support services, such as marketing and training, substantially in Hong Kong, to group members located throughout the Asia/Pacific region, and inter-group charges were made at an agreed mark-up of cost (typically

5% or 10%), the profits, being the mark-up, derived by the Hong Kong company for its services, were wholly assessable.

Clarification was sought from the IRD as to the tax treatment in the (reverse) situation where a Hong Kong company received support services from group members in the Asia/Pacific region, and paid inter-group charges at an agreed mark-up of cost.

Mr Chu advised that whether the service fees received by the overseas group members were arising in or derived from Hong Kong was a question of fact. It would depend on where the operations giving rise to the fees were carried out. With regard to the payment of service fees by the Hong Kong company, deduction would be allowed to the extent to which they were incurred in the production of chargeable profits. Again, this was also a question of fact. CIR pointed out that the 5%-10% guideline for the mark-up on services rendered by the Hong Kong company was a figure based on the IRD's experience. Even this was not an absolute rule and sometimes questions would be raised. Ms Macpherson said that it would be helpful if the IRD, in respect of the inter-group service charges paid by a Hong Kong company, could give some guidelines on the percentage of mark-up on cost that was allowable for deduction purposes. CIR explained that it would be difficult on the IRD's part to fix a percentage of allowable mark-up with the facts of individual cases not fully available. Mr Tam further pointed out that it was difficult to generalise as variable percentages of mark-up might be adopted in different arm's length transactions. He added that more information was available on the quantification of service as the costs on which it was based were incurred in Hong Kong and could be verified through field audits, etc.

(ii) Re-invoicing centre

The Institute would like to follow-up on the response from the IRD on the issues raised at the 2005 Annual Meeting regarding offshore claims on "booked-profit" (Agenda Item A(1)(c)(iii) of the minutes referred).

At the 2005 Annual Meeting, the IRD indicated that the commission income/spread derived by a re-invoicing centre should be chargeable to profits tax on the basis that the income/spread is derived from services rendered in Hong Kong. The Institute would like to seek the IRD's clarification as to the circumstances under which the IRD would consider the income/profit derived by a re-invoicing centre as a commission income/spread, and not a trading profit. In particular, the IRD also indicated in the 2005 Annual Meeting that "confirmation of sales and issue of

purchase orders were indications that it was a trading transaction”. However, a typical re-invoicing company (the activities of which were set out in paragraph 9 of DIPN 21) would not issue or accept purchase/sale orders and would assume minimal commercial risks from the trading transactions, which it merely booked. In such circumstances, the Institute would like to ask if the profit “booked” by the re-invoicing company should be a commission income/spread or a trading profit. If the former applied, the Institute would like the IRD to advise whether its position on re-invoicing companies had changed.

While the Institute noted the IRD’s subsequent response to the Institute when we followed up on this point after the 2005 annual meeting, i.e. that the IRD would endeavour to address the point before finalising the redrafting of DIPN 21, we should nevertheless be grateful to know the progress.

Mr Chu replied that DIPN 21 was being revised, including the part relating to “Trading Profits” covered in the existing paragraphs 6 to 12. The revision which involved rewriting other paragraphs would take some time to complete.

It was not possible to simply state the circumstances under which income/profit derived by a “re-invoicing centre” would be regarded as a commission income/spread and not as a trading profit. In each case the IRD needed to examine the nature of the operations and the type of risks in question to determine whether they constituted trading or the provision of services. The label “re-invoicing centre” clearly did not in itself provide the answer, as it meant different things to different people.

Mr Chu explained that the IRD would weigh various factors (such as where goods were purchased or sold, how goods were procured and sale solicited, how the finance was arranged, etc.) to decide whether a trading profit had a source in Hong Kong. Prima facie, if the acceptance or issue of the sale/purchase orders was in Hong Kong, the trading profit was having a source in Hong Kong and the profit arising from the transaction would be subject to Hong Kong Profits Tax, irrespective of the company in which the trading profit was booked.

Furthermore, if income, whether in the form of a commission, a fee or a price differential, accrued to a re-invoicing centre in Hong Kong and was in respect of a re-invoicing service provided in Hong Kong, it would be subject to Hong Kong Profits Tax.

Ms Macpherson asked if the IRD would take into account the points set out in the Board of Review Decision *D2/96* 11 IRBRD 300 in distinguishing a “re-invoicing service” and a “trading transaction”. Mr Tam said that *D2/96* was quite an old case and there were a number of Board of Review Decisions subsequently issued on locality of profits. The IRD anyhow would study *D2/96* to see if some useful guidelines could be adopted. Mr Chiu mentioned that there had been a recent Board of Review case on this subject, although the decision had not yet been delivered. CIR pointed out that DIPN 21 [“Locality of Profits”] was being revised. The Joint Liaison Committee on Taxation (JLCT) would be consulted before finalisation of the revised DIPN 21. The Institute could give comment on the revised DIPN 21 through its representative in the JLCT.

A1(b) DIPN 1 – Treatment for losses on long-term construction contracts under paragraphs 6 and 7 of Part B of DIPN 1

As Lord Millet said in the Hong Kong Court of Final Appeal’s decision in *CIR v. Secan Ltd. and Ranon Ltd.* ((2000) 5 HKTC 266) (“*Secan*”) that “[b]oth profits and losses therefore must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the [IRO]”, the Institute would like to know the basis for not allowing losses for long-term construction contracts in full in the year the losses were made in the accounts as stated in DIPN 1.

CIR advised that the Hong Kong Court of Final Appeal’s decision in *CIR v Secan Ltd. and Ranon Ltd.* ((2000) 5 HKTC 266) (*Secan*) established the principle that the tax treatment should follow the accounting treatment. The IRD’s view was that the principle should generally apply to all types of income and expense, except as otherwise provided for by the Inland Revenue Ordinance (IRO). As the making of provisions for foreseen losses was required by generally accepted accounting principles, and was not inconsistent with the provisions of the IRO, the IRD had confirmed that paragraphs 6 and 7 in Part B of DIPN 1, which was issued before *Secan*, were no longer applicable. Following *Secan*, the IRD agreed to allow a full deduction in the year the provisions were recognised in the accounts, provided that they were (i) made in accordance with the established accounting practice; and (ii) estimated with sufficient accuracy.

The new practice would apply to any open years of assessment (current or back years) including those under objection.

Mr. Chu confirmed that instructions on the new practice would be issued to assessors within the next few days.

The IRD would revise DIPN 1 in due course to reflect the above position.

AI(c) The impact of the Secan case

The IRD takes the view that the decision in the *Secan* case has not introduced any new principle, and also that the decision supports the position that profits, as reflected in a taxpayer's profit and loss account, are in principle taxable. Some practitioners, on the other hand, point out that not all profits contained in the profit and loss accounts are realised profits, and that taxing unrealised gains is not consistent with the principle of taxation that profits and losses should not be anticipated (referred to by Sir Thomas Bingham MR in the case of *Gallagher v Jones* [1993 STC537]).

With effect from 1 January 2005, the new Hong Kong Financial Reporting Standards ("HKFRSs") primarily based on fair value accounting applied to financial statements presenting a true and fair view.

A purely accounting-driven approach to taxation could lead to hardship and inequity. Unrealised profit did not give rise to positive cash flow and, therefore, in practice, it might be difficult for taxpayers to fund payments of tax liabilities arising from unrealised gains. Given the volatile nature of Hong Kong's markets, in some instances, a profit might never be realised from "gains" due to revaluations/marketing to market and, consequently, although tax might need to be paid in the interim, the relevant asset might eventually be sold at a loss. Given the absence of loss carry-back provisions in Hong Kong, there would be situations in which such losses would not be able to be recouped, leading to unfairness.

The Institute believed that there was a strong argument for principled departures from accounting definitions of profit for tax purposes. Such departures need not result in undue complexity in tax law. From a technical point of view, it should not be hard to legislate to, for example, exclude from tax revaluation gains on relevant assets.

In view of the potential difficulties and uncertainties, resulting from the broad application being given to the *Secan* decision, the Institute would like to know whether the IRD would support initiatives to legislate in specific cases, or more generally, to address the concerns and return to the basic principle of not anticipating profits?

Mr Tam explained that accounting standards were developed to fairly measure the true profit or loss of a business. Such true profit could be used for the purpose of dividend

distribution and other business purposes and should thus form a fair starting point in computing the assessable profit for tax purposes.

As often pointed out, accounting principles were not static but evolving. They might be modified, refined and elaborated over time as business circumstances changed and insights sharpened. So long as the principles remained current and generally accepted, they provided the best means in determining the profit of a business as accurately as possible.

In the new HKFRSs, it was considered fair and necessary to recognise the profits or loss arising from revaluation or marking financial instruments to market for business purposes. There was no justification why profits computed according to such standards should not be adopted for taxation purposes. For a going concern, any such losses were available for set-off against other profits for the same accounting period and the ultimate recoupment of such losses in later years was almost certain. Convergence of tax and accounting treatments appeared to be the worldwide trend because it helped to avoid uncertainties and administrative difficulties. Secan had not changed the law but simply affirmed the legitimacy of aligning the profits accounted for under established accounting principles with the assessable profits for tax purposes.

Mr Southwood asked whether the IRD's views could be reconciled with the "principle of not taxing unrealised profits". Mr Tam advised that, in this respect, the commonly referred case was the *Willingale* case [1978] STC 75, which actually concerned the presence of two acceptable accounting practices - one on realisation and one on accrual. The realisation principle was not necessarily the universal rule. One of the law Lords in *Gallagher v. Jones* [1993] STC 537 commented on the *Willingale* case at page 555 and made it clear that in appropriate circumstances the accounting practice of accrual might be acceptable. Mr Tam suggested that paragraphs 15 and 16 of DIPN 42 ["Taxation of Financial Instruments and Taxation of Foreign Exchange Differences"] might be referred to for a detailed elaboration. CIR advised that one must look to the IRO provisions to see if modification of the accounting practice was required in ascertaining assessable profits. She further pointed out that the practice of marking to market for financial instruments in fact had been adopted by financial institutions in Hong Kong for years.

Mr Southwood suggested that the accounting treatment should be the starting point only, as the law could diverge from this (e.g. in the case of depreciation allowances). He noted that in some jurisdictions, other measures, such as loss carry-back, were available

that could help to mitigate the impact of taxing on the basis of the accounting treatment. He asked whether the IRD would support proposals to legislate to counter the more onerous effects of taxing on this basis, as more and more new International Financial Reporting Standards (“IFRSs”) were being introduced. CIR replied that this was a policy matter, whereas the IRD’s role was to apply the law.

A1(d) “Share-based payment” – tax treatment

In the minutes of last year’s annual meeting, it was stated that “[t]he subject matter was not simple, and the IRD would form a committee to study the proper tax treatment”.

The Institute would like to be advised on the progress of the IRD’s deliberation on the issue. In particular, in view of the *Secan* decision, and its application by the IRD, the Institute should be grateful for the IRD’s confirmation on the deductibility of expenses associated with transactions in which share options were granted to employees, including where the stock options granted to employees had not been subsequently exercised due to, e.g. a fall in the stock price during the exercise period.

Further, in case an overseas parent company’s share option scheme extended to cover the employees of a Hong Kong subsidiary under a cost-recharge arrangement, the profits tax deduction of the subsidiary also appeared to be unclear. Under HKFRS 2, the charges to the profit and loss account of the subsidiary would still have to be made based on a valuation of the option costs of the parent company at date of grant (spread over a vesting period if applicable). However, the subsidiary might also separately agree to pay an amount (say between the market and exercise price of the shares) to its parent company upon its employees actually exercising the options under the recharge arrangement. As such, the subsidiary’s charges to its profit and loss accounts under HKFRS 2 could be different from the actual recharges made by the parent company in terms of both amounts and timing of incurrence. The Institute would be grateful if the IRD could also state its view on the profits tax deduction of the Hong Kong subsidiary in this regard.

Mr Tam explained that as there were no express provisions in the IRO governing share-based payments, the deductibility of such payments had to be considered under sections 16 and 17 of the IRO and case law thereon. Established accounting principles, which were not at odds with the express or implied provisions of the IRO, were also pertinent (see the *Secan* and *Gallagher* cases).

The IRD had done some study on the subject and was at present researching on the practices adopted by other countries. Upon finalisation of the research, the IRD would consider to issue a DIPN.

So far, the IRD had observed in *Lowry v. Consolidated African Selection Trust Ltd*, 23TC 259 that the difference between the par value and the market value of certain shares allotted to employees as remuneration for services was held to be non-deductible expenses. The UK followed the authority of that case and took the stance that, for periods starting before 1.1.2003, when a company issued shares it did not outlay any expenditure and so no deduction was allowable in computing the profits of the company's trade for tax purposes [see UK tax authority's document under reference BIM44240]. The relevant accounting practice appeared to be at odds with this authority.

Ms Florence Chan said that the matter was quite urgent as it was quite common for share options to be awarded to senior executives, but the existing cases dealt only with the situation where a company issued options directly to its employees. In Hong Kong, employees could be given options on the parent company's shares and there might be a charge-back arrangement with the Hong Kong subsidiary. The accounting entries could also be complicated.

CIR advised that it could be difficult to generalise, given the differences between individual cases and so taxpayers might consider applying for an advance ruling for individual cases where appropriate.

AI(e) DIPN 41 – Taxation of holiday journey benefits

It appeared to some practitioners that the IRD had adopted a rather strict interpretation of "holiday journey" in DIPN 41 and considered a one-day Hong Kong tour provided by an employer for a group of employees to be a holiday journey benefit of the employees concerned. This interpretation might be controversial as in many cases employees might only join a tour voluntarily or involuntarily so as to show support of a company's function rather than for personal enjoyment. Further, the administration of this type of holiday journey (e.g. a one-day Lamma Island seafood trip) was very cost ineffective for the employer.

Would the IRD consider revising its position by excluding a one-day local tour from the scope of the legislative provisions as a matter of concession? Or alternatively, would the IRD accept the disallowance of these "holiday journey" expenses by the employer for

profits tax purposes, instead of having to allocate the cost to the staff as taxable employee benefits?

Mrs Chan explained that deduction of an expense for profits tax purposes was governed by sections 16 and 17 of the IRO. The IRD did not encourage deviation from the law. The term “holiday journey” was defined under section 9(6) of the IRO as a journey taken for holiday purposes or, where a journey was taken for holiday and other purposes, the part of the journey taken for holiday purposes. This definition drew no distinction between a long and a short journey, nor distinguished journey taken within Hong Kong and outside Hong Kong, nor did it require considering whether the employee took the holiday journey voluntarily or involuntarily. Following this definition and provisions in section 9(2A), one-day local tour constituted a “holiday journey” and the amount paid by the employer should be apportioned and included as the employee’s assessable income. The position had been set out clearly in paragraph 18 of DIPN 41. So far, the IRD was not aware of any problem on the part of employers concerning record keeping and computation of employees’ holiday journey benefits from one-day local tour for the purposes of filing the tax returns.

The IRD could not accept the suggestion to disallow the “holiday benefits” expenses in the employer’s profits tax return in substitution of reporting the benefit as the employee’s taxable income. An employee’s salaries tax liability for holiday journey benefits was governed by section 9(2A)(c) and other related provision of the IRO. That the employer had added back the holiday journey expenses for profits tax purposes did not affect the chargeability of the related benefits under salaries tax and also the employer’s legal obligation to report the relevant amounts in the employer’s return. There would also be practical difficulties as the employees might not be in a position to know whether the employer had added back the expenses in question, thus resulting in possible under-reporting by the employees or double-taxation. This was not easy to circumvent given the section 4 restrictions where applicable.

A1(f) Section 51(2), IRO

Section 51(2) of the IRO required a taxpayer to report chargeability to tax within four months after the end of the basis period for the year of assessment unless the taxpayer had been required to furnish a return under section 51(1). The Institute would like to know what would be the best course of action for a company that closed its accounts on 30 June. The four-month period, therefore, would end on 31 October, while a tax return would not be sent out until the following year.

What would be the best course of action for the company to discharge its obligation under section 51? Would the company be liable to be penalised under section 82A, IRO if it failed to notify the IRD of chargeability to tax within the four-month period, even though it would receive a tax return in the normal course of events the following year?

Ms Lee advised that a person who failed to comply with the reporting requirement under section 51(2) was only liable to be penalised under section 82A if the person had failed to comply “without reasonable excuse”. Accordingly, where such a taxpayer had been receiving profits tax returns in past years, and could reasonably expect that in the normal course of events a return would be issued in the current year, there would be no need to advise chargeability within the four-month period. The IRD would consider to clarify this in the Block Extension Letter. However, if a taxpayer had been advised that a profits tax return would no longer be issued to him annually, or if it was a commencement case, the taxpayer would be required to notify the Commissioner within the stipulated period.

Mr Southwood sought confirmation that a taxpayer with, say, 30 June year end, who usually received a return in April, would not be penalised if he did not receive a return in a particular year and subsequently wrote to notify the IRD of the fact shortly after the time the return would normally have arrived. CIR considered that this would generally be a reasonable excuse.

A1(g) Profits tax return – Cat. 22 cases

We should like to know the current situation regarding the frequency of profits tax returns being issued to Cat. 22 cases and the current IRD policy on issuing such returns.

Ms Lee pointed out that this subject had been discussed previously - see the minutes of the 2002 Annual Meeting [Agenda Item A2(c)] and those of the 2003 Annual Meeting [Agenda Items A2(b) and A2(c)]. There had not been any subsequent change of the IRD practice.

Cases with a file reference prefix of “22” are “review files”. These were normally files of inactive companies or companies which had not had any assessable profits for several years. When a file was changed to a “review file”, a standard notice was issued, stating, amongst other things, that although the company would not be required to submit an annual profits tax return, the notice did not exempt the company from the requirement to lodge any profits tax return which might be issued from time to time. In

the majority of cases, such tax returns were issued on a 3 to 4-year cycle. There were, however, also “odd-issues” of returns where, for example, there was information indicating that a company was about to liquidate or had a potential tax liability.

CIR added that the IRD had many more inactive cases (e.g. loss cases and dormant companies) than active cases and it was not in the public interest to issue returns to them annually.

AI(h) Loss cases

The Institute understood that the IRD practice was not to agree tax losses until an assessment on assessable profits was issued. Under such circumstances, how far back would the IRD expect a taxpayer to retain information for possible enquiry?

Some practitioners had come across specific cases when the IRD asked for information exceeding the previous seven years of assessment. The Institute queried whether this was compatible with the Financial Secretary’s statement in the 2005/06 Budget Speech that “Hong Kong will continue to maintain the low and simple tax regime that underpins our success”.

What was the IRD’s policy in dealing with situations where the information might no longer be available, because e.g. it had been destroyed after the statutory time limit had expired? Would the IRD disallow some of the losses on the basis that information was not available?

Mr Chu replied that a taxpayer should keep business records for not less than 7 years. In general the IRD would try to quantify tax losses as far as possible. However, a taxpayer’s right to object only arose when there was an assessment. And the onus was on the taxpayer to prove the assessment to be excessive or incorrect. Where a taxpayer disagreed with the back-year losses computed by the assessor, it was in his interest to keep his records until the losses were exhausted.

Similar advice was given by the High Court in *CIR v. Common Empire Limited* [HCIA 1/2004 – date of decision 17 January 2006]. On the keeping of records for a sale of property case, Deputy Judge To said at paragraph 70 of the judgment that:

“... The duty to keep records of up to seven years does not prevent a taxpayer from keeping records beyond seven years. As rightly submitted by (Appellant’s

Counsel), arguments over whether a property is a capital asset or trading stock would necessarily require investigation into the circumstances surrounding its acquisition, which could have acquired more than six years ago. It certainly is in the taxpayer's interest to keep records until after the property has been disposed of and his tax liability in respect of it finalised, even if that involves keeping record beyond seven years."

Keeping records was thus necessary for the ascertainment of assessable profits. It was not at odds with the Financial Secretary's statement on maintaining a low and simple tax regime.

Agenda Item A2 – Provisional Tax Issues

A2(a) The application of section 63H(6), IRO

As indicated by the IRD at the 2005 Annual Meeting (under Agenda Item A2(c) – Issuing of provisional tax assessment/demand without a return), section 63H(6) permitted the assessor to assess or estimate the provisional tax where it was expedient to do so. In fact, the wording of section 63H(6) was "notwithstanding section (5), an assessor may assess or estimate the amount of provisional profits tax which any person is liable to pay if he is of the opinion that the person is about to leave Hong Kong or that for any other reason it is expedient to do so".

The IRD was requested to clarify the kind of circumstances in which it would be considered "expedient" to exercise the power under section 63H(6).

Mr Tam advised that the word "expedient" was not defined in the IRO. According to the Oxford Dictionary, as an adjective, "expedient" meant "useful or necessary for a particular purpose, but not always fair or right". The kind of circumstances in which an assessor might exercise the power under section 63H(6) would generally include those under which the collection of revenue might be at risk, such as leaving-Hong Kong and bankruptcy cases, though there could be other circumstances which warranted an assessor to exercise his power. The IRD assured the Institute that in all circumstances, the assessor would exercise his discretionary power with due care. CIR indicated that section 63H(6) cases were few in number.

A2(b) Section 63H(8), IRO

Section 63H(8) stated that for the purposes of Part XII, provisional profits tax shall be deemed to be a tax charged under the IRO and a notice under subsection (7) shall be deemed to be a notice of assessment.

It seemed that if the IRD had exercised the power under section 63H(6), an objection from the taxpayer could be entertained only when the final tax was determined because acceptance of an application for the holding over of payment of provisional profits tax under section 63J was discretionary. As a result, the taxpayer effectively had no right to object to provisional tax being assessed in any given circumstances, e.g. an assessment under section 63H(6) in relying on the power to issue such where “for any other reason it is expedient to do so”.

The Institute would appreciate clarification regarding:

- (i) the IRD’s view on the concern raised on the above assessments; and
- (ii) its policy on issuing provisional tax assessments to companies during their first year of operation.

Mr Tam explained that Part XII of the IRO was on matters relating to payment and recovery of tax only whereas Part XI was on matters relating to objections and appeals. A person aggrieved by a notice under section 63H(7) (deemed to be an assessment for the purposes of Part XII) did not have the objection right under section 64 which is in Part XI. The relief was by way of an application of holdover under section 63J. According to the Oxford Dictionary, as an adjective, “expedient” meant “useful or necessary for a particular purpose, but not always fair or right”. While the IRD always tried its best to be fair to a taxpayer, the IRD would also need to protect the revenue in appropriate cases.

For a newly incorporated company, it was the IRD’s practice to issue the first profits tax return to it 18 months after its date of incorporation. Normally, demand for payment of provisional profits tax would be preceded by the issue of a section 51(1) notice. However, there were cases in which the assessor would exercise his power under section 63H(4) to estimate the amount of provisional profits tax for the commencement year and the year succeeding. One example of such cases was companies involved in property transactions; where, e.g., information from the Stamp Office indicated cases of property dealing, then a provisional property tax demand might be issued.

Agenda Item A3 – Salaries Tax Issues

A3(a) DIPN 10 – Time apportionment claims

The Institute had received further queries from practitioners indicating that there had been incidents of assessors deviating from the three criteria laid down in DIPN 10 for reviewing time-apportionment claims of individuals. They pointed out that the assessors did not consider the “totality of facts” concept and disallowed taxpayers’ claims on the basis of certain minor facts (e.g. business card, work visa application form), without focusing on the substance of the employment arrangement.

In view of the unresolved uncertainties with respect to time-apportionment claims, the Institute requested for clarification as to the current stance of the IRD on offshore employment and, in particular, when the revised DIPN 10 will be issued.

CIR replied that the drafting of the revised DIPN was near completion. The IRD would invite comments from the JLCT and various parties when ready and HKICPA could give comments either directly or through its representative in the JLCT.

A3(b) DIPN on share awards

The IRD’s guidelines on taxability of stock option benefits in DIPN 38 were revised in March 2005. It was mentioned in DIPN 38 that the IRD would deal with the tax treatment of share awards in a separate practice note. The Institute would appreciate an update on the status of the matter.

CIR advised that the JLCT had set up a subcommittee studying the subject, and once the result was in hand the IRD would consider whether a DIPN should be prepared. The IRD had not received many enquiries from employers and employees on tax treatment of share awards. It seemed the award of shares to employees as part of their remuneration was still not widely practised. From experience, terms of one share award scheme differed substantially from the next. It was difficult to generalise. Each case had to be considered on its own facts. For this reason, where appropriate, employers should consider seeking an advance ruling to clarify the tax treatment.

A3(c) Compensation for loss of office / termination payments

The above subject matter was raised at the 2005 Annual Meeting (under Agenda Item A2(f)) - Compensation for loss of office). Practitioners were still asking whether, in view of the various Court / Board of Review decisions in the recent years the IRD would issue further guidelines or a DIPN on the subject and, if so, when?

Mrs Chan replied that there was no plan to issue a practice note on the subject. As mentioned in last year's minutes, different employers offered different terms for compensating their employees. Each case had to be considered on its own. Severance payment or compensation for loss of office if properly described should not attract salaries tax. In case of doubt, it was more appropriate for employers to seek advance ruling to clarify the tax treatment.

A3(d) Employer's return filing on cessation of employment or departure of employee

The due date to file Forms IR 56F/56G was one month before the date of cessation / departure from Hong Kong (section 52(5) and 52(6), IRO). However, it was quite common for the management to make decisions to terminate / relocate an employee at the last minute. It might be difficult, or even impossible, to adhere to this filing deadline all the time.

Also, section 52(7), IRO stipulated that employer needed only to withhold payments to a departing employee for one month after it had filed notice of the employee's departure from Hong Kong or – until a letter of release was received from the IRD. As such, it appeared that when a deferred remuneration was subsequently paid by the employer to the employee after the latter had departed from Hong Kong, the former was not in law obliged to withhold any Hong Kong tax payment, although it might have to file an amended Form IR 56G for tax reporting purposes. The Institute requested the IRD's confirmation that this interpretation of the law was correct. Otherwise, the Institute would be grateful for the IRD's advice as to the amount of the deferred remuneration to be withheld and the relevant law under which the employer was entitled to withhold payment in case such withholding was challenged by the employee concerned.

Mrs Chan advised that, firstly, sections 52(5) and 52(6) of the IRO required the employer of an employee who was chargeable to Salaries Tax to give written notice informing the date of cessation of the employee's employment or his expected date of departure from Hong Kong not later than one month before the respective dates, as the case might be. Proviso to the two sections however stipulated that the Commissioner might accept such shorter notice as she might deem reasonable. As such, in the special circumstances where the employee's employment was terminated on short notice, a notice of less than one month filed by the employer might be accepted as fulfilling the legal obligation. CIR said that it was advisable for tax practitioners to supply as much information as possible. If the employer informed the IRD in advance that the employee would be terminated on short notice, less than 1 month's notice of the subsequent termination would usually be accepted.

Secondly, section 52(2) of the IRO required the employer to state in a return, inter alia, the full amount of the remuneration of an employee, whether in cash or otherwise, for a relevant period. In case the employee was about to leave Hong Kong for any period exceeding one month, the employer was required to give an advance notice to the Commissioner regarding his departure from Hong Kong as required under section 52(6) of the IRO. These obligations were normally discharged by filing Form IR 56G to the IRD. In addition, by virtue of section 52(7), the employer was also required to withhold any payments of money to the employee for a period of one month from the date on which the notification was given, or until a "letter of release" had been received from the IRD, whichever is the earlier.

In the case where the employee was subsequently paid a deferred remuneration after his departure from Hong Kong, this effectively meant that the amount of total remuneration as declared by the employer in the original IR 56G was incorrect. Mrs Chan reminded that the employer should file an "additional" IR 56G to report the additional remuneration paid to the employee. The employer should insert the additional amount [not the total revised amount] in the appropriate item on the IR 56G and mark the word "ADDITIONAL" clearly on the right hand top corner of the sheet. Employers might refer to the IRD Homepage for further information [http://www.ird.gov.hk/eng/tax/ere_amd.htm].

As it had already been made clear in the earlier "letter of release" issued that it only applied to the balance of the moneys which was reported in the original IR 56G, the employer should likewise, under the authority of section 52(7), withhold all moneys payable to that employee for a period of one month from the date of filing the

“additional” IR 56G or until receipt of a letter of release from the IRD, if earlier. It should be noted that compliance with section 52(7) would constitute a defence in any proceedings against an employer in respect of his failure to make any payment to or for the benefit of the employee during the period concerned.

A3(e) Tax treatment for hypothetical tax deduction under tax equalisation schemes

Despite the fact that the tax treatment of “hypothetical tax” was raised in Agenda Item A3 of the 2004 Annual Meeting, some members had indicated that they were still confused and would like to seek further clarification of the issue.

In this regard the IRD’s comments on the correctness of the Hong Kong tax reporting basis of the taxpayer in the example set out below would be of general help to our members.

Example – Hong Kong tax reporting basis for hypothetical tax deduction

Assuming a Swiss national employed by a US company was seconded by the US company to work in Hong Kong. Under the tax equalisation scheme of the company, US would be treated as the employee’s home country. The employee was therefore subject to hypothetical tax deduction during the Hong Kong secondment, as if he had remained in the US. The applicable hypothetical tax deduction rate was 30%. But since he was a Swiss national, he was not liable to any actual US tax during his Hong Kong secondment, albeit the hypothetical tax deduction was made on the hypothetical basis that he would have been liable to US tax had he remained in the US.

Under the equalisation scheme, the employer would assume responsibility for all the employee’s actual home and host location taxes on employment income and would deduct a hypothetical tax from the employee through a payroll deduction.

His actual remuneration and Hong Kong tax reporting basis during the year in question were as follows:

<u>Actual remuneration and Hong Kong tax reporting basis for the Year in question</u>	<u>HK\$</u>
Gross normal remuneration	\$3,000,000
Hypo tax deduction	<u>(900,000)</u>

Net gain	<u>2,100,000</u>
Gross gain on exercise of share options	10,000,000
Hypo tax deduction	<u>(3,000,000)</u>
Net gain on share options	<u>7,000,000</u>
Actual Hong Kong tax liabilities of the previous year paid in the year in question, say	<u>336,000</u>
Actual home country tax paid	<u>0</u>
Total income reported for Hong Kong tax purposes \$(2,100,000 + 7,000,000 + 336,000)	<u>9,436,000*</u>

- * The Hong Kong tax reporting was made on the basis that, taking the employment terms and the tax equalisation scheme of the company together, the employee's contractual remuneration was not the gross income but the net gain, plus an assessable benefit of having his actual tax liabilities borne by the employer. Similarly, the hypothetical tax deduction on the share option gain was treated as effectively part of the consideration paid by the employee for exercising the share options.

Mrs Chan pointed out that the IRD did not consider it appropriate to comment on a hypothetical case in which the full details might not be known. If the Swiss national was not liable to US tax, it was strange that he would agree to have 30% of his income being deducted by his employer with no arrangement for payment of the withheld amount. The Institute's worked example suggested that the amount after deducting the withheld amount would be reported to the IRD. To determine whether the reporting was correct in the hypothetical case given, the IRD needed to examine the terms and conditions of the employment contract as well as the particular tax equalisation scheme rules. The IRD's position was that salaries tax was chargeable in respect of income accruing from all sources [section 11B]. In the absence of full details of the example concerned, the IRD was unable to confirm if the tax reporting basis on net remuneration received by the employee was proper.

Share option gain was treated differently from normal remuneration. The computation of share option gain was specifically governed by section 9(4)(a) of the IRO. The

provision only allowed deductions of the amount or value of the consideration given for the taxpayer's option shares and for the grant of the right from the amount that a person might reasonably expect to obtain from a sale in the open market at the time of the shares were acquired. As mentioned in Agenda Item A3 of the 2004 Annual Meeting, the IRD took the stance that the hypothetical tax deduction was not regarded a consideration for the option shares or the grant of right. Neither was it a cost incurred in selling the shares in the open market. Hence, the same was not deductible for Salaries Tax purposes and the employer should report the gross gain on the exercise of share options.

Ms Florence Chan said that under tax equalization programs of US companies, it was common for US tax to be deducted even if the employee was not a US resident or citizen and was not required to pay US tax. However, the employer would pay other local taxes on behalf of the employee. Such local taxes paid by the employer would be added back into the employee's income. Mrs Chan said that, from the IRD's experience, contracts often provided for a return of any withheld amounts later in the year. So it was not possible to come to a view without seeing the contract and the scheme rules. Mr Tam said that, as a general principle, the full amount should be reported. Tax paid was part of an employee's income and that would include tax paid in Hong Kong and, for example, in the US.

A3(f) Issuing return for reporting share option gain after departure

Taxpayers were required to file individual tax returns to report any share option gain after permanent departure. In these cases, it was noted that the IRD continued to issue individual income tax returns to these individuals in the years after the share option gain was reported. These returns might be sent back by the tax representative to the IRD requesting them to cancel the returns, however, the IRD continued to send reminders and compound notices. It appeared that once a return was issued, the individual needed to sign and file the return even if there was no income to report. In addition, the IRD would continue to issue tax return to that individual unless it was a departure case.

According to BIR 56A instruction notes, a 56B should be filed for former employees who had any share option gain. What would be the IRD's view on filing a 56G instead, in order to avoid unnecessary tax reporting for the following years.

Mrs Chan explained that IR56G was completed by an employer to comply with requirements under section 52(6) of the IRO (to notify the Commissioner when an

employee was about to depart from Hong Kong) and to report employee's income for the year of departure. Gain realised from the exercise of a share option after permanent departure was chargeable to Salaries Tax in the year of exercise and not the year of departure. As it was not a departure case in the year of exercise, the filing of IR56G was not appropriate.

In normal situations, when an IR 56B was received, the IRD system was to send a return to the employee, if one had not already been sent. For an employee who had departed from Hong Kong permanently, when an IR 56B was received in respect of the exercise of a share option, the case would be handled manually. A return would still be issued to the employee in the year of exercise but action would be taken by the case officer to suppress the issue of return in subsequent years. IRD officers would be reminded to follow this procedure.

Agenda Item A4 – Cross-border Tax Issues

A4(a) Applicability of Section 39E on contract processing and import processing arrangements

The Institute would like to follow-up on the responses from the IRD on issues raised at the 2004 Annual Meeting regarding the applicability of section 39E, IRO on contract processing arrangements (Agenda Item A(2)(e) refers).

- (i) The Institute would like to clarify the legislative intent of section 39E(1)(b)(i) of the IRO. If the intention was to deny capital allowances in a situation where the plant or machinery was leased for use by the lessee outside Hong Kong because the relevant lease rentals were offshore sourced and non-taxable, the Institute considered that section 18F would be sufficient to serve this purpose.

Mr Chiu replied that section 39E was enacted to limit the opportunities for tax deferral or avoidance through sale and leaseback, offshore equipment leasing and leveraged leasing arrangements. Further, the “used wholly or principally outside Hong Kong” condition in section 39E(1)(b)(i) aimed to encourage the generation of economic benefits in Hong Kong by the use of the machinery or plant in Hong Kong. This was explained in paragraph 16 of DIPN 15 (Revised). Section 39E was introduced in the year 1986 to limit the exploitation of the provisions of the IRO, which conferred tax benefits on a person who had not incurred capital expenditure on the provision of plant or machinery, and which might occur in the case of certain sale and lease back

arrangements or other leasing arrangements limiting the liability of the lessor in respect of the debt created in relation to the leasing arrangements. It was not for the intention stated by the Institute. Section 18F was introduced at a much earlier time. If section 18F was sufficient to counteract against the avoidance schemes before section 39E was introduced, the government would not have resorted to its introduction.

As stated in the Hansard, the Financial Secretary, when he moved the second reading of the Inland Revenue (Amendment) Bill 1986, said it was “to limit the opportunities for tax deferral through use of certain machinery or plant under leasing arrangements by denying to a lessor initial and annual allowances where machinery or plant was acquired by him under a sale and leaseback arrangement, or, being other than a ship or an aircraft, was acquired by him through a ‘leveraged lease’ transaction and is used wholly or principally outside Hong Kong”.

- (ii) While the IRD would allow 50% of capital allowances for contract processing arrangements (under which only 50% of the Hong Kong entities’ profits were taxable), the Institute would like the IRD to consider also granting such a concessionary treatment (i.e. not strictly applying section 39E) to import processing cases where the relevant Hong Kong entities’ profits were wholly subject to profits tax. In particular, as the IRD might appreciate, the transfer price for the goods sold by the mainland manufacturers to the Hong Kong entities would usually take into account the provision of plant and machinery by the Hong Kong entities (i.e. the transfer price would have been higher had the Hong Kong entities not provided such plant and machinery to the mainland entities). It should be noted that, given that the manufacturing of goods usually involved specialised technologies, and the generally limited working capital of the mainland entities, manufacturing plant and machinery were required to be provided by the Hong Kong entities under both contract processing and import processing arrangements.

Mr Chiu advised that the arrangement of allowing the Mainland entity to use the plant and machinery in a contract processing case fell within the provision of section 39E. As the plant and machinery were used by that entity outside Hong Kong, no depreciation allowances could be given. However, as 50:50 apportionment of assessable profits was allowed in such a case, the provision of section 39E had not been strictly applied, and, as a concession, 50% of capital allowances were similarly allowed.

There were fundamental differences in the terms of a contract processing agreement and an import processing agreement. Taxpayers involved in import processing

arrangements were regarded as traders, who were not owners of the plant and machinery. There was simply no legal basis for the IRD to extend the above-mentioned concession to these taxpayers.

Mr Chiu further pointed out that Assessors found out in some field audit cases that the plant and machinery, allegedly leased to an Foreign Investment Enterprise (FIE) in the Mainland and recorded as fixed assets in the balance sheet of the Hong Kong company, were in fact owned by the FIE on the Mainland. They were either injected as equity into the FIE or purchased by the FIE. In the customs declarations, the plant and machinery were declared as plant and machinery of the FIE. Exemption from customs duties and income tax relief were obtained by the FIE on the Mainland. No evidence was provided to show that the Hong Kong company had paid any withholding tax to the Mainland in respect of any consideration arising from the leasing of the plant and machinery on the Mainland.

- (iii) On a related issue, given the definition of “lease” under section 2 of the IRO, it appeared that the plant and machinery provided to the PRC entities under contract processing and import processing arrangements should constitute a “lease” (despite the fact that the assets were provided without charging lease rentals). The Institute would like to seek the IRD’s clarification as to whether such plant and machinery would be considered as “excluded fixed assets” under section 16G, IRO. If the answer was in the affirmative and section 39E applied only to import processing cases, this would mean that all Hong Kong entities having import processing arrangements would not be entitled to any deductions/capital allowances for the capital expenditure incurred on the plant and machinery.

Mr Chiu explained that the arrangement for a contract processing case was regarded as a “lease” and the plant and machinery were “excluded fixed assets” for section 16G purposes. However, as the taxpayer involved in an import processing arrangement had no entitlement to the plant and machinery, the question of lease did not arise. An import processing case had been considered by the Board of Review. In *D56/04*, 19 IRBRD 456, the Board, at p.483, agreed with the IRD’s view that such plant and machinery represented the taxpayer’s capital contribution to the Mainland entity and that depreciation allowance was not due.

Ms Macpherson said it was understood that section 39E were anti-avoidance provisions for defeating opportunities for tax deferral. However, she pointed out that in some import processing cases, the legal title of the plant and machinery still remained in the

Hong Kong entity. Further, the plant and machinery should be considered as being used by the Hong Kong entity in producing products for export.

CIR pointed out that, in import processing cases, the Hong Kong entity was a trader not taking part in any manufacturing processes. Rather, the products were manufactured by a separate entity on the other side of the border, i.e. on the Mainland. Evidence showed that the legal title of the plant and machinery was generally no longer held by the Hong Kong entity. The issue was to be resolved by considering two factors – whether the plant and machinery were owned by the Hong Kong entity and whether they were used in the production of its profits chargeable to tax under the IRO (if not otherwise excluded under section 39E(1)(b)(i)). Ms Macpherson pointed out that import processors incurred substantial costs on plant and machinery and the Mainland enterprise was in effect the manufacturer's agent producing goods for the Hong Kong entity. CIR said if, in a particular case, the two factors applied, then the matter could be considered further.

A4(b) Basis of income recognition by Hong Kong branch of a foreign company

A practitioner had informed the Institute of a case in which the taxpayer was a Hong Kong branch of a Japan-listed company engaged in construction projects, which had entered into a number of 1-5 year contracts. The company as a whole adopted the contract completion basis to recognise revenue. The taxpayer's recognition of income on a completion basis had previously been queried and then accepted by the assessor.

But, in October 2005, the senior assessor stated in his letter that "from the year of assessment 2004/05 onwards, the Hong Kong branch is strongly advised to adopt the percentage of completion basis" as the IRD "has to ascertain the Hong Kong branch's assessable profits on a reasonable basis".

The Institute understood that, under Japanese GAAP, Japanese companies were allowed to use the completion basis to recognise income, although the percentage-of-completion method might also be permissible. It seemed that, in practice, most Japanese companies used the completion basis for recognition of income in accounts because Japanese tax law required companies whose turnover exceeded certain amounts to use the completion method for recognition of income for tax purposes.

The Institute requested the IRD's advice in this situation whether the taxpayer was required, for Hong Kong tax filing purposes, to prepare accounts on a basis different from that used by its head office.

Ms Lee explained that the IRD's view and practice on ascertainment of profits for tax purposes in long-term building and engineering contracts were set out in Part B of DIPN 1. SSAP 23 and HKAS 11 prescribed that when the outcome of the construction contract could be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date. In the absence of statutory provision in the IRO, the method prescribed by SSAP 23 / HKAS 11 would govern the ascertainment of profits or losses for tax purposes.

The IRD's position regarding foreign corporations as stated in paragraph 19 of DIPN 40, was equally applicable to the present scenario. Strictly speaking financial statements should be prepared in accordance with the standards prescribed by the Institute. However, it was recognised that the accounts of foreign corporations and branches of them which were carrying on business in Hong Kong might be prepared on the basis of standards which varied from those in Hong Kong. In such a case, the IRD would generally accept accounting treatment which was:

- (i) in accordance with the relevant accounting standard of the home jurisdiction or IAS / IFRS;
- (ii) consistent with the true facts or otherwise apt to determine the true profits or losses of the business; and
- (iii) consistent with the relevant provisions of the IRO.

The essence was that the different accounting treatment adopted would enable the true profits or losses of the business to be determined. Ms Lee gave a 5-year contract, as an example under which a taxpayer contractor would receive the contract sum in stages and would also complete the construction in stages. A long-term contract under such circumstances could be likened to a series of subcontracts, which were completed by the contracting parties as and when progress payments were made against work done at each stage. Recognition of the profits by the percentage of completion method would reflect the profits which had been realised by the taxpayer in respect of each stage of the contract at the balance sheet date. It did not amount to any anticipation of profits but would reflect the true profit. On the other hand, recognition of the profits on completion basis would result in neither profit nor loss in the first 4 years and a huge profit or loss for the final year. It was considered that such a method did not reflect the true yearly profit or loss. Ms Lee said that if the completion basis reflected true profit,

then HKAS 11 should have allowed for it, but this approach was not permitted under HKAS 11. CIR added that if a company adopted domestic accounting standards that differed from HKFRSs on this point, it would be necessary for the company to recompute its assessable profits.

A4(c) Operation of section 15(1)(ba) of the IRO

Pursuant to section 15(1)(ba), IRO, sums received by persons not chargeable to profits tax for the use of intellectual property outside Hong Kong (“royalties”) were deemed to be taxable if the relevant amounts were deductible in ascertaining the payer’s assessable profits. In this regard, the Institute would like to know whether only 50% of the royalties would be deemed to be taxable under section 15(1)(ba) for contract processing cases referred to in DIPN 21, given that (effectively) only 50% of the royalties was claimed by the Hong Kong payer as deductible.

- (i) If the answer was negative (i.e. 100% of the royalties were deemed to be taxable), the Institute would like to know the technical basis for this treatment.
- (ii) The Institute understood that one of the objectives of introducing section 15(1)(ba) into the IRO was to achieve “tax symmetry”. If the IRD’s policy was to tax 100% of the royalties for contract processing cases, the Institute would like to seek the IRD’s clarification as to how this approach could be reconciled with the legislative intent of section 15(1)(ba).

Mr Chu advised that in the case of a contract processing arrangement where:

- * the manufacturing processes were completely carried out on the Mainland;
- * the profits of the Hong Kong manufacturing company was taxed on a 50:50 basis;
- and
- * the finished goods were shipped overseas directly from the Mainland without routing through Hong Kong,

the royalty paid by the Hong Kong manufacturing company would be taxed under section 15(1)(ba). In such a situation, if the payer of the royalty was taxed at 50% of its manufacturing profits (i.e. 50% of the royalty payment was claimed by the payer as deductible expenses), only 50% of the royalty income in the hands of the recipient would be deemed taxable receipt under section 15(1)(ba).

However, under many of the contract processing arrangements, goods subject to processing on the Mainland were, more often than not, transported back to Hong Kong

for sales in Hong Kong or for re-export. In these situations, the royalties were paid for the use of intellectual properties in Hong Kong within the meaning of section 15(1)(b). In such case, section 15(1)(ba) would not apply. It did not matter that the intellectual properties might also be used on the Mainland where the goods were manufactured. No apportionment of the receipt of royalty would be allowed. It should be noted that the import and re-export of goods under a particular trade mark could constitute the use of the trade mark in Hong Kong, and a royalty paid for the use of a trade mark in Hong Kong would remain chargeable in full under section 15(1)(b). However, if only transshipment was involved, the IRD conceded that this could be a grey area. The HKICPA said that if no concession was allowed simply because goods were transhipped through Hong Kong, this would not be favourable for Hong Kong's logistics industry. CIR said that the IRD would look again at this particular issue and if the law permitted the IRD would try to assist.

Post-meeting Note

As the import and re-export of goods under a Hong Kong-registered trade mark can constitute the "use" of the trade mark in Hong Kong, the IRD is of the view that a transshipment use of such a trade mark can also constitute a "use" of the trade mark in Hong Kong. Therefore, any royalty paid for such a transshipment use of trade mark in Hong Kong is chargeable to profits tax under section 15(1)(b) of the IRO, to the extent of any such payment made.

A4(d) Availability of deduction claim for Mainland foreign enterprise income tax (FEIT) paid by loss-making taxpayers

Under the provisions of section 50, IRO and the "Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income", a Hong Kong taxpayer, who derived profits assessable to Hong Kong profits tax, shall be allowed to deduct any tax paid in the Mainland against its Hong Kong profits tax payable. However, the amount of the tax credit allowed should not exceed the amount of tax payable. Should any tax paid in the Mainland exceed the allowable tax credit, the Hong Kong taxpayer was allowed to claim a deduction of such excess under the provisions of section 50(5).

In a situation where the Hong Kong taxpayer sustained a tax loss for a year of assessment, the tax paid by him in the Mainland would not be allowed as a credit. Given the above, the Institute considered that it followed logically that a Hong Kong taxpayer, who reported

an adjusted loss for a year of assessment, and hence was not entitled to a tax credit, should be allowed to deduct (in full) the tax paid in the Mainland during the relevant year of assessment, on the basis that such amount represented the excess of the tax paid in Mainland over the allowable tax credit, which was zero for loss-making taxpayers. As any tax paid in the Mainland which was not allowed as a tax credit was not available to be carried forward to subsequent years, it would be inequitable to loss-making taxpayers if the IRD were not to allow a deduction for the tax paid in the Mainland.

The Institute would be grateful for clarification of the IRD's position on the above-mentioned issue.

Mr Tam advised that the purpose of the Arrangement was to avoid double taxation of income arising from the differences in the taxation systems of the Mainland and Hong Kong. For the purpose of giving effect to the Arrangement, the Specification of Arrangements Order was made by the Chief Executive in Council on 24 February 1998 under section 49 of the IRO. According to the Arrangement, a Hong Kong resident who had suffered from tax on a source of income both on the Mainland and in Hong Kong, would be allowed to deduct the tax paid on the Mainland from his Hong Kong tax payable on the same income. On the other hand, a Mainland resident would be allowed to deduct the tax paid in Hong Kong from the tax payable on the Mainland. In other words, the granting of a tax credit was on condition that the same source of income had been subject to tax both on the Mainland and in Hong Kong. In the situation quoted, the taxpayer did not have a credit at all as no Hong Kong tax had been paid, therefore the question of "exceeds the credit therefor" did not arise.

A4(e) Taxation of Hong Kong residents seconded to work in the Mainland

It was not uncommon for Hong Kong residents to be seconded to work full-time in the Mainland, and hence to be fully taxable in the Mainland without time apportionment (by virtue of 国税函 [1995] 125 号), and to return to Hong Kong during weekends and holidays. (For mandatory provident fund purposes, they would most likely continue to hold their Hong Kong employment.) If they provided no services while they were in Hong Kong, they should be fully exempt from Hong Kong salaries tax by virtue of section 8(1A)(b) - and this position was clear. However, problems often arose if they returned to their Hong Kong office for meetings, say, once every month (i.e. 12 days a year) to report to the management on their Mainland work. The Institute's understanding of the IRD's current practice was to use section 8(1A)(c), but the apportionment was done based on their "physical presence" in the Mainland, which was very disadvantageous to the taxpayers, as the vast majority of their time in Hong Kong was for holidays. (If the

statutory meaning of section 8(1A)(c) were to be applied, their income should strictly be regarded as virtually wholly derived from their services rendered in the Mainland.).

Under the IRD's current practice, in some extreme cases where the taxpayers returned to Hong Kong on Fridays and went back to the Mainland on Mondays, the days in Mainland, for the purposes of the section 8(1A)(c) exclusion might be limited to 208 days only, or 4 days x 52 weeks (hence only 57% of their income would be exempt from Hong Kong salaries tax) when in fact they were fully taxed in the Mainland.

The Institute would like the IRD to clarify:

- (i) in the above example, whether it was possible to use $(365 - 12 \text{ calendar days}) / 365 \text{ calendar days}$ or, alternatively, $(5 \text{ work days} \times 52 \text{ weeks} - 12 \text{ days}) / (5 \text{ workdays} \times 52 \text{ weeks})$ for the purposes of section 8(1A)(c); and
- (ii) if not, how the Hong Kong - Mainland DTA could help to redress the double taxation problem above.

CIR explained that section 8(1A)(c) allowed a person to exclude from his income assessable to Hong Kong Salaries Tax that part of his income which was derived from services rendered by him on the Mainland where tax had been paid on the Mainland in respect of that income. For the purposes of quantifying the amount of income derived from services rendered on the Mainland, the IRD would look at the number of days, with any part of a day counted as a day in accordance with international rule, a taxpayer actually spent on the Mainland and apportion the income on a day-in day-out basis. The Mainland authorities, under the Arrangement, should tax the Hong Kong resident according to the days actually spent there. The holidays spent in Hong Kong should not be taken into account. If the taxpayer did not render any service during his stay in Hong Kong, he would not be liable to any personal tax in Hong Kong. Should the same income be taxed both by the Mainland and Hong Kong tax authorities, the existing mechanism had already provided effective double tax relief. Should there be widespread double taxation by the Mainland authorities arising from not adhering to the day-in day-out basis, taxpayers could bring the matter to the IRD's attention so that we could take the matter up with the Mainland authorities.

A4(f) Progress on double tax arrangement with the Mainland

The Institute made two submissions dated 25 August and 2 September 2005 on expanding the double tax arrangement with the Mainland, immediately prior to the meeting held

between the IRD and the State Administration of Taxation (“SAT”) in September 2005 on the subject matter.

The Institute would appreciate any update on the status of the Institute’s proposals on the subject matter and of the negotiations between the IRD and SAT.

CIR advised that both parties had exchanged their draft Models before the September 2005 meeting. The models formed the basis of discussion. Suggestions from various parties were carefully considered during the 3-day meeting. Agreement had not been reached on some of the major topics. The 2 sides agreed to work on the outstanding issues and meet again as soon as practicable to continue with the discussion.

Agenda Item A5 - Application of Penalty Policy under the IRO

A5(a) Sections 82A and 61A of the IRO

The Institute would like to follow-up on the response from the IRD on queries raised at the 2004 and 2005 Annual Meetings regarding the technical basis for applying section 82A, IRO on assessments raised under section 61A, IRO.

At the 2005 Annual Meeting, the IRD explained that “if a taxpayer has accepted an assessment under section 61A, it would be difficult for him to argue that in his own opinion his return was correct”, and in such a situation, the taxpayer should be regarded as a person who had made an incorrect return without reasonable excuse and so be liable to be assessed pursuant to section 82A.

Based on the above, the Institute would like to ask the IRD how the above could be reconciled with the instructions for completion of profits tax returns provided to taxpayers.

Page 1 of the return informed the taxpayer that “You are required under section 51(1) of the IRO to make on this form a true and correct return of Assessable Profits (or Adjusted Loss) and the Assessable Profits (or Adjusted Loss) are the net profits (or loss) [other than profits or loss arising from the sale of capital assets] for the basis period, arising in or derived from Hong Kong, calculated in accordance with the provision of Part IV of the IRO, from any trade, profession, or business carried on in Hong Kong.”

- (i) In accordance with the instructions for completion of profits tax returns, a taxpayer was required to file the profits tax return in accordance with the provision of Part IV of the IRO, instead of Part X under which section 61A fell. It followed that a

subsequent assessment raised under section 61A of the IRO should not in itself justify that the taxpayer did not make a true and correct profits tax return.

- (ii) If the IRD were to remain of the view that section 82A applied to section 61A cases, the Institute would like to ask the IRD as to the appropriate approach that the taxpayer should adopt when making a profits tax return. In particular, could a taxpayer be reasonably expected to “self-assess” his liability under section 61A when completing a tax return?

While the Institute noted the IRD’s subsequent response to the Institute when it followed up on this point after the 2005 Annual Meeting, i.e. that the IRD would endeavour to address the points before finalising the redrafting of DIPN 15, the Institute should nevertheless be grateful to know whether there had been any progress.

Mr Chiu pointed out that this question was not new but similar to questions raised and answered in previous annual meetings.

The profits tax return required the declaration of “Assessable Profits (or Adjusted Loss)” calculated in accordance with Part IV of the IRO. Section 14, the charging section, was in Part IV. Section 61A was in Part X. However, section 61A (so was section 60) was not a charging section. It did not create a separate liability for tax but was an aid to the charging section. It served to protect the liability for tax established under other provisions, including those in Part IV, of the IRO. These views were supported by *CIR v. Challenge Corporation*, (1986) 8 NZTC 5,001 (CA) and a recent Board of Review decision [D60/05] which was not yet published.

Mr Chiu explained that a taxpayer should therefore declare what should be the assessable profits (or adjusted loss) of his business in the return. The declaration of the true profits in the return by a taxpayer was not an “assessment”. See the observations of the High Court in *CIR v. Common Empire Limited* as to what constituted an “assessment” (i.e. an official act). Hence there was no question of a taxpayer making a self “assessment” under the IRO. If he failed to return what should have been the assessable profits, he might be liable for penalty.

The fact that a return was incorrect would not automatically lead to a penalty. Though the return previously submitted might be incorrect, the critical issue remained whether the taxpayer had a “reasonable excuse” or a “defence” under section 80, 82A or 82. Mr Tam said that, if a taxpayer had taken a different, but reasonable and justifiable view of

the law, and a “reasonable excuse” did exist, he should not incur a penalty.

To avoid the invocation of any of the penal provisions, a taxpayer when completing a return should make a full and frank disclosure of all material facts relating to the computation of assessable profit, in particular if the success of a “scheme” was entirely dependent upon the Commissioner never finding out the true facts. In such a situation, the “scheme” was more likely to be “evasion” and not “avoidance”. See *R v. Meares*, 37 ATR 321 at page 323 and *Denver Chemical Manufacturing Company v. COT*, 4 AITR 216 at page 222.

If a taxpayer had doubt about or was uncertain of a “scheme” on which he intended to embark, he could apply for an advance ruling in accordance with section 88A.

Ms Macpherson pointed out that the tax return referred only to making a return of assessable profits in accordance with Part IV of the IRO. Mr Tam replied that, nevertheless, when tax was assessed other provisions came into play. Ms Florence Chan noted that it could be complicated for a taxpayer who had to deal with overseas entities. CIR said that the main thing was that a taxpayer should not wilfully misreport. While an assessment under section 61A would mean that the original return was incorrect, if “reasonable excuse” applied or the IRD accepted the taxpayer’s representations, no penalty would be imposed.

Mr Tam referred the Institute’s representatives to Agenda Item A8(ii) of the minutes of the 2005 Annual Meeting for IRD’s views on penalty on tax avoidance cases. Those views were also included in DIPN No. 15 (Revised) issued in January 2006. Further, the IRD might consider modifying the relevant wording in the Profits Tax Return to remove the doubt raised by HKICPA.

A5(b) Group classifications

The Institute noted from the IRD’s published penalty policy that the loading of penalties under section 82A, IRO varied depending on the nature of omissions/under-statements in each case. The IRD had broadly classified the cases into groups (a), (b) and (c) as follows:-

Group (a) - cases where the taxpayers showed intentional disregard to the law and adopted deliberate cover-up tactics involving the preparation of a false set of books, padded wage rolls and fictitious entries or multiple omissions over a long period of time.

Group (b) - cases with slightly less serious acts of omission resulting from recklessness including the "hand in the till" type of evasion, failure to bring to account sales of scrap, and sheer gross negligence.

Group (c) - cases where the taxpayers failed to exercise reasonable care and omitted profits/income such as lease premium, one-off commission, etc.

The Institute would like to seek more guidance from the IRD on these categories; in particular, the Institute would like to know whether a challenge to a tax planning case would fall within Group (a), (b) or (c) under the IRD's penalty policy.

Mr Chiu pointed out that a taxpayer had intentionally disregarded the provisions of the IRO if he consciously decided to disregard clear obligations imposed on him by the provisions of the IRO. The finding might be based on direct evidence of the taxpayer's intention (e.g. an admission) or might be inferred from all the facts and surrounding circumstances. A person who acted intentionally decided to bring about a state of affairs which the person had a reasonable prospect of being able to bring about, by the person's own act of volition. See *Cunliffe v. Goodman* [1950] 2 KB 237.

Recklessness was gross carelessness. A taxpayer would have behaved recklessly if his conduct clearly showed disregard of, or indifference to, consequences that were foreseeable by a reasonable person as being a likely result of the actions. Recklessness involved something more than mere inadvertence or carelessness. It involved the running of what a reasonable person would regard as an unjustifiable risk that led to a tax undercharged.

The reasonable care test required a taxpayer to exercise the care that a reasonable, ordinary person would exercise in the circumstances of the taxpayer to fulfil the taxpayer's obligations imposed on him under the IRO. If the taxpayer was uncertain about the correct tax treatment of an item, reasonable care required him to make reasonable enquiries to resolve the issue. Where a taxpayer was uncertain about the correct tax treatment of an item, he might apply for an advance ruling.

Mr Chiu said that it had to be emphasised that each case had to be considered on the basis of all the relevant facts. The presence of one single factor would not be determinative of the penalty that applied. And as pointed out in the answer to Agenda Item A5(a) above, the mere labelling of an act as "avoidance" would not necessarily exempt a taxpayer from penalty or prosecution. Depending on the facts of the case, the

act might fall within any one of the three categories.

CIR said that there was now increased transparency in field audits. In all Unit 4 cases, the taxpayer would be told which category applied. If he disagreed with the category, the taxpayer could lodge an appeal.

Agenda Item A6 – Policy and Administrative Matters

A6(a) Processing of refunds

The Institute would like to seek clarification of the IRD's practice, including the timing, for processing profits tax refund cases and as to whether the IRD would consider reviewing the process for handling such refund cases.

Ms Lee advised that in general all cases, whether they were tax cases or refund cases, would be processed with the same priority. The IRD had from time to time reminded its officers to follow this practice closely. There might be other factors delaying an assessment or refund, e.g. response to the assessor's enquiry was outstanding, a longer extension was allowed to loss cases for filing return, etc. Practitioners should approach the case officers for clarification in case of doubt.

Mr Chan asked whether cases involving offshore claims normally would take a longer time to process the tax refunds. Ms Lee replied that generally the time required would depend on the volume of information involved. A case requiring detailed examination of bulky information understandably would require a longer time. Again, practitioners could approach the case officer. Case officers were encouraged to speak to practitioners rather than exchanging long letters. Ms Macpherson asked if the IRD would agree to meet practitioners together with their clients, to help resolve outstanding cases. CIR replied that case officers were always encouraged to do so and, for their own part, they did not want to have too many outstanding cases.

A6(b) IRD policy on the timing of issuing Chinese version of DIPNs

A practitioner pointed out to the Institute that the Chinese version of DIPN 38 – *Employees Share Option Benefits* was put on the IRD's website some time after the publication of the English version. The Institute would like to know the IRD's practice as regards the timing of issuing the Chinese versions of DIPNs.

Mr Tam advised that it was the IRD's aim to issue both versions as soon as they were ready. As technical terms and citation of authorities were involved in drafting DIPNs, it was the IRD's usual practice to prepare the English version first. It would normally take a longer time to prepare the Chinese version, which involved translation of technical terms, editing and re-editing work. The IRD would attempt to expedite the issue of the Chinese version of DIPNs.

A6(c) Extension of statutory objection deadline

Some practitioners had suggested extending the statutory objection deadline against Notices of Assessment to 2 months. As Notices of Assessment were mainly issued under the "Assess First, Audit Later" approach shortly after the submission of tax returns, it would seem feasible to allow extension of time for lodging objection by taxpayers / tax representatives. Would the IRD consider such a suggestion?

Mr Chu pointed out that adopting the AFAL approach in raising assessments did not have any bearing on the time required to lodge an objection. Under this system, assessments were normally issued based on the returns in the first instance. There was no justification to allow more time to a taxpayer to lodge objection to an assessment based on return. In any case the one-month statutory time limit for lodging an objection had a long history and worked well. Furthermore, there would be practical difficulties since the tax due date for a profits tax assessment was usually 4-6 weeks from the date of issue. If an objection could be lodged within a period of 2 months, the taxpayer would be required to pay the tax before the objection period expired, which impacted on the present standover arrangements.

Ms Yvonne Law said that the international firms often had to carry out an extensive, international, conflict search nowadays before they could take up a case. Furthermore, most objections could not be settled quickly, so it was frequently the case that the tax would have to be paid first. CIR said that the IRD did not have the power to extend the objection period without a change in the law and, for this to happen, a strong case would have to be put forward. However, the reasons given did not relate directly to problems with the return filing system. Normally, only absence from Hong Kong, sickness, etc. were accepted as justification for granting an extension.

A6(d) Lodgement of tax returns

The Institute invited the IRD to discuss the latest lodgement figures.

Ms Lee advised that Table A in Appendix A showed that the IRD issued fewer returns under the 2004/05 bulk issue. However, the number of failures to file by the due date remained high: nearly 10%. Table C showed the progressive lodgement patterns. The overall performance had slightly deteriorated, and in none of the cases had lodgement standard been met. Tax representatives were urged to improve their performance in the coming years.

The extended due dates for filing Profits Tax Returns for the year of assessment 2005/06 would be as follows:

<u>Accounting Date Code</u>	<u>Extended Due Date</u>
“N” code	2 May 2006 (no extension)
“D” code	15 August 2006 (no change)
“M” code	15 November 2006 (no change)
“M” code – current year loss cases	31 January 2007 (changed)

The extended due date for “M” code current year loss cases had been changed back to 31 January because Chinese New Year would be in middle of February 2007.

A6(e) Providing archive of IRO amendments on the website

At present, updates of the IRO could be viewed on the “What’s New” section of the IRD website, for a limited period of time (i.e. a couple of months). Would the IRD consider providing an archive of IRO updates on its website, indicating the dates when different amendments were made?

CIR advised that, for easy reference, the IRD would consider to add a section on “Inland Revenue Ordinance Amendments” under <Publications and Press Releases> in the IRD Homepage. The new section would provide an archive of amendments to the IRO from January 2003 onwards and list them in chronological order. A hyperlink to the corresponding gazette notice in the Government Logistics Department homepage (www.gld.gov.hk) would also be provided so that members of the public could easily access the details of the amendment if necessary.

A6(f) Timing for issuing minutes of Annual Meeting

The Institute adopted the practice of announcing the more urgent items arising from the Annual Meeting prior to the minutes being finalised. Nevertheless, it was still important

to agree and publish the full set of minutes promptly after the meeting. The Institute would give this appropriate priority and hoped that the IRD would do the same.

CIR advised that the IRD agreed with this approach.

A6(g) Announcement to members of urgent and relevant matters prior to finalisation of the minutes

In recent years, the IRD 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 2005/06 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 the more urgent and relevant matters discussed at the Annual Meeting, in advance of publication of the minutes.

CIR advised that the proposed arrangement was agreeable. This practice had worked well in previous years.

PART B - MATTERS RAISED BY IRD

Agenda Item B1 – Profits Tax

B1(a) Declaration of due representation in the Application for Block Extension

Ms Lee pointed out that, currently, tax representatives could submit application for extension of time for filing Profits Tax Returns under the Block Extension Scheme by providing a list of the clients they were representing. The companies as listed were accepted as the clients of the respective tax representatives by the IRD on an honour basis.

Ms Lee advised that in the Block Extension Letter to be issued in March 2006 (and thereafter), the IRD would ask the tax representatives to make a declaration in their

application for block extension for the coming year confirming that they had received written authorisation from their respective clients appointing them as the tax representative. CIR added that the authorisation should be made in writing bearing the client's signature and authorisation by way of emails was not acceptable. She explained that the concern had arisen as the result of issues raised with the Ombudsman.

Ms Macpherson asked whether there was any definition of a tax representative. Mr Chiu said that, under section 2 of the IRO, it was someone authorised in writing to act on another's behalf. CIR added that there was no licensing arrangement or agreed list of functions for tax representatives. Ms Macpherson said that firms usually required an engagement letter to be signed before they could act on behalf of a client. Sometimes a verbal agreement was received first and the signed engagement letter came only later. She envisaged some potential logistical problems with the timing and asked about the consequences of any inadvertent errors. The CIR indicated that there would be a degree of flexibility.

B1(b) Application for extension to file a profits tax return beyond the block extension date

Mr Chu advised that such applications would generally be rejected. For delay due to very exceptional circumstances, the IRD urged tax representatives to give a clear description of the difficulties in each application. Assessors would not be able to consider cases of genuine difficulties when all applications were in standard terms.

There were several incidences where a full account of the taxpayer's problems was given only when representation was made in response to a section 82A(4) notice. These incidences could be avoided by better communication.

B1(c) Evidence of payment of foreign tax to be supplied when claiming tax credit

Ms Lee pointed out that Note 4 to the Supplementary Form IR51S specified, among other things, that -

"(1) If a tax credit is claimed, evidence of payment of tax in the specified territory showing the nature, amount of income taxed and computation of tax paid should be submitted.

..... "

The IRD had encountered a number of cases where a tax credit was claimed but evidence of payment was not provided. The IRD urged tax representatives to ensure that such evidence was supplied when filing the return. This would save time and efforts on both sides.

Agenda Item B2 – Investigation and Field Audit

B2(a) Financial statements of overseas companies resident outside Hong Kong

Mr Chiu pointed out that, currently, some tax representatives failed to recognise that under certain situations, in particular when sections 20 and 61A were invoked, it was necessary for the IRD to examine and/or verify transactions between overseas companies resident outside Hong Kong (e.g. overseas subsidiaries etc.) and the taxpayer resident inside Hong Kong and advised their clients that it was not necessary to furnish the financial statements of the overseas companies even though they had possession of those financial statements.

The IRD wanted to remind practitioners that taxpayers were required to disclose transactions with closely connected non-resident persons in their Profits Tax returns and that the IRD would continue to ask for financial statements of overseas companies resident outside Hong Kong and would consider taking legal proceedings to enforce demands for information and documents.

Ms Macpherson said that practitioners were aware that section 51(4) of the IRO gave the IRD the power to require such information if it was in the taxpayer's possession. However, if the information was not in the taxpayer's possession, she assumed that there was no obligation to try to obtain it. Mr Chiu said that "furnish" in section 51(4) suggested something wider than merely "produce". CIR said that, if the overseas company was a closely-related entity, the IRD would assume that the taxpayer had the relevant information. The requirement should be interpreted in a wider sense than just possession at a particular point in time.

B2(b) Discrepancies detected by field audit

Mr Chiu explained that Table 1 in Appendix B was compiled to illustrate the specific problem areas detected in corporations with tax audits completed during the year ended 31 December 2005. Comparative figures for the years 2003 and 2004 were included.

Table 2 relates to specific cases with apparent discrepancies which should have been detectable through statutory audits.

Table 1 showed that Field Audit teams uncovered discrepancies in 180 corporation cases, 139 of which carried clean auditors' reports. Amount of discrepancies detected in the clean report cases accounted for 80% (75% for 2004) of the total discrepancies detected in corporation cases completed during the year and a total of \$184M tax was recovered from these cases. Average amount of discrepancy and tax per case slightly increased to \$8.7M from \$8.3M (figure for 2004) while tax undercharged per case increased to \$1.3M from \$1.1M (figure for 2004).

Discrepancies resulted mainly from overstatement of purchases, omission of sales and overclaim of expenses. In the majority of cases, the discrepancies were detected after examining the business ledgers and source documents. Unsubstantiated purchases were uncovered which, in the IRD's view, could have been detected during statutory audit by vouching the payments for the purchases.

Table 2 involved a company that wrongly charged bank loan expenses in its accounts even though the bank loan was borrowed by a related company incorporated in the BVI. The bank loan was not recorded in the balance sheet. No evidence that the company had been given the use of any of the funds raised. An unqualified audit report was given.

Agenda Item B3 – Date of Next Annual Meeting

CIR proposed that the 2007 Annual Meeting might be held on the Friday of 19 or 26 January 2007. The final date would be agreed between the Institute and the IRD in due course.

January 2006

Lodgement of Corporations and Partnerships Profits Tax Returns

A. Lodgement Comparison from 2002/03 to 2004/05

	<u>Y/A</u> <u>2002/03</u>	<u>Y/A</u> <u>2003/04</u>	<u>Y/A</u> <u>2004/05</u>	Comparison <u>2003/04</u> and <u>2004/05</u>
1. Bulk issue (on 1 April)	143,000	149,000	143,000	-4%
2. Cases with a failure to file by due date:-				
'N' Code	1,600	1,600	1,600	-
'D' Code	3,300	4,500	4,000	-11%
'M' Code	7,800	8,300	7,900	-5%
	<u>12,700</u>	<u>14,400</u>	<u>13,500</u>	-6%
3. Compound offers issued	6,000	6,800	5,700	-16%
4. Estimated assessments issued	3,300	4,100	4,300	5%

B. 2004/05 Detailed Profits Tax Returns Statistics

	<u>'N'</u>	<u>'D'</u>	<u>'M'</u>	<u>Total</u>
Total returns issued	18,000	45,000	103,000	166,000
Failure to file on time	1,600	4,000	7,900	13,500
Compound offers issued	700	1,900	3,100	5,700
Estimated assessments issued	500	1,300	2,500	4,300

C. Represented Profits Tax Returns - Lodgement Patterns

<u>Code</u>	<u>Lodgement Standard</u>	<u>Actual Performance</u>	
		<u>2004/05 PTRs</u>	<u>2003/04 PTRs</u>
D - 15 August	100%	80% ⁽¹⁾	81%
M - 31 August	25%	12%	13%
M - 30 September	55%	18%	19%
M - 31 October	80%	33%	34%
M - 15 November	100%	82% ⁽²⁾	82%

(1) 35% lodged within a few days around 15 August 2005 (35% for 2003/04 PTRs)

(2) 30% lodged within a few days around 15 November 2005 (26% for 2003/04 PTRs)

D. Tax Representatives with Lodgement Rate of less than 82% of 'M' code Returns as at 15.11.2005

1,645 T/Rs have 'M' Code clients. Of these, 743 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 82%</u>	<u>No. of non-compliance cases</u>	<u>% of total non-compliance cases</u>
Small size firms	100 or less	1,515	704	5,040	77%	1,483	684	4,915	75%
Medium size firms	101 - 300	119	38	1,435	22%	124	43	1,546	23%
Large size firms	over 300	11	1	59	1%	13	2	117	2%
		<u>1,645</u>	<u>743</u>	<u>6,534</u>	<u>100%</u>	<u>1,620</u>	<u>729</u>	<u>6,578</u>	<u>100%</u>

Table 1

Analysis of Completed FA Corporation Cases for the years ended 31 December 2003, 2004 and 2005

Auditor's Report = Unqualified	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2003	2004	2005	2003	2004	2005	2003	2004	2005
Sales omitted	32	21	21	16,892,243	29,188,511	20,591,422	2,561,569	4,520,540	2,897,294
Purchases overstated	7	10	4	19,936,197	33,730,413	1,728,123	3,119,654	5,449,859	350,862
Closing stock understated	1	3	4	298,503	4,107,878	1,598,848	69,838	657,261	169,850
Gross profit understated	45	27	31	130,484,373	53,783,583	63,387,464	17,600,635	8,552,421	9,968,242
Expenses over-claimed	46	32	37	20,994,539	14,253,326	10,131,095	2,940,470	2,303,064	1,145,114
Technical adjustments	41	40	47	25,385,266	23,741,968	10,082,151	3,153,671	3,329,950	2,420,874
Other	53	50	52	47,891,513	26,015,167	98,296,255	6,606,954	4,059,847	15,110,038
TOTAL	225*	183*	196*	\$261,882,634	\$184,820,846	\$205,815,358	\$36,052,791	\$28,872,942	\$32,062,274
TOTAL NUMBER OF CASES	145*	115*	139*						
AVERAGE AMOUNT PER CASE				\$1,806,087	\$1,607,138	\$1,480,686	\$248,640	\$251,069	\$230,664
* in one case there may be more than one type of discrepancy									
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2003	2004	2005	2003	2004	2005
Other statistics for the above cases: TOTAL AMOUNT				\$1,391,729,119	\$956,004,128	\$1,207,777,452	\$212,999,802	\$128,527,858	\$184,399,144
AVERAGE AMOUNT PER CASE				\$9,598,132	\$8,313,079	\$8,689,046	\$1,468,964	\$1,117,634	\$1,326,613

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Auditor's Report = Qualified	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2003	2004	2005	2003	2004	2005	2003	2004	2005
Sales omitted	6	11	9	8,152,108	8,479,097	15,606,685	1,250,459	1,017,664	2,414,546
Purchases overstated	2	5	6	2,566,865	15,543,940	14,497,553	410,699	2,587,502	2,425,785
Closing stock understated	2	1	1	288,327	3,485,370	691,601	46,132	557,659	110,656
Gross profit understated	7	13	9	20,839,244	29,320,487	21,857,935	3,495,251	4,232,930	3,159,332
Expenses over-claimed	13	20	11	5,826,223	11,993,085	1,981,307	828,407	1,774,074	313,644
Technical adjustments	8	11	11	1,243,841	13,490,940	1,859,998	160,684	2,226,380	234,992
Other	20	14	8	49,970,477	2,903,870	9,966,248	7,887,255	459,775	688,498
TOTAL	58*	75*	55*	\$88,887,085	\$85,216,789	\$66,461,327	\$14,078,887	\$12,855,984	\$9,347,453
TOTAL NUMBER OF CASES	38*	45*	41*						
AVERAGE AMOUNT PER CASE				\$2,339,134	\$1,893,706	\$1,621,008	\$370,497	\$285,689	\$227,987
* in one case there may be more than one type of discrepancy									
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2003	2004	2005	2003	2004	2005
Other statistics for the above cases: TOTAL AMOUNT				\$356,418,294	\$330,797,269	\$307,994,676	\$54,438,501	\$47,298,081	\$47,805,251
AVERAGE AMOUNT PER CASE				\$9,379,429	\$7,351,050	\$7,512,065	\$1,432,592	\$1,051,068	\$1,165,982

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TOTAL NUMBER OF CASES 183 160 180

				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2003	2004	2005	2003	2004	2005
Other statistics for the above cases: TOTAL AMOUNT				\$1,748,147,413	\$1,286,801,397	\$1,515,772,128	\$267,438,303	\$175,825,939	\$232,204,395
AVERAGE AMOUNT PER CASE				\$9,552,718	\$8,042,509	\$8,420,956	\$1,461,411	\$1,098,912	\$1,290,024

Table 2

**Field Audit case with discrepancy considered detectable through statutory audit
For the period from 1.1.2005 to 31.12.2005**

Item that should be detected by Auditor	Amount of item for audited year that should be detected	Reasons why the item should be detected	Auditor's Report	Discrepancy amount for audited year	Tax undercharged for audited year	Total discrepancy amount	Total tax undercharged
Interest deduction overclaimed	986,907	The taxpayer is a company carrying on an import and export business. It charged to its accounts interest payments on a bank loan. The IRD field auditor found that the relevant bank loan was not shown as liability in the balance sheet of the taxpayer. According to the loan agreement produced, the bank loan was borrowed by a related company of the taxpayer, a company incorporated in BVI, and not by the taxpayer.	Unqualified report	2,395,707	419,249	9,808,531	1,616,854