Annual Meeting

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 February 2009.

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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The 2008/09 annual meeting between the Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department was held on 6 February 2009 at the Inland Revenue Department.

In Attendance

Mr David Southwood  Chairman, Taxation Committee
Ms Ayesha Macpherson  Deputy Chairman, Taxation Committee
Ms Florence Chan  Member, Taxation Committee
Mr Alexander Mak  Member, Taxation Committee
Mr Fergus Wong  Member, Taxation Committee
Ms Alice Lam  Member, Taxation Committee
Mr Peter Tisman  Director, Specialist Practices
Ms Elena Chai  Manager, Specialist Practices

Inland Revenue Department (IRD)

Mrs Alice Lau  Commissioner of Inland Revenue
Mr Chu Yam-yuen  Deputy Commissioner of Inland Revenue (Technical)
Mrs Teresa Chu  Deputy Commissioner of Inland Revenue (Operations)
Mr Wong Kuen-fai  Assistant Commissioner of Inland Revenue
Mr Chiu Kwok-kit  Assistant Commissioner of Inland Revenue
Mrs Lai Chi Lai-ming  Assistant Commissioner of Inland Revenue
Mr Yim Kwok-cheong  Senior Assessor (Research)
Mrs Alice Lau (CIR) on behalf of the IRD welcomed the representatives of the Institute to the meeting. CIR expressed that the annual meeting was an important event at which the Institute and the IRD could discuss and resolve issues of common interest. Minutes of the annual meeting served as an important reference document for practitioners, and where appropriate, advance notice might be issued after the annual meeting to draw practitioners’ attention to particular issues. Mr Southwood thanked the IRD for arranging the annual meeting. The Institute also viewed the annual meeting as an important event which offered a valuable opportunity to clarify points of interest to both the Institute and the IRD.

**PART A - MATTERS RAISED BY THE INSTITUTE**

**Agenda Item A1 - Profits Tax Issues**

**(a) Amendments to HKAS 39**

In October 2008, the Institute issued amendments to HKAS39 permitting reclassification of certain non-derivative financial assets if conditions specified in the amendments were met. The amendments allowed companies to reclassify financial assets under Fair Value Through Profit and Loss (FVTPL) into other categories and financial assets under Available For Sale (AFS) into Loans & Receivable. Before reclassification, the unrealised gains/losses derived from FVTPL were taxable/deductible if they were sourced in Hong Kong.

The Institute would like the IRD to advise on the assessing practice for financial assets under FVTPL that were reclassified both at the time of reclassification and subsequent to reclassification, and whether any FAQs would be issued or revisions would be made to Departmental Interpretation and Practice Notes No. (DIPN) 42.

Mr Wong Kuen-fai (Mr Wong) explained that paragraph 9 of DIPN 42 stated that the accounting classifications of financial instruments did not necessarily determine the nature of the financial assets or financial liabilities, i.e. whether it was of capital or revenue nature. Whether the asset was of capital or revenue nature was a question that required a consideration of all the surrounding circumstances, including the accounting treatment. The same approach continued to apply to financial assets reclassified pursuant to the amendments to HKAS 39. It was necessary to ascertain the intention at the time of acquisition and whether there was a change of intention upon reclassification. Whether there was a change of intention was a question of fact to be decided after considering all the relevant facts and circumstances.
Mr Wong advised that, under the amendments to HKAS 39, the financial assets that could be reclassified out of the FVTPL category might include equity instruments and debt instruments.

Mr Wong explained that, for equity instruments and debts reclassified out of the FVTPL category, the difference between the carrying amount in the previous financial statements and the fair value at the date of reclassification taken to the profit and loss account was assessable or allowable, as the case might be.

If the IRD did not agree that there was a change of intention towards the equity instruments and debts upon reclassification, the gain or loss derived from their subsequent disposal would be taxed or allowed accordingly.

If the IRD accepted that there was a change of intention towards the equity instruments and debts, the subsequent change in value after reclassification would be capital in nature. CIR indicated that the onus was on the taxpayer to establish any change in intention.

CIR said that FAQ in the IRD website about DIPN 42 would be expanded to include the IRD’s practice.

(b) Certificate of Deposit

According to section 2 of the IRO, Certificate of Deposit (CD) means “a document relating to money, in any currency, which has been deposited with the issuer or some other person, being a document which recognizes an obligation to pay a stated amount to bearer or to order, with or without interest, and being a document by the delivery of which, with or without endorsement, the right to receive that stated amount, with or without interest, is transferable (emphasis added), and, in the case of any such document which is a prescribed instrument by virtue of paragraph (a) of the definition of “prescribed instrument” in section 137B of the Banking Ordinance (Cap 155), includes any right or interest referred to in paragraph (b) of that definition in respect of such document”.

The Institute would like IRD to clarify the interpretation of the phrase “a document by the delivery of which, with or without endorsement, the right to receive that stated amount, with or without interest, is transferable”. The Institute noted that in practice, many conventional CDs issued by banks were not in bearer form and were not transferable in practice by endorsement or delivery. If these conventional CDs were excluded for the purposes of the IRO, the statutory term “CD” might have limited practical application. The Institute requested IRD’s views on this observation.
Mr Chiu explained that, under the definition of certificate of deposit, if the document was not transferable by delivery, it was not a CD. However, it was still necessary to consider whether it fell within the definition of “prescribed instrument” under section 137B(1) of the Banking Ordinance.

(c) Tax characterisation of the nature of equity-linked notes

(i) In Agenda Item A1(d) of the 2008 Annual Meeting, IRD indicated that equity-linked notes (ELN) would normally be regarded as “certificates of deposits” unless there were features that suggested otherwise.

If the Institute’s observation in item (c) above is correct, it would appear that an ELN not transferable by delivery might not be regarded as a CD under the definition in the IRO. The Institute requested IRD’s view on this.

Mr Chiu advised that if the ELN was not transferable by delivery, it was not a CD.

(ii) IRD also expressed that it was necessary to examine the nature of the return and terms of issue of an ELN to determine whether the return was wholly made up of interest. This seemed to suggest that the nominal interest on an ELN could possibly be dissected into interest and other types of income.

In this connection, the Institute would like IRD to advise on whether the possible dissection approach is consistent with IRD’s general position that for tax purposes, the nature and locality of profit or loss of a hybrid instrument were determined on the basis that it was one single instrument.

Mr Chiu explained that, in paragraph 42 of DIPN 42, it was stated that for tax purposes, the nature (i.e. capital and revenue) and locality of profit or loss of a hybrid instrument were determined on the basis that it was one single instrument, meaning that the nature and locality of the profit or loss from the embedded derivative and the host contract would be accorded the same tax treatment. There was no suggestion that the return on an ELN could not be dissected into interest and other types of income, on a proper analysis of the terms of the ELN and if such was permitted by HKAS 39. IRD did not consider there was any inconsistency.
The Institute would like to use an example to illustrate the issues involved:

Example
An ELN with a nominal value of $3,000,000 was issued by an authorized institution in Hong Kong at 98.92% of the nominal value, giving an annualized yield of 9.26%. However, under the terms of the ELN, if on the valuation date, the closing price of the underlying shares on the Stock Exchange of Hong Kong was below the strike price as stipulated in the ELN, the holder would not receive the nominal sum of the ELN. Instead, the holder would receive the shares valued at the strike price equivalent to the nominal value of the ELN.

Scenario 1
The price of the shares did not fall below the strike price on the valuation date. Therefore, the holder received the nominal sum of the ELN in cash.

The Institute would like to know whether the discount on the ELN earned by the holder in the circumstances was wholly in the nature of interest, and if the income was interest, whether the applicable source rule was the “provision of credit” test (putting aside the possible application of the Interest Exemption Order).

Mr Chiu explained that, on the assumption that the ELN was transferable by delivery, the ELN in the example which recognized an obligation to pay a stated amount to bearer, would likely be a CD and the discount would be treated as interest income.

Mr Chiu said that, even if the ELN did not fall within the definition of CD, the discount (or part of it) might be interest income because the difference between nominal value and the purchase price represented consideration for the use of money paid by the ELN issuer.

Mr Chiu advised that the provision of credit test would be applicable for the purpose of determining the source of the interest income, if the holder of the ELN was not trading in ELN.

Scenario 2
The closing price of the shares on the valuation date fell below the strike price and the holder received the corresponding number of the shares instead of the nominal sum of the ELN in cash. In this case, the holder would suffer a loss on the settlement of the ELN.

The Institute would like to ask:

(a) whether the loss would be tax deductible if the ELN was held by a corporation; and
(b) whether the inherent high-risk profile of an ELN generally meant that transactions in this type of instruments were more likely to be regarded as trading transactions for tax purposes.

Mr Chiu explained that whether a gain or loss derived from the disposal of an asset was taxable or deductible depended on the nature of the asset, i.e. capital or revenue in nature. This was a question that required an examination of all the surrounding circumstances, including the risk profile of the subject instrument. If the corporation was not engaged in trading of ELN, the loss would not be deductible.

Ms Chan pointed out that, in scenario 1 and scenario 2 above, both interest income and loss due to drop in share price might be earned or suffered from the same instrument.

Mr Chiu explained that such an instrument would be treated as a hybrid instrument under HKAS 39, and the income and loss would be dealt with separately. However, it would not normally be accepted that the income and loss of the hybrid elements were of a different nature, i.e. one item was capital whereas the other item was revenue in nature, or one item was offshore income whereas the other item was onshore loss. Reason for disposal was also relevant to determining the nature of the instrument.

Ms Chan said that the counterparty was normally a bank and there was no secondary market. It seemed, therefore, that it was necessary to identify the host and the embedded elements. Mr Chiu said the Department would follow the accounting treatment.

The Institute representatives considered that the fundamental question was not whether a company was trading in ELNs or not, but the underlying intention. When it bought ELNs was done it as a capital investment or for earning income. CIR agreed that even if a taxpayer held only one ELN, it could be either capital or revenue and she considered that there was nothing new in this analysis.

(d) Contributions to defined benefit schemes

Owing to the recent global financial turmoil, the assets of some defined benefit schemes might have shrunk significantly. As such, employers operating these schemes might have large current-year charges to their profit and loss accounts to reflect their funding commitments to meet the liabilities of these schemes.

The Institute would like to know whether IRD would consider such charges as provision for “ordinary annual contribution” under section 17(1)(i) of the IRO.
Mr Chu advised that, the current year charge, albeit large in amount, to the employer’s profit and loss account pursuant to HKAS 19 was still treated, for profits tax purposes, as a provision for payment of contributions to the retirement scheme. It was allowed for deduction to the extent that the amount did not exceed 15% of the total emoluments of the employees for the period covered under section 17(1)(i) of the IRO.

(e) Relevance of profits being taxed elsewhere for offshore claims in Hong Kong

In the recently published Advance Ruling Case No. 37, the ruling that the Hong Kong branch (branch) of the company would not be chargeable to tax in Hong Kong was based on four assumptions. The Institute would like to seek IRD’s advice on the following assumptions:

(i) The existence of the branch under the arrangement did not form a transaction or scheme, or a part thereof, contrived to avoid or evade any fiscal liabilities whether in Hong Kong or other tax jurisdictions.

The Institute would like to enquire why the possible avoidance of fiscal liabilities in other tax jurisdictions was considered to be relevant.

CIR explained that the assumption was made to preserve IRD’s right to apply the relevant provisions in the IRO in dealing with possible avoidance or evasion of fiscal liabilities. Furthermore, to avoid Hong Kong being labelled as a tax haven, IRD must not let Hong Kong to be perceived as a place to assist entities to avoid or evade their fiscal liabilities.

(ii) Profits booked in the branch will be reported to the tax administration in Country X and will be subject to corporate tax in Country X under the company.

It is the Institute’s understanding that whether a branch is chargeable to tax in Hong Kong under section 14 of the IRO should be determined by what the branch does in Hong Kong, and the taxability of the relevant profits elsewhere should be irrelevant.

Therefore, the Institute would like to enquire why reporting of the profits booked in the branch to the tax administration in Country X which will be subject to corporate tax in Country X is considered relevant in the determination of source of profits in Hong Kong.
CIR explained that the company in its application stated that the profits booked in the branch would be reported to the tax administration in Country X and would be subject to corporate tax in Country X under the company. The purpose of putting down this assumption was just to reaffirm the company’s position. In reply to Mr Southwood, CIR confirmed that the point was related to the facts of this specific case and did not have general application.

CIR further explained the IRD’s stance that an offshore claim would not be accepted or denied by reference to whether tax had been paid overseas and all relevant considerations had to be taken into account.

In reply to Ms Macpherson, CIR confirmed that the fact that tax had not been paid overseas would not preclude an offshore claim. The IRD’s focus was on the Hong Kong side.

**f) Royalty paid to non-resident**

The royalty income received by a non-resident in a time period might not be the same as the amount charged as royalty expense in the profit and loss account of the payer for the same period due to the accounting treatments. Sections 15(1)(a), (b) and (ba) of the IRO used the phrase “received by or accrued to a person”, and hence royalty income would be taxable when paid or accrued whichever earlier. On the other hand, section 16(1) allowed expense to be deducted when “incurred”. As set out in DIPN 40, subject to other relevant provisions, deduction of expenses would be allowed when charged to the profit and loss account.

The Institute would like to know IRD’s view on when the royalty should be taxable, i.e. when the royalty was paid or when the royalty was charged to the profit and loss of the payer’s account.

Mrs Chu advised that the words “received by or accrued to” were used in sections 15(1)(a), (b) and (ba). A tax liability would arise when one of the two conditions was satisfied. Hence, royalty income would be taxable when paid or accrued whichever is earlier. In most cases, the time when the payer incurred the expenditure coincided with that when the income accrued to the recipient. Advanced payments were not deductible under section 16 as the expenditure had not been incurred. Under section 20B(2) of the IRO, the tax on the royalty paid to the non-resident was to be deducted by the payer from the royalty payable to the non-resident. The royalty payer did not suffer any additional cash outlay.
Mr. Fergus Wong mentioned that Assessors had raised enquiries on the different amounts of royalty charged in the payer’s accounts and income reported in the recipient’s tax return. He believed that the difference was purely attributed to timing difference. CIR said that queries were raised on a strictly necessary basis but assessors would be reminded to note that there may be timing differences.

(g) Deduction for environmental protection facility

Starting from the year of assessment 2008/09, taxpayers would be entitled to accelerated tax deduction for specified capital expenditure incurred on the provision or construction of eligible Environmental Protection Facility (EPF). The rate of deduction depended on whether the EPF was classified as Environmental Protection Machinery (EPM) or Environmental Protection Installation (EPI) as defined under section 16H of the IRO. In particular, taxpayers were entitled to an outright deduction for capital expenditure incurred on EPM in the year of purchase. On the other hand, deductions were allowed for capital expenditure incurred on the construction of EPI (which formed part of a building or structure) on a straight-line basis over a 5-year period, commencing from the year of acquisition.

The Institute would like to seek advice from IRD on the application of the above-mentioned provisions.

(i) Under Part 1 of Schedule 17 to the IRO, EPM was defined to mean: (1) low noise construction machinery or plant registered under the Quality Powered Mechanical Equipment system administered by the Environmental Protection Department (EPD); (2) air pollution control machinery or plant in compliance with the requirements under the Air Pollution Control Ordinance; (3) waste treatment machinery or plant in compliance with the requirements under the Waste Disposal Ordinance; and (4) wastewater treatment machinery or plant in compliance with the requirements under the Water Pollution Control Ordinance.

In this regard, the Institute would like to know whether the documents used for the purpose of registration/licensing of EPM with the EPD were sufficient as supporting documents to substantiate a claim that the relevant machinery or plant qualified for a deduction as EPM under section 16I of the IRO. If not, what documents were required?

Mr. Chu said that the documents used for the purpose of registration or licensing of EPM with the EPD, for example, the application submitted to and the approval granted by the Director of Environmental Protection, would normally be accepted by IRD as supporting
documents when a claim for deduction under section 16I of the IRO was considered. As with other deduction claims, taxpayers were not required to file the supporting documents with the tax returns.

Mr Chu advised that supporting documents might be required where the types of machinery or plant claimed for deduction did not appear to be a qualifying EPM (as their names so suggest or otherwise) or the amount claimed was substantial but no details/breakdowns were given, etc.

(ii) Section 16H of the IRO defines EPI as “any installation, or part of any installation, that is specified in Part 2 of Schedule 17 and forms a building or structure” [emphasis added]. Part 2 of Schedule 17 to the IRO specifies that EPI shall include: (1) certain renewable energy installations; and (2) “energy efficient building installations registered under the Hong Kong Energy Efficiency Registration Scheme for Buildings administered by the Electrical and Mechanical Services Department (EMSD)” (the Scheme).

Under the Scheme, energy efficient building installations included lighting installations, air conditioning installations, electrical installations and lift & escalator installations (collectively “Building Services Installations”). In addition to the Building Services Installations, the Performance-Based Building Energy Code (PB-BEC) had been developed and implemented under the Scheme since April 2003. This performance-based approach considered the various components (including Building Services Installations and building envelope) of building energy consumption altogether to determine whether the relevant building qualified for registration under the Scheme.

From the above, it was not clear whether Building Services Installations themselves would form a building or structure and, hence, whether they could qualify as EPI for the purposes of section 16H of the IRO.

Further, Building Services Installations (for example, escalator installations) would be machinery qualifying for depreciation allowances at a higher rate than that provided under section 16H of the IRO (i.e. 60% initial allowances plus annual allowances). Accordingly, it would seem that the new provisions might not offer accelerated tax deductions as far as Building Services Installations were concerned, unless a deduction was provided for the entire construction costs of a building where the building was registered under the Scheme. The Institute would like to seek IRD’s view on this matter.

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1 Building envelope is the ensemble of the building’s external walls as defined under Building Regulations.
Mr Chu explained that the new regime supplemented, not replaced, the depreciation allowances regime (the old regime) as far as “machinery or plant” was concerned. Therefore, for those air conditioning installations or lift & escalator installations that were within the meaning of “machinery or plant”, the taxpayer might choose to claim depreciation allowances under the old regime. The taxpayers, however, could not claim the deduction under section 16I if depreciation allowances had already been claimed for the same installation or the relevant part thereof [section 16I(5)].

Mr Chu advised that the definition of EPI in Schedule 17 only covered installations registered under the Scheme (i.e. lighting installations, air conditioning installations, electrical installations and lift & escalator installations) and not the building as such. The building envelope, hence, did not qualify for the deduction under section 16I, but commercial building allowance or industrial building allowance might be granted on the relevant costs of construction as appropriate.

Ms Macpherson noted that the EPM might also be eligible for depreciation allowances, which were more generous than the five-year, straight-line deduction under section 16I.

Mr Chu replied that installations generally did not qualify as machinery or plant, e.g., lighting systems could qualify for the deduction as EPI under section 16I. CIR said that the objective of the new provisions was to provide for more deductions so as to encourage the use of EPF. It was up to taxpayers to claim for the most advantageous deductions where there was overlap between different allowances or deductions. Information on what items would qualify for the section 16I deduction could be found at the website of the Environmental Protection Department.

(iii) Would there be any claw back of deductions claimed under section 16I of the IRO, in a case where EPD or EMSD subsequently withdrew a licence or de-registers machinery or plant?

Mr Chu advised that, if the licence or registration were cancelled or withdrawn, capital expenditure incurred prior to the effective date of cancellation or withdrawal would still be allowable for deduction and there would not be any claw back. However, if the licence were wrongly issued or the registration were wrongly made, then IRD would claw back the deduction claimed under section 16I because the relevant assets did not qualify as EPM or EPI ab initio.

Mr Fergus Wong asked what would happen to the expenditure not allowed so far if a licence or registration was cancelled or withdrawn during the five-year deduction period. Mr Chu indicated that no further deductions would be allowed in the remaining years.
(iv) Did IRD have any plans to revise DIPN 5 to include formal guidelines in respect of this new deduction?

Mr Chu advised that the IRD would consider revising DIPN 5 or issuing a new DIPN on the interpretation and application of the relevant provisions in the IRO relating to EPF.

(h) Customer loyalty programmes (HK(IFRIC) Interpretation 13)

In September 2007, the Institute issued the HK(IFRIC) Interpretation 13 addressing the accounting issues arising from “Customer loyalty programmes”. In such programmes, customers were provided with credits or points when they bought goods or services and these credits could be used to redeem awards such as free or discounted goods or services. The company would need to account for these credits as a separately identifiable component of the sales transaction(s) on which they were granted based on the fair value. This meant the “sales” revenue would include a component of payments for credits as unearned revenue.

The Institute requested the IRD to advise on:

(i) the assessing practice in relation to customer loyalty programmes and, in particular, whether the unearned revenue referred to above should be taxable until the credits or points are redeemed (or expired); and

(ii) whether any FAQs or DIPN would be issued on this subject.

Mr Wong advised that the Secan case had established the principle that in measuring profits for profits tax purposes and the tax treatment should follow the accounting treatment, except as otherwise provided for in the IRO. HK(IFRIC) Interpretation 13 provided that an entity that granted award credits should allocate some of the proceeds of the initial sale to the award credits as a liability (its obligation to provide the awards).

Mr Wong explained that the award credits were accounted for as a separate component of the sales transaction and should be measured by reference to their fair value. The entity should recognize the deferred portion of the proceeds as revenue when the award credits were redeemed or when it had fulfilled its obligations, depending on whether the awards were supplied by the entity itself or supplied by a third party with the entity collecting the consideration on its own account or on behalf of the third party.

Mr Wong advised that the IRD would generally accept that the unearned revenue attributable to the granting of award credits, subject to its being ascertained with sufficient
accuracy on a reasonable basis, would not be taxable. With respect to the timing of recognizing the consideration allocated to award credits as revenue, IRD would in general follow the accounting treatment as promulgated in HK(IFRIC) Interpretation 13.

Mr Wong said that, as the taxation treatment largely followed the accounting treatment, IRD did not consider FAQs were required.

(i) Tax treatment for reinstatement costs incurred

Under the terms of a lease agreement, a lessee of premises might be required to reinstate the condition of the premises back to their original condition.

The relevant accounting principles now required the lessee to accrue the reinstatement cost as an additional cost of the initial renovation. The reinstatement cost was to be provided based on the best estimate of the eventual costs of restoring the premises to their original state.

The Institute requested IRD’s advice in relation to the above:

(i) If IRD considered the expenditure to be capital in nature, would IRD consider that the best estimate of the reinstatement cost could be treated as part of the capital expenditure incurred on the initial renovation and qualify for commercial building allowances?

(ii) If IRD did not consider the reinstatement cost qualified for commercial building allowances, would the amount be deductible for profits tax purposes at the time the expenditure was incurred at the end of the lease?

(iii) Would IRD issue FAQs on this subject?

Mr Wong explained that, according to HKAS 37 (paragraph 14), a provision should be recognized when-

(a) an entity had a present obligation (legal or constructive) as a result of a past event;
(b) it was probable that an outflow of resources embodying economic benefits would be required to settle the obligation; and
(c) a reliable estimate could be made of the amount of the obligation.

Mr Wong advised that Example 3A in Appendix C to HKAS 37 was about the reinstatement of premises at the end of the lease. The conclusion of the example was that a provision was recognized and the costs of reinstatement were included as part of
the costs of the alternations of the premises at the beginning of the lease.

(i) It is stated in the question raised by the Institute that the reinstatement costs were to be provided on the best estimate of the eventual costs, the lease should be more than one year. As such, the lease was a capital asset. The reinstatement costs when incurred were thus part of the capital cost of acquiring the lease. According to HKAS 37, an entity needed to recognize the estimated costs of reinstatement as a provision. Since the estimated costs of reinstatement were a provision and no actual expenditure had been incurred, the estimate or provision did not qualify for commercial building allowance.

(ii) For reasons mentioned in (i) above, the reinstatement costs incurred at the end of the lease were still capital expenditure and hence were precluded from deduction under section 17(1)(c) of the IRO.

(iii) FAQs would be issued.

(j) Change of accounting date for post-1974 businesses

The current IRD’s assessing practice under section 18E was to allow post-1974 business in appropriate circumstances to have a basis period of less than 12 months to avoid double assessment of profits in the year of change of accounting date (for example, advance ruling cases 24 and 29 published on IRD website). It was noted that one of the acceptable reasons was “the change of accounting date is for administrative reasons and to reduce the problems arising on preparation of consolidated accounts due to different accounting year end date amongst the group companies.”

The Institute would like to ask IRD to provide general guidance on the “compelling reasons” that were acceptable by the Commissioner under section 18E. In view of the number of advance ruling cases, the Institute would like to know if IRD would consider issuing a DIPN on change of accounting date.

CIR advised that, when a post-1974 business changed its accounting date, section 18E gave the Commissioner the discretion to compute the profits of the year of assessment in which the change occurred and to re-compute the profits of the preceding year of assessment on such basis as she thought fit. The legislation did not prescribe the basis which the Commissioner should use. IRD would normally accept a basis period of less than 12 months where a subsidiary company changed its accounting date to achieve consistency with its group companies or to comply with a statute or requirements by a competent authority. As the situation of each case varied, it was thus difficult to specify the circumstances, other than the need to comply with the group accounting date, under
which the Commissioner would accept a basis period of less than 12 months. The advance ruling cases published in IRD’s website served as helpful illustrations of situations accepted by the Commissioner. At present, IRD did not consider there was a need to issue a DIPN on this topic.

**(k) DIPN 21 – Locality of Profits**

The Institute would like to enquire about the expected timetable for the issue of the revised DIPN 21.

CIR advised that the revised draft was sent to the Joint Liaison Committee on Taxation on 21 January 2009 for comment on or before 20 March 2009. IRD would consider the comments of the Committee and if necessary further update the DIPN. In response to Mr Southwood, CIR agreed the Institute could provide its own comments on the revised draft.

**Agenda Item A2 - Salaries Tax Issues**

**(a) Hybrid plans for share awards**

DIPN 38 was revised in March 2008 to cover share awards, which broadly categorized all schemes under the “upfront” and “back-end” approaches. However, there were some "hybrid" plans under which a taxpayer had already become the registered shareholder, and enjoyed all rights of a shareholder, at the date of grant (i.e. they mimicked the examples of the upfront approach). These shares (under the taxpayer’s name) were however, kept by a trust and if the employee left the company during the "vesting period", the shares would be forfeited and returned to the company.

Prior to the revision of DIPN 38, there were cases where IRD agreed an upfront approach (with discount on the fair market value) in relation to the hybrid plans described above. The Institute would like to know if IRD had switched to treating hybrid plans in accordance with the back end approach based on the revised DIPN 38 in the absence of a change of the legislation.

Practitioners opined that these plans should come under the upfront approach, as agreed by IRD in the past, albeit they had a "vesting" concept according to the revised DIPN 38.

The Institute requested IRD to advise on the assessing practice for the hybrid plans described above.
Mr Chiu advised that, under DIPN 38, two approaches were used to assess share awards (i.e. upfront and back-end) depending on the terms of share-based remuneration schemes. Hybrid plans had not been defined in DIPN 38 because their terms differed substantially and employees’ rights varied significantly.

Mr Chiu said that, generally, if there were vesting conditions as well as a vesting period, the back-end approach would be more appropriate. Before deciding which assessing approach was applicable, IRD would consider all the facts and circumstances of the hybrid plan.

Mr Chiu explained that, if an assessing approach had been agreed with the employer in respect of a share-based remuneration scheme, IRD would not normally deviate from the approach. However, if an employee did not accept the agreement, he could exercise his right of objection. In such a case, the objection would be considered on a case-by-case basis. If a new share-based remuneration scheme was set up to replace an old scheme, IRD would examine all the facts and circumstances of the new scheme to decide whether the same assessing approach should be adopted.

(b) Notional vesting of share awards

DIPN 38 (Revised) set out that employees permanently departing Hong Kong might elect to have their share awards (taxed under the “back end” approach) assessed on a notional basis.

However, in contrast to the notional assessment of share options upon permanent departure, IRD had stated that subsequent requests to revise the assessment would not be entertained unless the assessment was objected to within the statutory objection period (i.e. within one month after the issue date of the assessment).

In practice, a substantial amount of time was likely to have lapsed between an employee’s receiving his final assessment and the actual vesting of the share awards, thus making it difficult for an employee to lodge a valid objection within the statutory time limit.

In this regard, the Institute would like to know whether IRD would consider amending this practice and adopting a similar approach to the revision of assessments pertaining to the notional assessment of share options. The Institute also would like to know:

(i) Whether the election could be withdrawn where the shares taxed on the back end approach subsequently did not vest?
(ii) Whether IRD would consider adopting the same approach in paragraph 73 of DIPN 38 (Revised) for the situation where the benefit arising on the vesting of the share awards was less than the amount assessed on the notional basis?

(iii) The rationale for maintaining the differing tax treatments of share options and share awards if there was no intention to align the difference.

Mr Chiu explained that an election to assess share awards under the back-end approach on a notional basis upon the taxpayer’s permanent departure from Hong Kong was in essence an agreement that bound IRD and taxpayer regarding the valuation of share award benefits that accrued in the year of cessation of employment in Hong Kong. IRD would not raise an additional assessment even if value of shares subsequently vested in the taxpayer turned out to be much higher.

Mr Chiu advised that the above approach would not apply to share options because in Sawhney, the Court of First Instance ruled that salaries tax assessments should be raised in the years in which the taxpayer exercised his share options notwithstanding his employment had ceased. In view of this judgment, it would not be inappropriate to accept a revision of the assessment of share option benefits assessed on a notional basis upon the taxpayer’s permanent departure from Hong Kong.

Mr Southwood asked about the situation of an individual that had opted for a back-end approach but because, for example, he left the company unexpectedly, the shares never vested. CIR said that, in principle, assessments needed to be definite, so it was matter of deciding at the outset on a front-end or back-end approach and then accepting the consequences. However, in isolated cases, due to exceptional circumstances, further consideration might be given.

(c) Interaction between statutory severance payment and long service payment with contractual gratuity

The Court of Appeal ruled the case of CIR v Tsai Ge Wah in favour of the CIR on its facts. It was held in the case that the previous contractual gratuities paid to the taxpayer were already larger than the statutory long service payment payable to the taxpayer on the eventual termination of his employment. Therefore, no part of the gratuity from the final contract was reduced by the statutory long service payment – as, on account of the contractual gratuities previously paid, no such payment was due to the taxpayer on the final termination of employment. Accordingly, the final gratuity received was entirely gratuity and therefore, fully taxable.
The case was decided on its specific facts. In cases where there was only one contractual term involving no previous gratuities (or previous gratuities were less than the statutory payments payable upon termination of employment), the tax issue arising from the order of payments would remain. This was because the order of payments would affect the tax position of a taxpayer according to the current assessing practice of IRD.

On this issue, the Board of Review in the case made the following comments:

“In the present case, we have decided on the facts that section 31YAA of the EO [Employment Ordinance] applies [meaning long service payment was received first] and not section 31Y [of the EO which means gratuity was received first] and as a result, the Taxpayer is able to enjoy the tax benefit accorded to him by the Revenue’s aforesaid policy and practice…It appears to us that in some cases whether sections…31Y or sections…31YAA should apply, will depend on the employers’ treatments of the payments to the employees…No doubt, these results are not only undesirable but are also unfair…Thus, we feel that we ought to raise the question as to whether the Revenue should see fit to extend its aforesaid declared policy and established practice to situations where section 31I [relating to severance payments] and section 31Y of the EO apply.”

The Institute would like to know IRD’s view on these comments from the Board of Review in respect of statutory long service payment and severance payment, and whether there would be any change in the assessing practice.

Mr Chiu said that the Court of Appeal in Tsai Ge Wah allowed the appeal of CIR. In the judgment, the Court of Appeal after examining the reasoning of the Board of Review and the Court of First Instance ruled that the contract gratuity did not include a long service payment. As a rule, service payments or payments for service were chargeable under salaries tax. The concession of CIR only applied to a long service payment paid upon termination of employment in strict accordance with the Employment Ordinance. In Tsai Ge Wah, IRD did not agree that the contract gratuity comprised any long service payment. At present, CIR was reviewing the judgment and conditions under which the concession should be given. More guidance would be provided to taxpayers in due course. CIR would not refrain from assessing a service payment if the sum in question was not a long service payment paid in accordance with the Employment Ordinance.

Ms Chan asked whether the tax treatment of a payment should be in accordance with the nature of the payment as confirmed by the employer. CIR advised that the label of a payment was inconclusive and reference had to be made to the real nature of the payment.
Agenda Item A3 - Cross-border Tax Issues

(a) Depreciation on plant and machinery used in import processing trade

While this subject had been raised at the previous three annual meetings with IRD (Agenda Item A4(a) in 2006, Item A3(b) in 2007 and Item A3(b) in 2008 annual meetings) the concerns remained as it affected many taxpayers involved in manufacturing operations in the Mainland. This was particularly important during the current difficult times faced by manufacturing businesses.

IRD had raised a number of concerns, such as whether the plant & machinery (P&M) had been sold or transferred to other parties, whether depreciation allowances on the same P&M had been claimed by third parties, whether the P&M had been used to manufacture goods sold other than to the taxpayer, etc.

(i) The Institute would like to know, in principle, whether IRD considered that depreciation allowances could, in any circumstances, be granted to a Hong Kong taxpayer who owned P&M under a non-contract processing arrangement, where the P&M were used in the Mainland by a Mainland entity to produce goods sold to the Hong Kong taxpayer whose profits were 100% taxable in Hong Kong (and whether 50% of the depreciation allowances on the P&M would be granted if the profits of the Hong Kong taxpayer were 50% taxable in Hong Kong).

If IRD considered that this was not possible because of the operation of section 39E of the IRO, the Institute would like to know how to reconcile the difference in practice for allowing 50% depreciation allowances by concession in contract processing cases while disallowing depreciation allowances in import processing cases.

If IRD considered that their present position should be maintained, the Institute would like to know whether, in view of the current difficulties faced by manufacturers, IRD would consider allowing depreciation allowances by concession to taxpayers operating import processing arrangements (if not permanently, at least for a finite period) so that they would be on a level playing field with those operating contract processing arrangements.

CIR explained that, as indicated in the 2008 Annual Meeting [Agenda Item A3(b)], IRD considered that the provisions in section 39E(1)(b)(i) were clear and unambiguous and that no depreciation allowances should be given to the owner if the plant and machinery were used wholly or principally outside Hong Kong by a person other than the taxpayer.

In a contract processing arrangement, the Hong Kong entity had carried out activities in the Mainland and Hong Kong. According to the provisions of the DTA with the Mainland,
the Hong Kong entity with a contract processing arrangement could be regarded as
having a permanent establishment in the Mainland and was liable to tax there.
Reference could be made to paragraph 7 of DIPN 44. IRD was of the view that Hong
Kong entities which manufactured goods through a contract processing arrangement had
operations in the Mainland whereby they were regarded as using the plant and machinery
there. In these situations, section 39E(1)(b)(i) was not applicable and they were allowed
depreciation allowances as a concession. For entities engaging in import processing
arrangement, it was the foreign investment enterprises in the Mainland which used the
plant and machinery. Hence, section 39E(1)(b)(i) applied to deny depreciation
allowances.

(ii) The Institute would like to know if the position would be different if the Mainland
sub-contractor were an unrelated third party, in which case the concern about the
relevant P&M being contributed as an equity investment by the Hong Kong taxpayer to
the Mainland subcontractor should generally be allayed?

CIR advised that a taxpayer who had contributed plant and machinery as equity
investment was clearly not entitled to depreciation allowances because he no longer
owned the plant and machinery. Section 39E was not engaged.

CIR explained that the operation of section 39E(1)(b)(i) did not hinge on whether the
person who used the plant and machinery overseas was a related party or not.

(iii) The Institute would like to know how many cases of disputes involving rejection of
claims for depreciation allowances under section 39E (1)(b)(i) for import processing
arrangements were being handled by IRD and whether IRD anticipated that any of
these disputes would be brought before the Board of Review or the Court.

CIR said that IRD did not have statistics on the number of claims rejected. Any taxpayer
who was engaged in import processing arrangement and does not agree with the denial of
depreciation allowances under section 39E(1)(b)(i) of the IRO could pursue his claim
through the objection and appeal channel. Recently a case involving this issue was
heard by the Board of Review and a decision was pending.

(iv) The Institute would like to know if IRD agreed that the original intention of enacting
section 39E was not to target taxpayers involved in manufacturing operations in the
Mainland.
CIR advised that section 39E was enacted to limit the opportunities for tax deferral or avoidance through sale and leaseback, offshore equipment leasing and leveraged leasing arrangement. As explained in paragraph 16 of DIPN 15 (Revised), the condition of “used wholly or principally outside Hong Kong” in section 39E(1)(b)(i) aimed to encourage the generation of economic benefits in Hong Kong by the use of machinery or plant in Hong Kong. The meaning of the condition was plain and clear.

Mr Mak recalled that when the provision was first introduced, it had been observed that there were few cases of plant and machinery being used by Hong Kong manufacturers in the Mainland. CIR said that, even were this so, in the case of import processing, ownership of the plant and machinery changed hands. For contract processing cases, the concession would continue to apply, but it would not be further expanded.

(b) Practice pending the appeal in the case of CIR v Datatronic Limited

The Institute noted that IRD was appealing the case of CIR v Datatronic Limited. However, the appeal was not to be heard until June 2009. In the light of the decision of the Court of First Instance in that case, the Institute would like to know IRD’s practice in relation to import processing cases pending the hearing of the appeal.

CIR said that it was clear that IRD did not agree with the decision of the Court of First Instance in the case of CIR v Datatronic Limited and had lodged an appeal to the Court of Appeal. The same issue had been raised in previous meetings at which IRD had made clear its position. At present, there was no intention to change the practice.

Mr Southwood asked what approach IRD would take where a taxpayer filed on the basis of the court’s decision in the Datatronic case. CIR said that while the IRD would not change its practice, the taxpayer could exercise the right to object.

Agenda Items A4 - Double Taxation Agreements

(a) Certificate of Hong Kong Resident Status for the purpose of the double taxation arrangement between the Mainland and Hong Kong

DIPN 44 set out the procedures for applying a Certificate of Hong Kong Resident Status for the purpose of the double taxation arrangement between the Mainland and Hong Kong (the DTA).
(i) When a Hong Kong-incorporated company receiving dividend from a Mainland resident company claimed the 5% reduced withholding tax rate according to the DTA, the Mainland provincial tax bureaux sometimes still required the Hong Kong company to provide a Certificate of Resident Status from IRD although the DTA stipulated that a Hong Kong-incorporated company was a Hong Kong tax resident. The current practice of IRD was not to issue a certificate unless a referral letter had been issued by the Mainland provincial tax bureau. However, the Mainland provincial tax bureaux were not always prepared to issue such a referral letter, especially those which were not very familiar with international double taxation arrangements. In that case, the Hong Kong company might be prevented from enjoying the beneficial 5% withholding tax rate under the DTA and was instead taxed at the 10% rate. It could take considerable time and effort to obtain a refund of withholding tax from the Mainland tax bureaux.

The Institute requested IRD to consider introducing greater flexibility in the procedures for issuing a Certificate of Hong Kong Resident Status to Hong Kong-incorporated companies and arrangements for assisting Hong Kong-incorporated companies where they were unable to obtain a referral letter from the Mainland tax authorities.

CIR advised that, in order to claim any benefits under the DTA, an applicant had to be the resident of either the Mainland or Hong Kong. For this purpose, the State Administration of Taxation (the SAT) and IRD had agreed upon the administrative procedures in issuing a certificate of resident status and issued Guoshuihan [2007] No. 403 and DIPN 44 respectively. Hong Kong incorporated companies might report to IRD any deviation of the agreed practice by the Mainland authorities so that IRD could bring it to the attention of SAT.

(ii) IRD had stated in the “FAQ” section of its website that, where the Mainland tax authorities could not ascertain if a person was a resident of Hong Kong from available information, the Mainland tax authorities (at the provincial (city) level or higher) would issue a referral letter entitled《關於請求香港特別行政區稅務主管當局出具居民證明的函》to the person concerned for applying a "Certificate of Hong Kong Resident Status" from IRD.

The Institute would like to seek IRD’s advice on:

(a) whether, under such circumstances, a referral letter was a prerequisite for an application for a certificate of Hong Kong resident status for the purpose of the DTA; and
(b) whether IRD would accept and process an application where the referral letter was issued by the Mainland tax authorities at a level lower than the provincial (city) level.

CIR advised that, as agreed between SAT and IRD, a person who wished to claim benefits under the DTA should produce the readily available evidence, such as Certificate of Incorporation and Certified Extract of Information on the Business Register, to substantiate its Hong Kong resident status. Only when the Mainland tax authority was not able to ascertain the resident status would it issue a referral letter to the person. This arrangement applied to both SAT and IRD. There was no strong justification to dispense with the requirement of a referral letter.

CIR said that, according to the agreed procedures with SAT, IRD would not accept and process an application where the referral letter was issued by a Mainland tax authority at a level lower than the provincial (city) level.

(c) Did procedures similar to the above apply equally where taxpayers apply for a certificate of Hong Kong resident status for the purpose of double taxation agreements between Hong Kong and other jurisdictions (i.e. those with Belgium, Thailand, Luxembourg and Vietnam)?

CIR advised that the procedures for applying for a certificate of resident status adopted for the DTA with the Mainland did not apply to the cases of Belgium, Thailand, Luxembourg and Vietnam as there was no such request for proof of residence from those competent authorities.

(b) Tax credit for withholding tax

Recently the Shanghai Tax Authority had requested foreign banks in the Mainland to withhold tax on loan interest paid to overseas parties. Where such withholding tax was paid, and the loan and relevant interest income was booked by a Hong Kong branch of a foreign bank and treated as taxable in Hong Kong, the Institute would like to clarify if IRD would allow a full tax credit in Hong Kong for the Mainland withholding tax paid under the DTA.

The DTA would apply if the taxpayer was a Hong Kong resident. In this regard, the Institute noted that in DIPN 44 paragraph 27, IRD had stated that if the Hong Kong branch of an overseas bank was managed in Hong Kong, the bank would be regarded as a
resident of Hong Kong. However, the Mainland took the view that in deciding whether an overseas bank was normally managed or controlled in Hong Kong, one should consider the management or control of the bank instead of only the Hong Kong branch. The Institute would like to know:

(i) The specific situations in which IRD would give a full tax credit for the Mainland withholding tax suffered by the Hong Kong branch of the overseas bank.

(ii) Whether a full tax credit would still be given in Hong Kong if the Mainland levied withholding tax using the rate per the double taxation agreement between the Mainland and the home country of the overseas bank.

Mr Chu explained that section 50 of the IRO provided for the allowance of tax credit in respect of arrangements having effect under section 49. This section stipulated that only tax paid in the Mainland “which under the arrangements is to be so allowed” would qualify for a tax credit. Under Article 21(2) of the DTA, it provided that “tax paid in the Mainland of China in accordance with the provisions of this Arrangement in respect of any item of income derived from sources in the Mainland of China by a resident of the Hong Kong Special Administrative Region shall be allowed as a credit against Hong Kong Special Administrative Region tax”. Therefore, any withholding tax imposed on interest income by the Mainland authorities not in accordance with Article 10 of the DTA (which provided that the withholding tax rate should not exceed 7% of the gross amount of the interest) was outside the scope of the relief provided under the DTA and hence not eligible for tax credit under section 50 of the IRO.

Mr Chu said that, on the other hand, Hong Kong’s position with respect to the Hong Kong branch of an overseas bank, which was normally managed or controlled in Hong Kong, was clearly stated in paragraph 27 of DIPN 44. In other words, the bank would be regarded as a resident of Hong Kong. Therefore, the IRD would regard the withholding tax paid in the Mainland, up to the extent of 7% of the gross amount of the interest, as tax paid in the Mainland in accordance with the DTA and tax credit would be given accordingly under section 50(2). Any excess of such tax, which was not so allowed [see sections 50(3) and (4)], would be allowed as a deduction under section 50(5).

(c) Foreign tax credit for companies

In Item A4(d) of the 2006 annual meeting, IRD had advised on the assessing position in the case where an income of a Hong Kong resident was subject to tax in the Mainland but the Hong Kong resident had an overall loss in Hong Kong after taking into account the same income. According to IRD’s explanation, a deduction claim for the foreign tax paid in such a case would not be allowed as “the taxpayer does not have a credit at all as no Hong
Kong tax had been paid, therefore the question of ‘exceeds the credit therefore did not arise.”

The Institute would like to know the assessing position in the situation where the Hong Kong resident had Hong Kong tax payable for the current year of assessment after setting off the allowable losses brought forward against the assessable profits and the taxpayer had paid foreign corporate income tax on a portion of the income that was subject to Hong Kong tax in the current year.

In this scenario, the Institute understood that the Hong Kong resident would be able to claim tax credit on the foreign tax paid, subject to the limits stipulated in sections 50(3) and 50(4) of the IRO. Section 50(5) further provided that any foreign tax paid that was not allowed as a tax credit would be allowed as a deduction against the same income that was subject to foreign tax. The Institute would like to raise the following questions:

(i) In determining the amount of income that was subject to foreign tax, to what extent would the losses brought forward from prior years be taken into account? For example, would the amount of losses brought forward be considered as attributable to the overall operations of the Hong Kong company as a whole and be used to set off against profits that were subject to Hong Kong tax only or profits that were subject to both Hong Kong and foreign tax on an "average" basis?

(ii) Was there any alternative basis that IRD considered to be acceptable (for example, to set off the losses brought forward against income other than that subject to foreign tax first, hence providing a more favourable treatment to taxpayers)?

(iii) How would the effective tax rate be computed for the purpose of section 50(3)?

(i) Mr Chu advised that, unless the IRO provided for a specific method of set off, e.g. sections 19CA, 19CB and 20AD, any set-off of losses was to be made in accordance with section 19C. The loss would be treated as attributable to all the profits (including profits subject to foreign tax) made by the company.

(ii) Mr Chu said that, as indicated in (i) above, the alternative basis was not a method specified in the IRO.

(iii) Mr Chu explained that, when there were losses brought forward, the effective tax rate was computed by reference to the tax chargeable on the net assessable profits, i.e. after set-off of loss brought forward.
(d) Foreign tax credit for individuals

Under the DTA, IRD allowed a foreign tax credit on the Mainland individual income tax (PRC IIT) paid to be set off against the Hong Kong salaries tax of the individual as illustrated in example 6 in paragraph 132 of DIPN 44. However, in this example, it seemed that the taxpayer would be better off to claim the exemption under section 8(1A)(c).

There were situations where the taxpayer could be better off claiming a tax credit. For example, those who were subject to PRC IIT in full but spent a significant number of days in Hong Kong. Section 8(1A)(c) allowed only the income related to services in the Mainland to be exempted while tax credit would be allowed for all the income subject to PRC IIT. However, the Institute noted that in some recent cases (one of which a Commissioner's determination was issued), IRD would pro-rate the "net" PRC IIT by the ratio of the PRC source income to the total income in the same manner as the section 8(1A)(c) cases (which was not the approach suggested in the DIPN). Effectively, this would seem to mean that taxpayers could never achieve a better outcome from the foreign tax credit provisions under the DTA as compared with a section 8(1A)(c) claim. If so, the DTA provisions would appear to offer no benefit for salaries tax purposes.

The Institute would like to know whether, where relevant, IRD would advise taxpayers to withdraw tax credit claims under the DTA and to claim a section 8(1A)(c) exemption (given the IRD's practice in other circumstances to advise taxpayers of the most favourable tax options, such as electing for personal assessment and electing to relate back lump sums under section 11D(b)).

Mr Chiu advised that, if it was a Hong Kong employment, the full amount of salary income including bonus would be subject to Hong Kong salaries tax under section 8(1). Tax credit under section 50 would be provided in respect of China IIT charged on salary income attributable to services rendered in the Mainland. If the salary income was not attributable to services rendered in the Mainland, tax credit would not be provided even if China IIT had been paid.

Mr Chiu explained that the arrangement with the Mainland and provisions in section 8(1A)(c) were measures to provide relief due to double taxation. In double taxation cases, since the facts were complex with different permutations, it would be difficult for IRD to offer taxpayers suggestions in every case about the relief measures that they should elect for, and the IRD did not have the facilities to do this.
(e) Exchange of information clause of double tax agreements

The government recently conducted a consultation to ascertain whether Hong Kong should move towards a more liberal exchange of information (EoI) regime (i.e. to adopt the EoI provisions of the 2004 version of the OECD model tax convention in signing comprehensive double tax agreements with other jurisdictions). The Institute and various other professional and business organisations were consulted and had made submissions.

(i) The Institute would like to have an update on the status of the negotiations of double taxation agreements with treaty partners where adopting the 2004 version of the EoI provisions was not an issue.

(ii) The Institute would like to know whether IRD had assessed the resources that would be required if the 2004 version of the EoI provisions were adopted and, if yes, the level of additional resources required.

(i) CIR advised that the IRD had experienced great difficulties negotiating with treaty partners on the ground that Hong Kong was unable to adopt the 2004 version of the EoI. Hong Kong presently had 8 negotiations put on hold primarily on such ground, many of which were Hong Kong’s major trading partners. Many others had indicated that they would only start a negotiation if Hong Kong moved to the 2004 version. The fact that Hong Kong had been able to conclude some agreements in the past years based on the 1995 version did not mean that the EoI was not an issue. Rather, the success was due to the IRD’s deliberate efforts in targeting some Asian and European countries that were more restrictive on EoI matters. It was pertinent to point out that the norm for all OECD economies and most European countries was to base EoI provisions on the 2004 version. Presently, one negotiation based on the 1995 version was still in progress.

(ii) CIR said that the IRD had made reference to the experience of some other jurisdictions with extensive DTA networks on the resources in adopting the 2004 EoI version. It was noted that they generally required limited resources. As an example, one country having a network of over 50 DTAs and a much larger economy than Hong Kong, received about 100 requests a year. Given that Hong Kong would only provide information based on specific requests, i.e. there would not be any automatic exchanges or spontaneous exchanges of information, it was envisaged that the additional resources required for Hong Kong to move to the 2004 version would not be substantial.
Agenda Items A5 - Departmental Policy and Administrative Matters

(a) Refund for holdover of provisional profits tax

Suppose a taxpayer had paid an amount of provisional profits tax for a year that exceeded the sum of the final tax payable for the same year and provisional tax payable for the following year.

Section 63K of the IRO provided that the amount of provisional profits tax paid for a year of assessment would be applied to settle (a) the profits tax payable for that year of assessment; then (b) the provisional profits tax payable in respect of the year of assessment succeeding that year of assessment. Any amount not so applied should be refunded to the taxpayer.

In the situation quoted above, if the taxpayer applied for a holdover of provisional profits tax under section 63J of the IRO, it would seem to follow that a refund of the heldover amount should be made to the taxpayer. The Institute would like to seek IRD’s view on this observation.

Mr Chu explained that there were two arguments against giving a refund in the above situation. First, an application under section 63J was merely a request to the Commissioner “to have the payment of the whole or part of [the provisional profits] tax held over until he is required to pay profits tax for that year of assessment”. In other words, it was only the payment of [the whole or part of] the provisional profits tax which was held over. The section did not authorise or mandate a refund to be made.

Secondly, in section 63K(b), the phrase “the provisional profits tax payable” referred to the provisional profits tax which was charged in the relevant notice of assessment and which was payable by the taxpayer. When an application was made under section 63J, the payment of the whole or part of the provisional profits tax would be held over as appropriate, but the “provisional profits tax payable” as such had not been amended in any way. Therefore, no refund would be generated in the exercise.

Mr Chu said that, despite the above observation, it was noted that an anomaly might arise in a situation where the provisional profits tax was effectively “paid” by way of set-off by virtue of the operation of section 63K(b), since the “paid” provisional tax was no longer eligible for holdover. This might not be the intention of the legislature because the effect was to deny the application of a section to relieve hardship in those cases where the application was most needed. The IRD would therefore, as a concession, refund any held over amount of “paid” provisional tax (both profits and salaries) in those specific circumstances.
Mr Chu explained that another situation under which paid provisional tax would be refunded upon a holdover application was where the provisional tax was “paid” by way of set-off by an overpayment due to (i) revision of the final assessment for the current year of assessment (upon objection or otherwise); or (ii) another tax bill being overpaid.

Mr Chu advised that the Assessor would ensure that all assessments were finalized and that the taxpayer had no outstanding tax liabilities before making the refund.

(b) Holdover of provisional salaries tax where tax is paid outside Hong Kong

Section 8(1A)(c) of the IRO provides that income arising in or derived from Hong Kong from any employment “excludes income derived by a person from services rendered by him in any territory outside Hong Kong where—

• By the laws of the territory where the services are rendered, the income is chargeable to tax of substantially the same nature as salaries tax under (the IRO); and
• The Commissioner is satisfied that that person has, by deduction or otherwise, paid tax of that nature in that territory in respect of the income.”

Further, section 63(E)(2b) of the IRO provides that where the net chargeable income during the year of assessment of the person assessed to provisional salaries tax is, or is likely to be, less than 90% of the net chargeable income for the year preceding the year of assessment or of the estimated sum in respect of which such person is liable to pay provisional salaries tax, a holdover application may be applied for.

In this connection, paragraph 38 of DIPN 10 (Revised) states that a valid reason accepted for holding over of provisional salaries tax is where the taxpayer can show that once foreign tax is paid, his assessable income (after excluding that part subject to the foreign tax) will be less than 90% of that for the previous year.

Practitioners recently came across cases where IRD had rejected holding over of provisional salaries tax on the basis that no foreign tax returns and receipts could be provided. It was common that the basis period for assessment to Hong Kong salaries tax was different from that of foreign jurisdictions. As a result, no foreign tax returns would have been filed or tax receipts received at the time the application for holding over of provisional tax was made.

The Institute would like to seek IRD’s advice on the type of documentation required to substantiate a holdover application for provisional tax if foreign tax returns and receipts were not available.
Mr Chiu advised that, to support a holdover application on the ground that the net chargeable income after invoking section 8(1A)(c) was likely to be less than 90 per cent compared with the preceding year, the taxpayer had to provide sufficient details, e.g. employment contract, terms of service, place of service, overseas tax registration, employment visa, estimated amount of salary income chargeable to overseas tax, calculations of estimated overseas tax and the exact reasons why overseas tax would be chargeable. While taxpayers might not be able to provide all the information, they should be able to establish a reasonable case that section 63E had been satisfied.

Mr Chiu pointed out that a foreign tax return was not a prerequisite for such a holdover application.

(c) Audited accounts to support profits tax return for deregistration of a company

Unlike in the case of a company in members’ voluntary liquidation, IRD generally required that the final accounts accompanying the final tax return of a company applying for deregistration had to be audited (as indicated in Q24 of FAQ: Issue of Notice of No Objection to a Company Being Deregistered published on the IRD website).

The Institute noted that, as the Companies Ordinance did not require the final accounts to be tabled in a general meeting of shareholders to approve the deregistration, there was no legal requirement for the accounts to be audited.

(i) The Institute would like IRD to explain the legal basis for the different requirements on companies in members’ voluntary liquidation and those applying for deregistration for filing audited accounts.

(ii) Whether IRD would accept management accounts certified by a company director or directors instead of audited accounts, similar to liquidation cases where a liquidator or director could certify the management accounts used to support the profits tax return.

Mr Wong explained that, under sections 111(1), 122(1) and 129C(1) of the Companies Ordinance, a company was obligated to hold an annual general meeting and lay at the meeting a profit and loss account and the auditors’ report. An exemption is provided to a dormant company registered pursuant to section 344A of the Companies Ordinance. Another exemption was made to a liquidator in sections 238 and 247 under which he was only required to table an account of his acts and dealings. No auditor’s report was required. IRD was not aware of any provisions in the Companies Ordinance which exempt a company applying for deregistration of its obligations under sections 111(1), 122(1) and 129C(1). That being the case, IRD would not accept certified management
accounts for companies applying for deregistration.

(d) Assessments to tax representatives

The Institute understood from practitioners that, on a number of occasions this year, IRD had not sent copies of property tax assessments, or salaries tax assessments, to tax representatives, even though the appointment of tax representatives was clearly marked on the property tax return or individual tax returns for the year concerned. As a result, tax representatives were unable to advise clients on the correctness of the tax assessments issued and unable to lodge objections or holdover application on behalf of clients before the deadline as a result.

The Institute would like to seek IRD’s view on this.

Mr Chiu advised that, to ensure that a copy of the tax assessment could reach the tax representative, IRD should be notified of appointment of a tax representative at the earliest possible time without waiting for the issue of tax returns. Normally, there was a time gap between the notification of appointment of a new tax representative and the updating of IRD’s database. It was also important to quote file references when communicating with the IRD to minimize delays. When processing a tax return submitted by a taxpayer, the update of address and tax representative information was given first priority. This was to ensure that a tax assessment could reach the taxpayer and his tax representative.

(e) Time extension for filing tax return form BIR 60

The current requirement was for extension of time for the submission of individual tax returns (form BIR 60) to be requested monthly and on a case-by-case basis. Taxpayers, who were professionally represented might be included in the block extension scheme, which allowed an automatic extension to the beginning of July. Between the beginning of July and the beginning of September, tax representatives generally were still awaiting information (usually from various overseas sources) for completion of tax returns. As a result, a large number of individual extension requests might need to be prepared by a tax representative every month. This presented difficulties for tax representatives and the Institute would like to know if IRD would consider accepting either:

(i) monthly requests in respect of groups of taxpayers, listed by section number and/or employer file number; or

(ii) individual requests for a two-month extension on a case-by-case basis.
Mr Chiu advised that further extension of time beyond the normal extension date for filing the BIR 60 would not be granted except in exceptional circumstances. Applications for further extension should be made on a case-by-case basis. If the reasons or exceptional circumstances were the same for employees of a company, the request for further extension could be made by way of a list.

(f) Penalties

(i) Field audit cases

There were cases where a taxpayer had to file the current year tax return with a field audit for prior years still pending. As the field audit had not yet been settled, the filing basis for the current year might not be accepted when the field audit was finalised. As such, if penalties were to be imposed by the field audit, penalties would also be imposed for the current year.

If the taxpayer had the opportunity to agree the filing basis with IRD before filing the current year tax return, the filing basis should be “correct” according to IRD. On the other hand, the taxpayer filed the current year return using the basis prior to the field audit settlement with a note in the profits tax return stating that it was “subject to the outcome of the field audit or tax investigation”. As the field audit settlement had not yet been finalised and the taxpayer had made full disclosure in the current year tax return, it would seem to be inappropriate to impose penalties for the current year. The Institute would like to know IRD’s view on this.

Mrs Lai advised that it was the primary duty of taxpayers to file accurate tax returns.

During the course of a field audit or investigation, the taxpayer was expected to review his past returns and to ensure that the returns to be submitted by him would comply with the requirements of the law.

Mrs Lai explained that taxpayers’ cooperation by making a prompt, full and frank disclosure of all material facts and providing complete and accurate information relating to the computation of assessable profits would facilitate the early finalisation of the audit or investigation. Hence, the attitude of and the remedial actions taken by the taxpayer were among the major factors to be considered when imposing penalties. If a taxpayer chose to sit back and left it to IRD to find out the discrepancies and build up the case, it was by no means a mitigation factor for consideration of penalty.
Mrs Lai said that CIR or her deputies would invite taxpayers to make representations before imposing a penalty under section 82A. Whether or not a taxpayer had any reasonable excuse in making an incorrect return was a question of fact. Generally speaking, nominal or partial disclosure could hardly mitigate the wrongdoings or spare the taxpayer from penalty.

Mrs Lai advised that, if the back year returns were still under field audit, taxpayers should ensure full disclosure of all material facts, how and to what extent the filing basis in the current year return might be affected by the outcome of the current field audit and investigation, and provide full reasons for continuing to adopt such filing basis so that ascertainment of the correct amount of assessable profits could be made. CIR explained that, by reference to the penalty policy, acts done by a taxpayer in facilitating the finalisation of a field audit or tax investigation would be taken into account in determining the level of penalty. Mr Chu advised that taxpayers should also make full disclosure of facts and give explanations in the current year return in respect of technical arguments on taxability or deductibility of profits or expenses.

(ii) Holdover applications

Penalties might be imposed under the IRO if information provided for the application to holdover provisional tax was found to inaccurate. The Institute would like IRD to advise on the penalty policy in relation to provisional tax, as the currently published penalty policy seemed to be applicable only to final tax.

Mrs Chu advised that, under section 2 of the IRO, the term “tax” included provisional tax. A taxpayer who evaded provisional taxes was liable to penalty under sections 80 and 82A. These offences included the provision of incorrect information in relation to an application to holdover provisional tax. The current penalty policy could be applied to incorrect holdover claims, where appropriate.

(g) Website publication

(i) Advance ruling cases

Currently, advance ruling cases published on IRD’s website were listed by case number with the IRO section(s) quoted. Thus the only information about a case might be, for example, that it related to section 14 of the IRO. With the number of cases growing (37 cases up to the end of November 2008), it might be difficult for readers to search for the relevant cases only by reference to section numbers of the IRO.
The Institute would like to ask if IRD would consider indexing the advance ruling cases similar to the Board of Review cases, which showed the issues involved (e.g. “source of profits - service income”).

Mrs Chu advised that IRD would prepare a subject index for the advance ruling cases published on IRD’s website.

(ii) Status of tax cases

The Institute would like to ask if IRD would consider expediting the process of updating the status of tax cases on its website as it might be difficult to ascertain the status of important cases during the time lag of updating the website.

Mrs Chu advised that the status of tax cases was updated on a monthly basis on the IRD website. The date of last revision was specified. Given that the parties normally had over a month to lodge an appeal, more frequent updating was not considered justified.

(h) Impact of the Court of Final Appeal's decision on the Koon Wing Yee case

The Institute would like to know IRD’s view on whether the Court of Final Appeal’s decision on the Koon Wing Yee case had any impact on levying penalties by IRD.

Mrs Lai advised that in the light of the judgement of the Court of Final Appeal in Koon Wing Yee v Insider Dealing Tribunal [2008] 3 HKLRD 372, IRD accepted that proceedings under section 82A did involve a criminal charge for the purposes of Articles 10-11 of the Bill of Rights. But, the fact that additional tax proceedings involved a “criminal charge” for human rights purposes did not necessarily mean that all the consequences of a criminal trial applied in relation to the substance of the matter.

Mrs Lai explained that CIR was an administrative authority, discharging administrative and not judicial functions in assessing additional tax. CIR was an administrator who could not be considered to satisfy the requirements of Article 10 of the Bill of Rights. Our tax system on additional tax was not incompatible with Article 10 so long as a taxpayer could bring any such decision affecting him before a judicial body that had full jurisdiction including power to quash in all aspects, on questions of fact, and law, the challenged decision.
In *Koon Wing Yee*, the Court of Final Appeal concluded that Article 11 of the Bill of Rights required the criminal standard of proof, i.e. proof beyond reasonable doubt, to be applied in relation to a criminal charge. *Koon Wing Yee* did not address the distinct question of the onus of proof, which was not in issue in that case.

Mrs Lai explained that, in section 82A proceedings, section 68(4) of the IRO placed the onus of proof on the taxpayer [to prove that the additional tax assessment was excessive or incorrect, and the proof of the existence of a reasonable excuse]. The question therefore arose of whether section 68(4) was consistent with the presumption of innocence under Article 11.

It is established in case law that the constitutional protection accorded to the presumption of innocence was not absolute and capable of derogation. Reverse onus of proof might be justified if it was rationally connected with the pursuit of a legitimate societal aim and it was no more than necessary for the achievement of that aim.\(^2\)

Mrs Lai further explained that the tax reporting system in Hong Kong was an honour system. The filing of incorrect tax returns caused loss to government revenue and was unfair to the community at large. The legitimate aim of the penalty tax assessment was the prevention, suppression and punishment for incorrect tax returns. Whether the assessment of additional tax was incorrect were matters that were or should be within the taxpayer’s own knowledge or to which he or she had ready access.

IRD had sought legal advice and considered that the application of section 68(4) of the IRO, read with section 82B(3), imposing a reverse persuasive burden on the taxpayer was justifiable and proportionate and hence, did not breach Article 11 of the Bill of Rights.

Therefore, it was IRD’s view that the additional tax under section 82A was not incompatible with human rights laws.

In response to Mr Tisman, CIR remarked that, while the burden lay with the taxpayer, this was a burden requiring the taxpayer to prove his case on a balance of probabilities.

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1. Article 10: Equality before courts and right to fair and public hearing
   Article 11: Rights of persons charged with or convicted of criminal offence
2. HKSAR v Ng Po On [FACC 6/2007]
(i) Electronic profits tax returns

The Institute would like to enquire whether the Board of Inland Revenue would examine the electronic tax return forms and whether consultation with practitioners would be conducted before the forms were finalised.

Mr Wong said that, according to section 51AA(2) of the IRO, electronic returns had to be furnished to IRD through a system, use a template or contain particulars specified by the Board of Inland Revenue. Hence, it was clear that the endorsement of the Board of Inland Revenue had to be sought in relation to the design of the return.

Mr Wong advised that IRD was looking into the technical and legal requirements of e-filing of profits tax returns by corporations and partnerships. Practitioners would be consulted at a later stage when more concrete details were available.

(j) Lodgment of tax returns and filing deadlines for 2008/09

The Institute would be interested to know the latest statistics on the filing of tax returns and the filing deadlines for 2008/09.

Mr Wong advised that, as shown in Table 1, IRD issued more returns in the 2007/08 bulk issue exercise than the previous years. Compared with 2006/07, more “N” code returns were not filed by the due date. Table 2 was a breakdown of the filing position for files under different coding. Table 3 showed the progressive filing results. The average performance rate up to 15 November dropped to 75%, which was 3% below that of last year. Tax representatives were urged to improve their performance. Table 4 was a comparative analysis of compliance with the block extension scheme.

Bulk Issue of 2008/09 Profits Tax Returns

The bulk issue of 2008/09 Profits Tax Returns for “active” files would be made on 1 April 2009. The extended due dates for filing 2008/09 Profits Tax Returns would be:

<table>
<thead>
<tr>
<th>Accounting Date Code</th>
<th>Extended Due Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>“N” code</td>
<td>4 May 2009 (no extension)</td>
</tr>
<tr>
<td>“D” code</td>
<td>15 August 2009 (no change)</td>
</tr>
<tr>
<td>“M” code</td>
<td>16 November 2009 (no change)</td>
</tr>
<tr>
<td>“M” code – current year loss cases</td>
<td>1 February 2010 (no change)</td>
</tr>
</tbody>
</table>
PART B - MATTERS RAISED BY IRD

Agenda Item B1 – Requests for Extension for Filing Individuals Tax Returns

Mr Chiu advised that IRD noted that a big accountancy firm had submitted some 300 requests for extension for filing 2007/08 Individuals Tax Returns with no file number quoted. It was subsequently revealed that in many cases a tax return in fact had not been issued. Further, some cases were related to expatriates who did not even have a Hong Kong Identity Card number according to IRD’s records. Some 120 requests with similar irregularities were also received from another big accountancy firm.

IRD would like to remind practitioners that extension for filing Individuals Tax Returns should be submitted with sufficient details and for appropriate cases only. In future, if the file number was not given, the request for extension might not be entertained.

Agenda Item B2 - Investigation and Field Audit : Discrepancies Detected by Field Audit

Mrs Lai advised 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 2008. Comparative figures for the years 2006 and 2007 were included. Table 2 related to a particular case with apparent irregularities which should have been detected during the statutory audit.

Mrs Lai pointed out that, as shown in Table 1, Field Audit teams uncovered discrepancies in 258 corporation cases, of which 211 carried clean auditors’ reports. Amount of discrepancies detected in the clean report cases account for 90% (80% for 2007) of the total discrepancies detected in corporation cases completed during the year and total tax of $568 million was recovered from these cases. Average understatement per clean report case increased from $9.8 million (figure for 2007) to $16.7 million, while tax undercharged per clean report case increased from $1.5 million (figure for 2007) to $2.6 million.

Mrs Lai advised that discrepancies resulted mainly from omission of sales, understatement of gross profits and over claim of expenses. In the majority of cases, the discrepancies were detected after examining the business ledgers and source documents.
Ms Lam noted that the figure for discrepancies by nature under “others” was quite large. Mrs Lai said that they included cases such as offshore claims, profits of companies interposed in a group, depreciation allowances etc.

Ms Chan asked if the increase in the amount of discrepancies identified was due to more resources being deployed to field audit and investigation. CIR replied in the negative. However, the IRD past experience indicated that a better economy might be a contributing factor.

Table 2 involved a company that did not make a full record of sales in the books of accounts and reported an estimated sum, which was grossly unsubstantiated.

**Agenda Item B3 - Date of Next Annual Meeting**

The date of the next meeting would be agreed between the Institute and the IRD in due course.
Appendix A

Lodgement of Corporations and Partnerships Profits Tax Returns

Table 1
Lodgement Comparison from 2005/06 to 2007/08

<table>
<thead>
<tr>
<th>Comparison</th>
<th>2006/07</th>
<th>2007/08</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Bulk issue (on 1 April)</td>
<td>146,000</td>
<td>149,000</td>
</tr>
<tr>
<td>2. Cases with a failure to file by due date:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>'N' Code</td>
<td>1,600</td>
<td>1,700</td>
</tr>
<tr>
<td>'D' Code</td>
<td>4,000</td>
<td>5,200</td>
</tr>
<tr>
<td>'M' Code</td>
<td>8,500</td>
<td>10,000</td>
</tr>
<tr>
<td>Total</td>
<td>14,100</td>
<td>16,900</td>
</tr>
<tr>
<td>3. Compound offers issued</td>
<td>5,500</td>
<td>6,700</td>
</tr>
<tr>
<td>4. Estimated assessments issued</td>
<td>5,200</td>
<td>6,800</td>
</tr>
</tbody>
</table>

Table 2
2007/08 Detailed Profits Tax Returns Statistics

<table>
<thead>
<tr>
<th>'N'</th>
<th>'D'</th>
<th>'M'</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total returns issued</td>
<td>16,400</td>
<td>44,100</td>
<td>94,500</td>
</tr>
<tr>
<td>Failure to file on time</td>
<td>1,900</td>
<td>4,600</td>
<td>10,600</td>
</tr>
<tr>
<td>Compound offers issued</td>
<td>1,500</td>
<td>1,900</td>
<td>3,800</td>
</tr>
<tr>
<td>Estimated assessments issued</td>
<td>250</td>
<td>1,800</td>
<td>4,500</td>
</tr>
</tbody>
</table>
Table 3
Represented Profits Tax Returns - Lodgement Patterns

<table>
<thead>
<tr>
<th>Code</th>
<th>Lodgement Standard</th>
<th>Actual Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2007/08 PTRs</td>
</tr>
<tr>
<td>D - 25 August</td>
<td>100%</td>
<td>85% (2)</td>
</tr>
<tr>
<td>M - 31 August</td>
<td>25%</td>
<td>10%</td>
</tr>
<tr>
<td>M - 30 September</td>
<td>55%</td>
<td>15%</td>
</tr>
<tr>
<td>M - 31 October</td>
<td>80%</td>
<td>30%</td>
</tr>
<tr>
<td>M - 15 November</td>
<td>100%</td>
<td>75% (3)</td>
</tr>
</tbody>
</table>

(1) At the request of HKICPA, the original extended due date (15 August 2008) was extended to 22 August 2008. Owing to the hoisting of typhoon signal on 22 and 23 August 2008, the final due date was extended to 25 August 2008.

(2) 17% lodged within a few days around 25 August 2008 (35% lodged within a few days around 15 August 2007 for 2006/07 PTRs)

(3) 20% lodged within a few days around 15 November 2008 (29% lodged within a few days around 15 November 2007 for 2006/07 PTRs)

Table 4
Tax Representatives with Lodgement Rate of less than 75% of ‘M’ code Returns as at 15.11.2008

1,578 T/Rs have ‘M’ Code clients. Of these, 755 firms were below the average performance rate of 75%.

An analysis of the firms, based on size, is:-

<table>
<thead>
<tr>
<th></th>
<th>Current Year Performance</th>
<th>Last Year Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of clients per firm</td>
<td>No. of firms</td>
</tr>
<tr>
<td>Small size firms</td>
<td>100</td>
<td>1,437</td>
</tr>
<tr>
<td>Medium size firms</td>
<td>101 - 300</td>
<td>129</td>
</tr>
<tr>
<td>Large size firms</td>
<td>over 300</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1,578</td>
</tr>
</tbody>
</table>
### Table 1
Analysis of Completed FA Corporation Cases for the years ended 31 December 2006, 2007 and 2008

<table>
<thead>
<tr>
<th>Auditor's Report = Unqualified</th>
<th>Number</th>
<th>Discrepancy Amount by Nature</th>
<th>Tax Undercharged by Nature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales omitted</td>
<td>40</td>
<td>22</td>
<td>40</td>
</tr>
<tr>
<td>Purchases overstated</td>
<td>7</td>
<td>12</td>
<td>17</td>
</tr>
<tr>
<td>Closing stock understated</td>
<td>1</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Gross profit understated</td>
<td>17</td>
<td>31</td>
<td>25</td>
</tr>
<tr>
<td>Expenses over-claimed</td>
<td>57</td>
<td>69</td>
<td>64</td>
</tr>
<tr>
<td>Technical adjustments</td>
<td>45</td>
<td>56</td>
<td>56</td>
</tr>
<tr>
<td>Other</td>
<td>69</td>
<td>69</td>
<td>65</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>236*</td>
<td>262*</td>
<td>268*</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Auditor's Report = Qualified</th>
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<tbody>
<tr>
<td>Sales omitted</td>
<td>13</td>
<td>5</td>
<td>12</td>
</tr>
<tr>
<td>Purchases overstated</td>
<td>3</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Closing stock understated</td>
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<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Gross profit understated</td>
<td>17</td>
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<td>11</td>
</tr>
<tr>
<td>Expenses over-claimed</td>
<td>28</td>
<td>13</td>
<td>15</td>
</tr>
<tr>
<td>Technical adjustments</td>
<td>19</td>
<td>10</td>
<td>13</td>
</tr>
<tr>
<td>Other</td>
<td>24</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>106*</td>
<td>57*</td>
<td>68*</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Number</th>
<th>Discrepancy Amount by Nature</th>
<th>Tax Undercharged by Nature</th>
</tr>
</thead>
<tbody>
<tr>
<td>184*</td>
<td>$1,377,511</td>
<td>$2,472,695</td>
</tr>
<tr>
<td>191*</td>
<td>$3,114,585</td>
<td>$404,474</td>
</tr>
<tr>
<td>211*</td>
<td>$498,671</td>
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<th>Number</th>
<th>Discrepancy Amount by Nature</th>
<th>Tax Undercharged by Nature</th>
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<tbody>
<tr>
<td>70*</td>
<td>$1,864,478</td>
<td>$2,411,241</td>
</tr>
<tr>
<td>41*</td>
<td>$2,129,445</td>
<td>$348,969</td>
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<tr>
<td>47*</td>
<td>$299,820</td>
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</table>

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<th>Number</th>
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</thead>
<tbody>
<tr>
<td>254</td>
<td>$9,880,640</td>
<td>$11,600,597</td>
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<tr>
<td>232</td>
<td>$7,996,974</td>
<td>$1,199,631</td>
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<td>258</td>
<td></td>
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### Appendix B

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</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>236*</td>
<td>262*</td>
<td>268*</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Auditor's Report = Qualified</th>
<th>Number</th>
<th>Discrepancy Amount by Nature</th>
<th>Tax Undercharged by Nature</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales omitted</td>
<td>13</td>
<td>5</td>
<td>12</td>
</tr>
<tr>
<td>Purchases overstated</td>
<td>3</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Closing stock understated</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Gross profit understated</td>
<td>17</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>Expenses over-claimed</td>
<td>28</td>
<td>13</td>
<td>15</td>
</tr>
<tr>
<td>Technical adjustments</td>
<td>19</td>
<td>10</td>
<td>13</td>
</tr>
<tr>
<td>Other</td>
<td>24</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>106*</td>
<td>57*</td>
<td>68*</td>
</tr>
</tbody>
</table>

- * in one case there may be more than one type of discrepancy
<table>
<thead>
<tr>
<th>Item that should be detected by Auditor</th>
<th>Amount of item for audited year that should be detected</th>
<th>Reasons why the item should be detected</th>
<th>Auditor’s Report</th>
<th>Profits understated for audited year</th>
<th>Tax undercharged for audited year</th>
<th>Total discrepancy amount</th>
<th>Total tax undercharged</th>
</tr>
</thead>
<tbody>
<tr>
<td>Omission and understatement of sales</td>
<td>$13,882,358</td>
<td>The taxpayer carried on the business of import and export of goods. The reported income was an estimate in round sum based on expenses incurred. IRD’s field auditor found that whilst full documentation for individual sales transactions were kept, they were not recorded in the books of accounts of the company.</td>
<td>Unqualified report</td>
<td>$287,973</td>
<td>$51,579</td>
<td>$3,391,227</td>
<td>$495,363</td>
</tr>
</tbody>
</table>