



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



Module Preparation Seminar (Part II)
for
Module D on Taxation

Speaker
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2. QP MD & FE

- ❑ Module D – Learning Outcomes & Chapters 2 & 10
- ❑ PC Taxation - syllabus
- ❑ Final Exam – Special Topics List

DIPN I I - Tax Evasion

- ❑ Definition of “tax evasion”?
- ❑ “Evasion” involves some deliberate act on the part of the taxpayer.
- ❑ Dixon J in *Denver Chemical Manufacturing Co. v. FCT*, 4 AITR 216, at page 222:
 - more than avoid
 - more than a mere withholding of information
 - more than mere furnishing of misleading information
 - **some blameworthy act or omission on the part of the taxpayer or other responsible persons**

Tax Evasion

- ❑ IRD considers that the term “evasion” includes:
 - (a) deliberate non-lodgement of a **return**;
 - (b) deliberate understatement of **income** or over-claiming of **deductions**;
 - (c) understatement of income or over-claiming of deductions owing to ignorance of taxation **obligations**; and
 - (d) overly aggressive **tax planning**.
- ❑ The purpose of **field audit and investigation** is to secure maximum possible voluntary **compliance** through a balanced program of audit and investigation.
- ❑ The three main objectives are:
 - to recover **back taxes**;
 - to provide a deterrent to tax evasion by the imposition of **penalties**, either administratively or through the institution of prosecution action; and
 - to educate taxpayers on the need to file proper and correct **returns**.

Submission of Tax Return

- ❑ Under **section 51(1)** of the Ordinance, a written notice may be given to any person requiring him within a reasonable time stated in such notice to furnish a return of assessable profits.
- ❑ If their businesses generate gross income exceeding the amount specified by the Department, usually in the notes of the return, **supporting documents**, including a copy of the accounts (audited accounts if the taxpayer is a corporation) and a tax computation with supporting schedules showing how the amount of assessable profits is arrived at, are required to be submitted with the completed tax returns.

Assess First and Audit Later (AFAL)

- ❑ Since April 2001, the Department has used a computerised AFAL system for screening tax returns for automated assessment and selecting cases for post assessment audit and investigation.
- ❑ The **AFAL system** screens out the returns which meet the pre-set criteria for automated assessment. A certain percentage of these automated assessments are then selected based on additional criteria for audit and investigation by IRD.
- ❑ Returns not meeting the pre-set criteria for automated assessment are screened manually by assessing officers to determine whether they should be subject to in-depth examination prior to assessment.

Three tier audit system

- ❑ The implementation of the AFAL system enables the Department to focus on assessing complex cases and conducting post assessment **desk audits, field audits and investigations**.

Assessments

- ❑ **Section 59(2)(a)** of the Ordinance provides that where a person has furnished a return under **section 51**, the Assessor may “accept the return and make an assessment accordingly”.
- ❑ Post assessment audits and investigations are to identify possible unassessed or under-assessed cases and selection of cases is either based on risk areas or by random checking.
- ❑ In field audits and investigations, it is necessary that **additional assessments** will be issued after clarifying with the taxpayers. The power of the Assessor to raise assessments under **section 60** of the Ordinance in field audits and investigations has been confirmed in court judgements.
- ❑ In field audits and investigations, assessments are often re-opened because of **additional information** coming to light.

- ❑ A field audit or investigation can be a time consuming exercise and could possibly take more than a year to complete. In order to protect the revenue, it is often necessary for Assessors to raise **estimated assessments** during the course of investigation, particularly in the following circumstances:
 - to meet the 6 year time limit for raising back year assessments under **section 60**;
 - in deceased cases (under **section 54** of the Ordinance, where the person died on or after 11 February 2006, no assessments in respect of a period prior to his death shall be made after the expiry of 3 years immediately after that year of assessment);
 - where the taxpayer is about to **leave Hong Kong**; or
 - where there are indications that the taxpayer is delaying the **investigation process**.
- ❑ In law, the Assessor is not obliged to disclose the basis of the assessment per the judgement in *Mok Tsze Fung v. CIR, 1 HKTC 166*. If he considers it appropriate, the taxpayer should lodge a notice of objection to a protective assessment in order to keep the matter open and accordingly protect his interests.

Desk Audit

- ❑ **Desk audit** is examination of an automated assessment case.
- ❑ During the desk audit, the assessing officer would examine all aspects of the case to see whether the reported profits or income are correct, although special attention should be paid to any risk areas based on which a particular case is selected. **Written enquiries** will be raised when clarifications are to be sought.
- ❑ Taxpayers have to **comply** with the notice issued by the assessing officer and furnish the required information.

Field Audit

- ❑ The Department commenced to conduct field audits of taxpayers' businesses in June 1991 when it set up a Field Audit Group. In April 2000, the Field Audit Group and the Investigation Unit were merged to form the present **Field Audit and Investigation Unit**. **Field audit** action is normally initiated when irregularities or indications of non-compliance with the requirements of the Ordinance are detected.
- ❑ Field auditors ascertain the correctness of returns not only by examining books of account and records, but also by visiting taxpayers' business premises. It gives the Department's enforcement activities a more visible presence, and consequently encourages the lodgement of correct returns.
- ❑ Field audit work is normally focused on the most recent **year of assessment** for which a tax return has been submitted. Where appropriate and when agreed with the taxpayers, field auditors will project the discrepancies for back years based on the field audit findings. Other quantification methods may also be employed for ascertaining the amount of understatements of profits for the years involved.

Investigation

- ❑ **Tax investigation** is an in-depth examination where **tax evasion** is suspected.
- ❑ **Penal action** is taken to create a deterrent effect.
- ❑ An investigation normally covers the **6 years** of assessment prior to the year of assessment in which the investigation commences.
- ❑ In a case of fraud or wilful evasion, the investigation is extended to cover **10 years** of assessment.

- ❑ A taxpayer should make a **full voluntary disclosure** as soon as he notices that his tax affairs are not in order. It is the practice of the Commissioner to be influenced where a person has made a full confession in respect of any offence to which he has been a party, has facilitated investigation and has provided correct returns accompanied by detailed supporting statements. It is important to note, however, that any attempt to make a nominal or partial disclosure (e.g. in the hope that the Department would not take the matter further) would be regarded as a serious aggravating factor.

Process - Case selection

- ❑ The activities of the Field Audit and Investigation Unit are largely targeted at areas where **non-compliance** is apparent. Rigid case selection criteria are not generally applied.
- ❑ To a certain extent, field auditors and investigators are guided by their experience and knowledge in selecting cases through the application functions provided under the AFAL system. Cases may also be selected on a random basis as a means of promoting voluntary compliance.
- ❑ However, it can be said that a field audit or investigation is normally initiated where characteristics or **indications of non-compliance**, such as the following, are present:
 - a) the auditors' report in respect of the accounts of an incorporated business is heavily qualified;
 - b) a business has an unreasonably low turnover or profit percentage (having regard to factors such as the nature of the business, its location and type of customers);
 - c) persistent failure to lodge, or late lodgement of, tax returns;
 - d) failure to keep proper business records; and
 - e) failure to provide material information requested by an Assessor.

❑ Furthermore, where results of audits or investigations indicate that compliance problems are prevalent in a **particular trade or industry**, field audits or investigations on a project basis are generally undertaken in respect of the trade or industry concerned.

❑ The interview is a **fact finding process**. At least two officers of the Department will be present during the interview. The field auditor or investigator will explain the penalty provisions of the Ordinance and request the taxpayer to identify the aspects of the returns which are incorrect. The taxpayer will also be asked to specify the manner of concealment or omission of profits or income. Reasonable time will be allowed to the taxpayer to enable him to prepare revised financial statements and quantify understatements.

- ❑ Following the initial interview, the field auditor or investigator may, under the authority of **section 51(4)(a)** of the Ordinance, issue a notice to the taxpayer requiring him to produce his business books and records for examination.
- ❑ **Section 51C** of the Ordinance requires a taxpayer to keep proper business records and to retain such records for a period of not less than 7 years after the completion of the transactions. The section was amended in 1995 to specify the minimum records that a business must keep and to increase the maximum **fine** for non-compliance to level 6.
- ❑ A taxpayer who fails to produce the relevant records may be prosecuted or asked to pay a **compound penalty** for non-compliance. If a field visit to the taxpayer's business premises is conducted, the field auditor or investigator will be able to gain a better understanding of the operations of the business and of the manner in which the accounting records are kept.

- ❑ The **initial interview** in relation to a field audit case is attended by at least two field auditors and is normally conducted at the business premises of the taxpayer.
- ❑ It is more common for a case of average complexity to take a period of **three to six months to complete**. That said, the speedy progress of a field audit case depends to a large extent not only on the complexity of the taxpayer's business affairs, but also on the support and co-operation of the taxpayer and his representative.
- ❑ Where a taxpayer's returns are defective, full disclosure of the irregularities or omissions by the taxpayer or his representative should be made at the earliest possible time. All proposals and revised accounts or statements are subject to detailed examination and any substantial discrepancy uncovered would be taken into consideration when **penalties** are considered.

Examination of books and records

- ❑ **Section 51C** of the Ordinance has set out in detail what are regarded as “records” for taxation purposes, and to specify the minimum records that must be maintained by a taxpayer to enable, in effect, business transactions to be traced, explained and verified.
- ❑ To this end, the section now requires that businesses keep books of account and the underlying documents, such as vouchers, bank statements, invoices and receipts, which substantiate the entries in the accounts. The **record keeping requirements** stipulated in the Ordinance are further discussed in the information pamphlet entitled “A Guide To Keeping Business Records”, which may be downloaded from the Department's website.

Settlement methods

- ❑ A key element in determining the appropriate method of quantification to be used is the reliability of the taxpayer's books and records. If they are reliable, a “**direct**” **approach** can be used, whereas if they are incomplete or unreliable, an “**indirect**” **method** will be called for.
- ❑ Experience has shown that one of the common areas for irregularities and errors is in relation to the recording of details in respect of **trading stock figures**. If warranted, the field auditor or investigator may also attend the physical stocktaking of the taxpayer. Such attendance may help ascertain whether proper steps and procedures have been taken to ensure the accuracy of the figures reported.
- ❑ The back duty assessments generally have to be based on indirect methods. Indirect methods are founded on an investigation of the taxpayer's personal affairs. There is no single “best” indirect method of quantification. One commonly used method involves the preparation of an **Assets Betterment Statement**. Others include the **Bank Deposits Method**, the **Business Economics (Percentage Computation) Method**, and the **Projection Method**.

Settlement methods

- ❑ In essence, the function of an ABS is to disclose the correct taxable profits or income of a person by adding to the person's yearly asset increase (i.e. the excess of net assets in any one year over the previous year) all expenditure of a non-allowable nature. Receipts which are of a capital nature or otherwise not assessable are deducted from the sum of these items to arrive at the betterment profits (adjustments are also made if necessary in respect of any applicable depreciation allowances or balancing charges). This can be summarised simply by the following formula : **Betterment Profits = Increase in Net Assets + Disallowable Expenditure – Non-taxable Receipts**
- ❑ **Bank Deposits Method:** For wholly or partly cash trade businesses, it is worthwhile to prepare a monthly summary of the bank deposits to help ascertain if there are any other bank accounts which have not been detected (e.g. this may be apparent if there are marked fluctuations in monthly deposits). An adjustment for the amount of cash receipts directly used for payment of business and personal expenses is required. It is generally acceptable to apply the “**average**” or “**representative**” **gross profit ratio to the total bank deposits** to quantify the understatement of gross profits. In doing so, it should always be borne in mind to exclude those deposits, such as rebates, commission, sale of scrap, etc., which are entirely assessable. However, unidentified deposits are usually included on the assumption that they are ordinary business receipts.

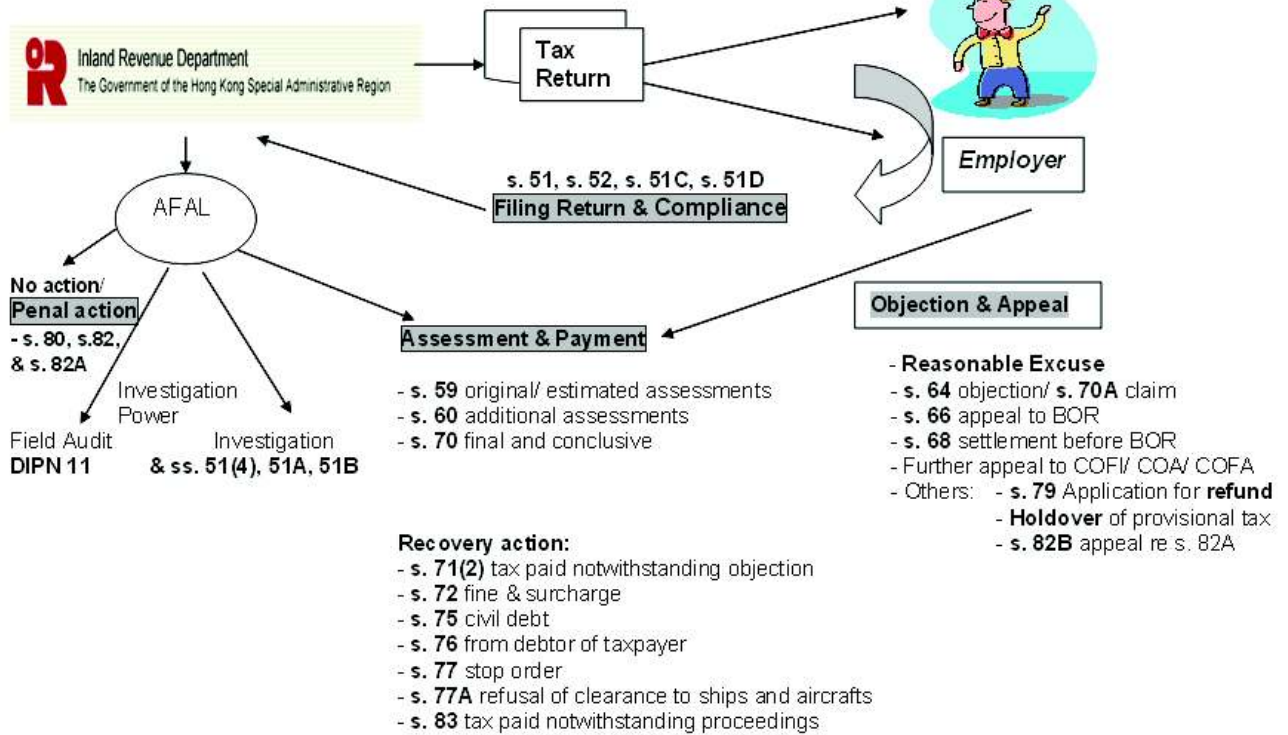
Settlement methods

- ❑ **Percentage Computation Method** - This method involves the **application of percentages or ratios** (considered typical of business operations similar to those of the taxpayer) to **particular known amounts**, for the purpose of computing figures required to determine the taxpayer's assessable profits.
- ❑ **Projection Method** - Where the representative is confident that the taxpayer's assessable profits have been correctly determined for a particular year of assessment, the relevant figure may be used for the purpose of estimating assessable profits for years where profits have been understated (provided that a more accurate means cannot readily be used). In such circumstances, this method can be a useful means of expediting the settlement of a field audit or investigation. However, care should be taken to ensure that the **basis of projection** is reasonable and can be supported by reliable primary data. Any changes in the taxpayer's operation or business environment should also be taken into account.

Finalizing an audit or investigation

- ❑ The settlement form only covers the taxpayer's basic tax liabilities for the years in question. It is clearly stated on the form that acceptance of the specified additional assessable profits or income does not conclude the whole matter and that the case will be put up to the Commissioner or a delegated senior officer for consideration of penalty action. In this regard, the field auditor or investigator reminds the taxpayer that any agreed understatement of profits or income may be subject to **penalty action under section 80, 82 or 82A of the Ordinance**.
- ❑ Furthermore, where it has been established during the course of an audit that the taxpayer has failed to **comply with other requirements** laid down in the Ordinance (e.g. those concerning the keeping of proper books and records, or the requirement to inform the Commissioner of chargeability to tax), the taxpayer's attention is also drawn to relevant provisions.

Mind Map



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Exercises

Practice Q1 & Q2

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- ❑ Where transactions involve a **related company incorporated overseas**, field auditors commonly examine issues such as the following:
 - (a) the deductibility of expenses or payments to the related offshore company;
 - (b) the extent to which the Hong Kong company's expenses were incurred in the production of profits of the related offshore company;
 - (c) the chargeability to Hong Kong profits tax of the profits of the related offshore company.
- ❑ Information relating to the issue of whether an offshore company has derived assessable profits (or the quantum of such profits), including profits tax returns, supporting accounts, bank statements and underlying books and records, must be provided if requested, irrespective of the place of incorporation of the company concerned. Failure to provide full and complete information may lead to an estimated assessment being raised under section 59(2)(b) or 59(3) of the Ordinance. In such a case, the basis of determination of any subsequent objection or appeal would be dependent upon the provision of all necessary information.

- ❑ From time to time, field auditors come across cases where offshore companies chargeable to profits tax under **sections 14, 15(1)(a), 15(1)(b), 15(1)(ba), or 21A** have failed to report their liabilities.
- ❑ Where a taxpayer deals with a closely connected non-resident person on a non-arm's length basis, **section 20(2)** of the Ordinance has application where the course of business between a taxpayer and a closely connected non-resident person is so arranged that it produces to the taxpayer either no profits which arise in or derive from Hong Kong, or less than the ordinary profits which might be expected to arise in or derive from Hong Kong. The section provides that in such a situation the business done by the non-resident person in pursuance of his connection with the taxpayer shall be deemed to be carried on in Hong Kong, and that the profits of the non-resident person shall be assessed in the name of the taxpayer as if the taxpayer were the agent of the non-resident person.
- ❑ Apart from section 20(2), the Department may also apply the **general anti-avoidance provisions or other provisions** of the Ordinance relevant to the circumstances of the case to ensure that tax is not avoided.

- ❑ The Department takes a serious view of any scheme which involves a taxpayer carrying on business in Hong Kong seeking to “**book**” **Hong Kong profits** to an offshore associate. Typically such cases involve circumstances where:
 - (a) the non-resident person does not carry out substantial activity on its own in HK or elsewhere (e.g. it does not run an office or employ staff);
 - (b) the taxpayer performs all the activities in Hong Kong which in substance give rise to the profits;
 - (c) there is no commercial justification for the establishment of the non-resident person; and
 - (d) the profits are merely “booked” in the accounts of the non-resident person.
- ❑ The Department does not hesitate to apply the general anti-avoidance provisions of the Ordinance in relation to any such case. The imposition of penalties is considered if relevant facts are not disclosed as and when required. In the latter regard, opportunity is taken to remind taxpayers and their representatives of the need, when completing tax returns, to accurately answer the questions concerning transactions for/with non-residents.

Penalties

- ❑ One of the main purposes underlying the Department’s field audit and investigation activities is to deter tax evasion. The deterrent effect could not be accomplished without the imposition of penalties. Where requirements under the Ordinance are not complied with, the relevant penal provisions allow, depending on the nature of the matter involved, **prosecution action under sections 80 and 82** or **assessment to additional tax under section 82A**. The Ordinance also provides in sections 80 and 82 that as an alternative to proceeding with a prosecution, the Commissioner may “**compound**” **the relevant offence** (i.e. accept a monetary settlement instead of sanctioning the institution of a prosecution).
- ❑ So far as is relevant, the maximum penalty under section 80 is a **fine** at level 3 for each offence and a further fine of **treble the amount of tax undercharged**.
- ❑ The maximum penalty under section 82 is:
 - On summary conviction - A **fine** at level 3 for each offence and a further fine of **treble the amount of tax** which has been **undercharged** in consequence of the offence, or which would have been undercharged if the offence has not been detected, and to **imprisonment for 6 months**.
 - On indictment - A **fine** at level 5 for each offence and a further fine of **treble the amount of tax** which has been **undercharged** in consequence of the offence, or which would have been undercharged if the offence has not been detected, and to **imprisonment for 3 years**.

Penalties

- ❑ If no prosecution has been instituted under section 80(2) or 82(1) against the taxpayer in respect of the omission of assessable profits, the Commissioner may impose **additional tax under section 82A of the Ordinance**. The **maximum penalty is 3 times** the amount of **tax** which has been **undercharged** in consequence of the omission, or which would have been undercharged if the omission had not been detected.
- ❑ Before making an assessment of additional tax, the Commissioner or Deputy Commissioner arranges for a **notice** to be given to the taxpayer stating the offence in respect of which he intends to assess additional tax. The taxpayer is then allowed a specified period of at least 21 days to make **written representations** with regard to the proposed assessment to additional tax. The Commissioner or Deputy Commissioner considers and takes into account any representations received during the specified period when determining the amount of additional tax. The taxpayer can **appeal to the Board of Review** against the assessment to additional tax if he is aggrieved by the assessment.

Exercises

Practice Q3 & Q4

Question Bank: Q1 – Assessments

Mr. and Mrs. Chan carry on a trading business in Hong Kong via Late Ltd (Late). Late has been reporting tax losses in all previous years up to the year of assessment 2009/10, which is the last year for which a profits tax return has been filed.

In April 2013, the Inland Revenue Department issued the company's 2012/13 profits tax return for completion. Due to a lack of communication between Mr. and Mrs. Chan, the 2012/13 tax return was not attended to. In September 2013, Mr. Chan received an estimated profits tax assessment for the year of assessment 2012/13 dated 5 September 2013 seeking to tax an estimated assessable profit of \$1,000,000. Mr. Chan is shocked by the assessment and seeks advice on the course of actions available to him.

Required:

(a) Explain the circumstances leading to the issuance of an estimated profits tax assessment by the Inland Revenue Department as found in the case of Late Ltd.

(5 marks)

(b) Explain the various courses of action available to Mr. Chan and their respective implications or consequences.

(11 marks)

(16 marks)

Answer 1

- (a) An estimated assessment may be issued by an assessor under s.59 of the IRO under any of the following circumstances:
- (i) Where the taxpayer fails to file the required tax return after the expiry of the specified period but the assessor is of the opinion that the taxpayer has income chargeable to tax under the IRO. Such estimated assessment will not affect the liabilities of the taxpayer to be subject to a penalty by reason of the failure or neglect to file the return.
 - (ii) Where the taxpayer has submitted the tax return but the reported profits are not accepted by the assessor. Examples include those returns that may contain insufficient information to enable the tax to be ascertained or that may contain certain income or deduction items that are disagreed with by the assessor. The assessor may then make an estimate based on the information available or by reference to his/her past experience or the results of similar taxpayers.
 - (iii) Where the assessor finds or considers that the books and accounts of the taxpayer have not been satisfactorily or adequately kept, leading to the concern that the tax return may not be reliable. In these circumstances, the assessor may make reference to the industry practice and its usual rate of profit for that type of trade or business to the turnover for the relevant period.

In the case of Late Ltd it is obvious that the issuance of an estimated assessment was driven by the failure to file the 2012/13 profits tax return issued in April 2013. In the absence of the tax return as well as any response from the company to apply for an extension for filing etc the assessor has chosen to issue the estimated assessment. However, given that the estimated assessment was issued with a significant profit, it is likely that there should be other information available to the assessor leading to the belief that Late Ltd has such an amount of profit chargeable to tax.

- (b) On behalf of Late Ltd, Mr. Chan should immediately file a valid objection against the estimated assessment under s.59 (3) of the IRO. To ensure that the objection is valid, Mr. Chan must observe the following:
- (i) The objection must be lodged in writing addressed to the Commissioner.
 - (ii) The objection must state precisely the grounds for the objection, such as the estimated profits being too excessive and why.
 - (iii) The objection must be received by the Commissioner within one month after the date of the notice of estimated assessment, unless the Commissioner extends the permitted period or accepts a late notice based on a reasonable cause.
 - (iv) In Late Ltd's case, since the estimated assessment was issued under s.59(3), i.e. in the absence of a valid return, the objection must also be lodged together with a valid return of income, including all the documents required to be submitted with the tax return such as the income statement and relevant documents in support thereof.

In lodging the objection, Mr. Chan may consider applying for the tax to be held over pending the determination of the objection. It is of course subject to the agreement of the Commissioner who will consider the application and determine whether and how the holdover would be granted. There are various choices of tax holdover to be considered by Mr. Chan:

- (1) Unconditional holdover – i.e. The amount of tax assessed will not be payable until the objection is determined. This would usually be granted if it is quite obvious that the objection would be allowed (e.g. a mistake has been made by the assessor, new facts are presented or the assessment is estimated and a return has been supplied with adequate and correct information), or where a highly contentious point of law is involved. However, Mr. Chan should take note that, in the event that the tax becomes ultimately payable, it would carry interest from the later of the original due date or the date of the holdover notice to the date that the objection is determined.
- (2) Holdover with tax reserve certificate – i.e. a tax reserve certificate of an amount equivalent to the tax amount assessed is required to be purchased as a condition for granting the holdover. It is the usual practice to specially earmark the certificate with the objection lodged, so as to distinguish this from other tax reserve certificates that may also be bought by the same taxpayer. This earmarked certificate will only bear interest if the tax is ultimately held not to be payable and this certificate is therefore surrendered for cash.
- (3) Holdover with bank guarantee – i.e. a bank guarantee or undertaking is required to be issued by a local bank to cover the tax in dispute plus any interest that may accrue. This is usually granted only when the taxpayer may have financial difficulty in purchasing the tax reserve certificate. Interest would be charged in the same manner as for unconditional hold-over on the amount that has been held over but becomes payable upon settlement of the objection.

In the case of Late Ltd Mr. Chan should first consider which holdover option he would prefer based on his assessment of the present case in dispute. If he is confident that the estimated assessment must be an error and will be annulled ultimately, he should apply for an unconditional holdover. However, if there is a possibility that a certain amount of tax is ultimately found payable, he may consider applying for a holdover with tax reserve certificate. As noted above, the preferred option suggested by Mr. Chan will still be subject to agreement by the Commissioner.

Question Bank: Q2 – Merger & acquisition

The director of Expansion Co Ltd (Expansion Co) recently gave a briefing on the outcome of the due diligence conducted on a company targeted for acquisition (Target Co). The tax related aspects of the briefing are summarised as follows:

- (a) Target Co has assessable profits of \$12 million for the year of assessment 2006/07. A tax assessment was issued per the tax return and tax payments were made before the due dates.
- (b) Copies of profits tax returns for the years of assessment from 2002/03 to 2006/07 have been obtained and found to be in order. All years were tax-paying and assessments were issued per the tax returns lodged.
- (c) No record of any tax query from the Inland Revenue Department (IRD) was found.
- (d) The shareholder of Target Co has agreed to include the following clauses in the 'Share Sale and Purchase Agreement':
 - (i) Clause 4.1 – Seller (i.e. Shareholder of Target Co) hereby warrants and guarantees that all tax assessments prior to and including 2006/07 are finalised with no outstanding tax queries.
 - (ii) Clause 4.2 – Seller has agreed that, in the event of any tax queries or additional assessment raised by the IRD in respect of the years of assessment prior to and including 2006/07, Seller (including the directors of Target Co as named in Appendix A) will be fully responsible for handling the tax queries directly with the IRD, including negotiating with the IRD on behalf of the company.

Required:

Advise the director of Expansion Co Ltd on each of the above points covered at the due diligence briefing. You should address any potential tax risks that may be faced by Expansion Co Ltd in respect of the acquisition of Target Co in terms of tax compliance and whether the suggested clauses 4.1 and 4.2 to be included in the Share Sale and Purchase Agreement are sufficient and would be effective to protect Expansion Co Ltd (and Target Co) in the event of a tax challenge being raised for any prior year.

(16 marks)

Answer 2

From the briefing, it would seem that Target Co has maintained a satisfactory level of tax compliance in terms of profits tax return filing and tax payments. There is no record of tax queries raised by the IRD in prior years. This may indicate that the tax returns have been prepared at a very good standard and/or no major and contentious tax adjustments have been made in the tax returns filed. However, it is assumed that all tax records are made available for due diligence purpose or requests for information for inspection have been properly and completely made. To avoid unnecessary misunderstanding or disputes on unintentional non-disclosure, the seller, i.e. the shareholder of Target Co, should give an undertaking that all tax related records have been fully disclosed and made available during the due diligence.

The question states that all prior years' assessments were issued per the tax returns lodged. The shareholder also agreed to undertake that these assessments were finalised (clause 4.1). Unfortunately, this undertaking is not practically effective. Under the IRO, s.60 (1) empowers the assessor to raise any assessment within six years after the end of the year of assessment in which the transaction or event occurs. In the case of fraud or willful evasion, the six-year time limit prescribed for raising an assessment is extended to 10 years. The power also extends to additional assessments in respect of any year of assessment for which an assessment has already been issued, if the assessor is of the opinion that the taxpayer has been under-assessed for that year of assessment.

Moreover, under s.70, an assessment is final and conclusive only if:

- (i) no valid objection or appeal has been lodged;
- (ii) an objection or appeal has been withdrawn or an appeal has been dismissed;
- (iii) the assessment under an objection has been agreed; or
- (iv) assessment is determined upon objection or appeal and no further appeal has been lodged.

Based on the proviso to s.70, the assessor can still raise an additional assessment to a final and conclusive assessment provided that it does not involve re-opening any question or matter which has previously been determined on an objection or appeal.

Further, Target Co has a number of obligations to comply with pursuant to the IRO, e.g. complete and correct filing of employer's returns for pension and remuneration accrued to its officers and employees. The briefing did not represent or warrant that Target Co has fully complied with such obligations.

Therefore, instead of asking for an undertaking, Expansion Co should ask for an indemnity from the seller to shelter any additional tax liabilities that may arise as a result of additional assessments being raised by the assessor within the time limit of six years, or ten years in the case of fraud or willful evasion plus the penalty thereon, if any, as well as all liabilities arising from failing to comply with any of the obligations under the IRO.

Any notice of additional assessment will be issued to Target Co as a separate and independent legal entity. It will not be issued to the seller (i.e. the current shareholder of Target Co) nor to Expansion Co. It is not affected by the fact that the company's management or shareholding has been changed. Target Co cannot use this as an excuse to avoid responding to any queries raised by the assessor. It may be possible for the company to request for additional time to submit the information required on the basis that the change in the company's management might have an impact on the collection of information.

However, when queries and additional assessments are raised, the management of Target Co is responsible for handling them with the IRD. Although Target Co may appoint the seller or Expansion Co or any other person if appropriate as its representative in dealing with the IRD, the primary responsibility is still on Target Co. As such, the inclusion of clause 4.2 in the Share Sale and Purchase Agreement to hold the seller as well as the previous management persons responsible is not

practically effective. Moreover, should there be any tax payments to be made; it would be for the account of Target Co but not the seller or any individual person.

To protect Expansion Co against any potential additional tax liability, penalty and costs arising to Target Co from any event occurred before the change in shareholding, an indemnity should be obtained from the seller, i.e. the current shareholder of Target Co, so that any additional tax cost including penalty, costs for failing to comply with the said obligations and surcharge may be compensated by them.

Another risk to Expansion Co is that if the conduct of handling any tax query or assessment is being placed in the hands of the persons who are no longer the current management of the company, the company's interests may not be well protected. In the event that an additional (or estimated) assessment is issued and disagreed by the company, objection should be lodged in writing within one month, addressed to the CIR, stating clearly the ground of objection. If no objection is lodged before the due date, the assessment will become final and conclusive after that date and cannot be challenged further.

Other courses of action may include whether tax payment should be made or held-over. These courses of actions would involve a great deal of management decisions to be made in the best interests of Target Co. Expansion Co should ensure that Target Co retains the rights and controls over the conduct of these tax disputes after the acquisition and secure an undertaking from the seller that it would provide necessary information and other assistance to Target Co in attending to these disputes.

Question Bank: Q3 – Anti-avoidance

Assume today is 1 December 2013.

Aggressive Co Ltd (the Company) carries on a project consultancy business in Hong Kong, and makes up its accounts to 31 December each year. In reviewing the Company's projected profit and loss account for the year ending 31 December 2013, the Company's financial controller was concerned about the significant profits earned resulting in an increase in both the 2013/14 final profits tax and the 2013/14 provisional profits tax payable. He has the following ideas in mind:

(a) He has identified two fee invoices that have been issued to customers on 30 November 2013. Corresponding credit notes will be issued to cancel the invoices; and identical invoices will be re-issued to the customers in January 2014.

(b) An expense voucher will be prepared to claim a whole year's salary payable to an independent project consultant engaged to work for the Company during the year ending 31 December 2013. The named project consultant will be the financial controller's mother, who is a full-time housewife.

Required:

In the context of tax avoidance, discuss the extent of risk to Aggressive Co Ltd arising from the implementation of the financial controller's ideas.

Note: you are not required to discuss any accounting or auditing implications for Aggressive Co Ltd, or the tax positions of the relevant customers or of the independent project consultant under the respective ideas.

(17 marks)

Answer 3

There are two general anti-avoidance provisions under the IRO, ss.61 and 61A. Under s.61, the Assessor is empowered to disregard a transaction and assess the taxpayer accordingly, if:

- (a) There is a transaction, being the whole transaction rather than the part of it;
- (b) The transaction is artificial or fictitious, generally referred to as a transaction that is not commercially realistic; and
- (c) The transaction has the effect of reducing the tax payable.

In the case of Aggressive Co Ltd (the Company), 'transactions' would refer to the cancellation of the November invoices and the re-issuance of the January invoices under idea (a); and the preparation of a salary voucher to the individual project consultant under idea (b). These transactions would be artificial or fictitious unless there is commercial reason to cancel the November invoices and replace them with the January invoices; and unless the individual consultant has actually performed the consultancy services to the Company.

The last condition for s.61 to apply is that the transaction must have the effect of reducing the tax payable. This would be applicable to idea (b) where the expense voucher would have the effect of increasing the Company's deductible expenses and reducing the Company's tax payable for the year. However, it may not be applicable to idea (a) on the basis that the tax liability of the Company has not been 'reduced', but only 'postponed' from 2013/14 to 2014/15. As a result, s.61 may not apply to 'disregard' the transaction under idea (a).

In 1986, the second general anti-avoidance provision, s.61A, was introduced. For s.61A to apply, the conditions to be fulfilled are: (1) there must be a transaction which includes a transaction, operation or scheme whether or not they are enforceable by legal proceedings; and this covers single, multiple or composite transactions; (2) the taxpayer must obtain a tax benefit which is defined to include (i) the avoidance of tax liability, (ii) the postponement of tax liability by shifting the tax to a later year, or (iii) the reduction in the amount of tax by altering the assessable profit/income to a lower level; and (3) having regard to the seven specific matters, the transaction must be entered into or carried out for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit.

In the case of the Company, conditions (1) and (2) are satisfied. As for (3), the seven specified matters as defined under DIPN No. 15 (revised) are:

- (i) The manner in which the transaction was entered into or carried out

In this case, the fact that the November invoices have already been issued but subsequently cancelled before the year end and replaced by January invoices would be sufficient to support that the transaction was intended to be removed from the accounting year 2013, unless there is a justified commercial reason to explain. The preparation of an expense voucher under idea (b) right before the year end but covering the salary for the whole year is another example of a pre-year end transaction aimed at altering the Company's profits for 2013.

- (ii) The form and substance of the transaction

The legal form of the transaction under idea (a) would be the invoices and credit notes. This legality would be compared to the substance of the transaction, i.e. what is the reason for the cancellation of the November invoices and re-issuance of the January invoices. For idea (b), the expense voucher is not sufficient unless a letter of engagement is in place. Moreover, the substance of idea (b), i.e. whether and what services have actually been performed would be examined.

(iii) The result that would have been achieved by the transaction without s.61A

If s.61A was not applicable, the relevant fee income from the November invoices would become taxable income for the year ending 31 December 2014 instead of 31 December 2013, and the tax liability is postponed. This is a timing effect. Moreover, the Company's profits tax payable for 2013/14 would be reduced to the extent the individual consultant's salary is allowed as a tax deduction.

(iv) Any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction

If both ideas are implemented, the changes in the Company's financial position would include the deferral of tax payment in respect of the November invoice values and the reduction of its tax liability in respect of the consultant's deductible salary.

(v) Any change in the financial position of any person who has, or has had, any connection with the relevant person

Under idea (a), the change in financial position of the Company's customers would be the deferral of fee payments and the corresponding tax deductions in their own tax returns. This is again a timing effect. Under idea (b), whether there is any change in the financial position of the individual project consultant (the financial controller's mother) would depend on the income position of that individual. If the named individual does not earn any income during the year and the amount of salary does not exceed the statutory personal allowance, she may not be subject to any tax and thus her financial position is not changed before and after the transaction.

(vi) Whether the transaction has created rights and obligations that would not normally be created between persons dealing with each other at arm's length under a similar transaction

The cancellation and re-issuance of the November invoices do not seem to have altered the rights and obligations of the Company or its customers other than the fact that this would not normally happen in an arm's length situation. As for idea (b), unnecessary rights and obligations have been created to the financial controller's mother unless she is *de facto* competent to perform the services (albeit being a housewife) and have actually performed such services.

(vii) The participation in the transaction of a corporation resident or carrying on business outside Hong Kong

This matter is not relevant in the Company's case.

Based on DIPN No. 15 (revised), each of the above matters would be considered and weighed in order to draw a conclusion as to whether the transaction was entered into for the sole or dominant purpose of obtaining a tax benefit. Each matter does not necessarily carry equal weighting and each case has to be considered on its own merit. Based on the above analysis, it is likely that the transactions conducted under both ideas (a) and (b) would be considered as carried out for the sole or dominant purpose of obtaining a tax benefit.

The consequences to the Company would be an assessment to be made by the Commissioner on the basis that either the transaction did not take place; or that an arm's length value is substituted. As a result, for idea (a), it might be possible that the January invoices would be disregarded and the original November invoices would be recognised as part of the 2008 assessable profits of the Company. The tax assessment for 2013/14 would be issued accordingly. As for idea (b), it is likely that the salary voucher would be ignored and no deduction would be allowed to the Company.

Question Bank: Q4 - Investigation

Your client, Ms Lim, is the sole proprietor of a garment business. She has recently received a query from the Inland Revenue Department (IRD) regarding the source of funds she used to purchase two flats in late 2013. The IRD has found that Ms Lim had not reported all the business' sales in her profits tax returns submitted for the years of assessment 2005/06 to 2012/13. The omitted sales represented about one-fifth of the total sales.

Ms Lim told the IRD that she was illiterate and relied on her bookkeeper to handle all the accounting and tax matters. She claimed to have no knowledge of the omission. Although she now wants to disclose her true profits to the department, her accountant has not kept proper books and records from which you could prepare revised accounts.

Required:**(a) Advise Ms Lim on the following matters:**

- (i) The obligations that are contained in the Inland Revenue Ordinance in regard to the keeping of business records. (4 marks)**

 - (ii) The penalty and prosecution action (if any) that could be taken against her by the Inland Revenue Department. (9 marks)**
- (b) You have decided to prepare an assets betterment statement for submission to the Inland Revenue Department. Make a brief list of the initial information and records you would require Ms Lim to produce to you. (4 marks)**

(Total 17 marks)

Answer 4

- (a)
- (i) The statutory obligation to keep business records is contained in s.51C which requires every person carrying on a trade, profession or business to keep sufficient records, either in English or Chinese, of income and expenditure to enable the assessable profits to be readily ascertained. Further, there is an obligation to retain such records for at least seven years after the transactions to which they relate, subject only to the following exceptions (neither of which is relevant to this case): 2
- (1) When a corporation has been dissolved all records may be destroyed.
 - (2) Records may be destroyed in any other case where the Commissioner gives his consent. 1
- 'Records' include books of account (whether in legible form or by computer), receipts and payments, income and expenditure, together with vouchers, bank statements, invoices, receipts and other documents necessary to verify the entries in the accounts. It also includes records of assets and liabilities, goods purchased and sold, details of sellers and buyers, records of stocktakings and records of services provided. 1
- (ii) With regard to the omission of sales, s.80 (2) (a) provides, *inter alia*, that any person who without reasonable excuse makes an incorrect return by omitting or understating something is guilty of an offence. If prosecuted and convicted, the maximum punishment is a fine at level 3 (\$10,000) for each charge and a further fine of treble the amount of tax that has or would have been undercharged as a result of the omission or understatement. The Commissioner may compound these offences and settle for a monetary penalty under s.80 (5). 1.5
- In cases of fraud and willful evasion, action may be taken under s.82 (1) which can lead to imprisonment in addition to the usual fines. In order for a prosecution under s.82 to succeed, fraud or willful default to evade tax must be proved; and in practice this may be difficult. The following acts, if committed with the deliberate objective of evading tax, fall within the provisions of s.82 (1):
- (1) An omission from a return.
 - (2) A false entry or statement in a return.
 - (3) A false statement in a claim for a deduction or allowance.
 - (4) Signing a statement/ return without reasonable grounds for believing it is true. 2
- In Ms Lim's case, in view of the magnitude of the understatement, the recurrent omission over eight consecutive years, Ms Lim's willful intent to evade tax is likely established. Prosecution under s.82 (1) may be instituted against Ms Lim. The maximum punishment under s.82 is a fine at level 5 (\$50,000) for each charge and a further fine of treble the amount of tax undercharged and imprisonment for three years. It should also be noted that multiple offences may be committed by Ms Lim under s.82 (1), e.g. the omission of sales may amount to both an omission from the return as well as a false entry or statement in a return. The Commissioner may, however, compound these offences under s.82 (2). 2
- If no prosecution under s.80 (2) or 82(1) has been instituted, the Commissioner or Deputy Commissioner may penalise Ms Lim by way of assessment to additional tax under s.82A up to a maximum of treble the amount of tax undercharged. Section 82B provides Ms Lim with a right of appeal to the Board of Review against the imposition and/or quantum of any additional tax assessed. 1

Illiteracy and reliance on bookkeepers may not be sufficient defenses in a prosecution which is a criminal proceeding, nor are they reasonable excuses in terms of ss.80 or 82A. Ms Lim's co-operation and full voluntary disclosure might be considered as mitigating factors when passing sentence or imposing monetary penalties. The time span and magnitude of the understatement, however, are aggravating factors.

1.5

With regard to the failure to keep adequate business records without reasonable excuse, this is an offence under s.80 (1A). Under s.80 (1A) the court may impose a maximum fine at level 6 (\$100,000) but the Commissioner may, and often does, compound the offence under s.80(5).

1

(b) At the outset, you should require *inter alia*:

- (1) A list of the business books (if any).
- (2) A list of the bank accounts in operation, both business and personal.
- (3) A list of property, investments and other assets, including such items acquired in the name of other persons.
- (4) A list of bank accounts which have been closed and particulars of property etc, sold during the relevant period.
- (5) A list of all liabilities.
- (6) A list of the assets and liabilities on hand at the beginning of the relevant period.
- (7) A copy of the tax returns and assessments raised.
- (8) A list of the name of all family members.
- (9) A list of debtors and creditors at the beginning and end of the period under investigation.

0.5 marks each, maximum 4