

TAX BULLETIN

ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG SOCIETY OF ACCOUNTANTS — 2000



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SOCIETY OF
ACCOUNTANTS

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Preamble

As part of the Society's regular dialogue with the Government to facilitate tax compliance, improve procedural arrangements and to clarify areas of interpretation, representatives of the Society met the Commissioner of Inland Revenue ("CIR"), and members of her staff in March 2000.

As in the past, the agenda took on board items received from a circulation to members of the Society prior to the meeting. The minutes of the meeting, prepared by the Inland Revenue Department ("IRD") are reproduced in full in this Tax Bulletin and should be of assistance in members' future dealings with the IRD. Part A contains items raised by the Society and Part B, items raised by IRD.

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Full Minutes

The 1999/2000 annual meeting between the Hong Kong Society of Accountants' Taxation Committee and the Commissioner of Inland Revenue was held on Friday, 3 March 2000 at the Inland Revenue Department.

IN ATTENDANCE

Hong Kong Society of Accountants (HKSA)

Mr Tim Lui	Chairman, Taxation Committee
Ms Yvonne Law	Member, Taxation Committee
Ms Elizabeth Law	Member, Taxation Committee
Mr John Reid	Member, Taxation Committee
Mr David Smith	Member, Taxation Committee
Ms David Southwood	Member, Taxation Committee
Mr Peter Tisman	Deputy Director of Professional Practices

Inland Revenue Department (IRD)

Mrs Agnes Sin	Commissioner of Inland Revenue [CIR]
Mrs Alice Lau	Deputy Commissioner of Inland Revenue (Technical)
Mr Elmo D'Souza	Deputy Commissioner of Inland Revenue (Operations)
Mr Patrick Tam	Assistant Commissioner of Inland Revenue
Mr Raymond Luk	Assistant Commissioner of Inland Revenue
Mr Trevor Richmond	Senior Assessor (Special Duties)

The CIR welcomed the Society's representatives to the meeting. After introducing the IRD members, she reiterated her support for the annual meeting as a practical forum of communication between the Society's members and IRD on areas of mutual concern.

Mr Lui, after thanking CIR for her warm welcome, confirmed the Society's commitment to the meeting as a channel for resolving technical problems that arise from time to time. Discussion of the meeting's agenda then commenced.

AGENDA ITEM A1 – INTERPRETATION AND PRACTICE NOTES

A1(a) DIPN No. 1.

The Society asked why the reference to “valuation surplus” in the former paragraph 17 of DIPN No. 1 had been deleted.

The CIR advised that paragraph 17 of the superseded DIPN No. 1 reflected the Sharkey v Wernher principle. Since there were conflicting Board of Review decisions on applicability of the principle in Hong Kong, when the DIPN was revised, in October 1998, the reference was omitted pending the clarification through the Courts. She also said that in the “Quitsubdue” decision, the applicability of the Sharkey v Wernher principle to Hong Kong was obiter. IRD is awaiting a direct ruling on this point. In the interim, Sharkey v Wernher continues to apply in appropriate circumstances. She said the DIPN will further be revised once the issue is clarified.

The CIR also indicated that capital increments in the value of property prior to the date of a change of intention would be excluded from trading profit.

A1(b) DIPN No. 21

The HKSA wished to know if IRD intends to review DIPN No. 21 in the light of the OECD guidelines for the taxation of financial institutions involved in global trading.

The CIR advised that DIPN No. 21 (dealing with the locality where profits are earned) has a separate section specifically addressing the practices for financial institutions. The current practice is working well and no difficulties had been encountered.

The OECD has, she said, only issued a discussion draft on the Taxation of Global Trading of Financial Instruments in 1998. This is not confined to the taxation of financial institutions. The basic principles of the operations test still apply. The matter is still in the development stage and IRD will keep a watch on emerging developments. In the interim, cases will be looked at reasonably and Hong Kong's source rules will be applied.

As regards advance pricing agreements made in other jurisdictions, the CIR indicated that IRD may be prepared to consider them if they were reasonable.

A1(c) Salaries Tax Implications of Stock Options

The HKSA asked if IRD is planning to issue a DIPN on the salaries tax implications of issues of stock options to employees. It also wished to know IRD's view of the taxation position where the award or exercise of an option takes place prior to assignment to, or post-departure from, Hong Kong.

The CIR advised that the question of issuing a DIPN on the treatment of stock options under salaries tax is currently under consideration. This involves a thorough review of a range of

issues associated with stock options issued to employees, including those mentioned by the Society. She said that if it is decided to proceed with the DIPN, efforts will be made to cover all of the more common issues, including the two scenarios put forward by the Society. Any DIPN issued will reflect the law, as IRD sees it to be, at the time the DIPN is issued.

A1(d) Authority of DIPNs

The HKSA wished to know if DIPNs can be regarded as being binding on the Department in all circumstances. If the answer was “no”, it wanted to know under what circumstances they could be overruled. In particular, the Society sought to clarify the application of DIPN No. 15 in relation to invoking section 61A.

The CIR noted each DIPN's cover sheet states that it is issued for the information and guidance of taxpayers. A DIPN is the Commissioner's interpretation of the law and not the law itself. Although DIPNs do not bind either the Commissioner or taxpayers, assessors will normally follow DIPNs. However, assessors must exercise professional judgment and there can be no “hard and fast” rule but it is only in exceptional cases that a treatment deviating from that laid out in the DIPN may be necessary. Objections against such assessments are dealt with in the usual way.

Mr D'Souza confirmed that when raising assessments under section 61A, the specified procedure is always followed. Section 61A(2) provides that the power to make an assessment under section 61A can only be exercised by an assistant commissioner. Assistant commissioners consider the seven factors specified in the section prior to making the assessment.

AGENDA ITEM A2 – PROFESSIONAL INCOME RECEIVED INDIRECTLY

The Society pointed out that professional persons, and doctors in particular, receive income directly through their practice and indirectly through consulting work carried out work at other institutions, such as hospitals. Administrative problems arise when the professional person returns his income under profits tax but (for example) the hospital where he consulted (and which collected on his behalf the professional fees due to him from the patients) reports such payments using Form IR56B. It suggested the problem could be avoided if the institutions reported these payments using Form IR56M. It suggested IRD issued guidance notes to relevant organizations.

Mr Luk advised that Form IR56M had been introduced to facilitate the reporting of payments made to persons who were not employees. Payments reported on Form IR56M are recorded separately from salary payments in IRD's database. Hospitals have been asked to use Form IR56M to report payments to consulting doctors. When the bulk issue of Employers Returns is distributed each year, a supply of Form IR56M, together with covering instructions explaining their use, are issued if the employer filed Form IR56M in the previous year.

At IRD seminars organized for employers, participants are alerted to the correct method of reporting payments to persons who are not employees. Further, when an organization incorrectly reports non-employment income on Form IR56B, a letter explaining the use of Form IR56M is issued. The CIR commented that employer cooperation was essential resolving this type of problem.

AGENDA ITEM A3 – PERSONAL ASSESSMENT

A3(a) Elections for Personal Assessment

The Society asked IRD to consider allowing elections for personal assessment to be made on an individual basis when spouses are separately assessed.

The CIR noted that for many years, this item had featured in the Society's annual Budget submissions. She reminded members that the purpose of the annual meeting between the Society and the CIR is to discuss practical taxation issues associated with the day to day administration of professional accounting practices. The meeting has never been intended to be a forum to discuss taxation policy issues.

The requirement for married couples to jointly elect to be personally assessed has its roots in the introduction of separate taxation for married salaried taxpayers. Then, separate taxation for taxpayers became standard under each of the primary charges (property tax, salaries tax and profits tax) and no person was compelled to be assessed on the joint income of himself/herself and his or her spouse. The CIR pointed out that personal assessment is not a tax, but a tax relief. Every married couple pays less tax under personal assessment than they would (in aggregate) pay if assessed separately. In addition, under both personal assessment and joint assessment, a situation of horizontal equivalence exists and married couples with the same overall income (regardless of chargeable source) pay the same amount of tax.

The CIR suggested that in future years, if this issue remained a concern to the Society, it would be more appropriate to only include it in the annual Budget proposal.

A3(b) Charging Provisional Tax When Personal Assessment is Elected

The HKSA wished to clarify apparent inconsistencies that occurred in the charging of provisional tax when taxpayers elect personal assessment.

The Society was advised that different provisions apply to the three primary charges. Sections 63J(2)(d) & 63O(2)(d) of the IRO allow for provisional profits tax and provisional property tax to be heldover where a taxpayer has elected personal assessment if the election is likely to reduce the provisional tax liability. There is no equivalent provision in section 63E for salaries tax.

An election for personal assessment generally reduces a person's tax liability to property tax and profits tax by way of allowances and concessionary deductions. This is, however, not the situation for large income taxpayers. To date, IRD's practice has been not to charge provisional profits tax or provisional property tax where personal assessment is elected. This avoided inconvenience for taxpayers and administrative work for IRD. With effect from 1 April 2000, provisional profits tax and provisional property tax will be charged for personal assessment cases if, in the preceding year, a person's assessable profits from each sole proprietorship business owned by the person or net assessable value of all solely owned properties or any jointly-owned property is of a considerable level. This mirrors the current Unit 1 practice for partnerships. Taxpayers may lodge holdover applications to reflect any reduced liability attributable to a personal assessment election.

AGENDA ITEM A4 – TAX RESERVE CERTIFICATES

A4(a) Date to Which Interest is Calculated

The Society pointed out that no interest is paid on tax reserve certificates (TRCs) from the date of determination to the date of issuance of any refund. There is a time-lag of over one month between the two dates and it proposed IRD should issue the Redemption Statement and cheques within one week after the date of determination. Where this is not possible, interest should be paid up to the date the cheque is issued.

The CIR explained that section 71(7)(d) of the IRO provided the legislative framework for the payment of interest on TRCs. Interest is calculated from the date of issue of the TRC to the date of the final determination of the objection or appeal. Any change to this would require a legislative amendment. She also noted that as interest on tax heldover unconditionally is also only calculated to the date of final determination of the objection or appeal, there was symmetry in the interest calculation procedures.

A statutory period of one month is allowed from the date of determination of an objection for an appeal to be lodged. Appeals Section generally waits for 5-6 weeks (to allow for possible delays) prior to referring a file for issue of a revised assessment. The Assessing Unit needs about 2 weeks to prepare and issue the revised assessments and prepare the covering letters for the objection and redemption of the TRC. The taxpayer must endorse the TRCs and tender it for redemption, which takes about one week. The TRC redemption process takes 10-14 working days (depending upon the time of year) and the overall time for a TRC refund to be issued is 10-12 weeks from the date of issue of the determination. The issue of TRC refunds can be speeded up considerably if a taxpayer gave written notice waiving the right of appeal.

A4(b) Disparity in Interest Rates

The Society drew attention to the difference in the interest rates charged where an objection or appeal is determined against the taxpayer and an unconditional holdover (or conditional holdover with a banker's guarantee) had been allowed with the interest rate received when a TRC has been purchased and the taxpayer's objection or appeal was successful. It suggested the interest rate payable on unconditional holdovers be no more than, say, 3% above the TRC interest rate.

The CIR advised that the interest rate payable on TRCs is fixed periodically by the Secretary for the Treasury by reference to deposit rates paid by the major banks. It reflects prevailing money market conditions. The interest rate charged on tax heldover unconditionally is the rate applicable to judgement debts and is specified by the Chief Justice under section 50 of the District Court Ordinance. [At the time, the judgement debt interest rate was equivalent to the banks' prime rate plus a margin of 2.75%]. The CIR confirmed that taxpayers are advised of the interest rate payable on TRCs and those charges on unconditional standovers of tax. Purchasing a TRC is always an option available to taxpayers.

As regards bank guarantees, the CIR said that under section 71(9), no guarantee was accepted unless there was a concurrent undertaking to pay the interest. The Society commented that in the DIPN, this should be made clearer. The CIR replied that when the DIPN is revised, this point would be further clarified.

A4(c) Alleged Discrepancy Between Sections 71(2) and 71(10)

The HKSA asked the CIR to clarify an apparent discrepancy between sections 71(2) and 71(10) of the IRO with paragraph 8(vi) of DIPN 6. The Society said the IRO suggests that interest is payable only on tax that becomes due following an unconditional holdover. The DIPN, it thought, suggested that interest is also payable where a banker's undertaking is required to be furnished under part (b) of the proviso to s71(2). It also considered a standard form of a banker's undertaking which is acceptable to IRD should be published or made available upon request.

The Society was advised by the CIR that proviso (b) to section 71(2) allows tax to be held over conditionally on a banker's undertaking being furnished as security for payment of the tax to be held over. The form and content of the undertaking is specified in section 71(9). Section 71(9)(e)(ii) provides the undertaking must include an undertaking to pay interest on the tax held over at the rate specified in section 79(11). Guarantees not satisfying the requirements of section 71(9) are not accepted. IRD will publish an acceptable form of banker's undertaking on the IRD web site. Mr D'Souza added that bank guarantees are used infrequently.

When DIPN 6 is next revised, the CIR said it would specify more clearly the basis of the requirement for interest to be paid on tax heldover conditionally upon a banker's undertaking being provided.

AGENDA ITEM 5 – COMMERCIAL BUILDING ALLOWANCE

A5(a) Determination of Cost of Construction

The Society said commercial building allowance may be difficult to calculate if the first assignment value is not discoverable from a land search.

Mr Tam said that in most cases, a land search will yield the first assignment consideration. If the Land Registry records do not record the first assignment value, the "earliest" assignment value recorded in the Land Office (although it may not be the "first" assignment) may be used. In exceptional cases, if the Land Registry records do not show any prior transactions, a percentage of the purchase price paid by the current owner can be used. The older the building, the smaller the percentage will be. Percentages ranging from 10% to 33 $\frac{1}{3}$ % have been agreed to be reasonable but what percentage is reasonable depends upon the age and location of the property.

A5(b) Buildings Purchased Prior to 1 April 1998

The HKSA wished to clarify IRD's practice as regards estimating relevant costs and associated allowances for buildings purchased prior to 1 April 1998.

Mr Tam said that, in accordance with long-established practice, normally one-half of the first assignment value is taken as the relevant cost. For leasehold improvements, the original cost of additions made in recent years is generally available from the accounting records. For "older" improvements, if it is difficult to trace the original costs, IRD practice is to take 80% of the cost as at the end of 1997/98 as the relevant cost for section 33A(4). He said

that the 20% reduction in the cost base is a notional deduction to cover the rebuilding allowances granted under section 36.

Determining a cost of construction based on first assignment value was the standing practice for many years. It was only in exceptional cases, where the amounts involved are small, that costs of construction based on the purchase price paid by the taxpayer have been accepted. The Society suggested that there could be problems if taxpayers had adopted costs of construction based on an assignment subsequent to the first assignment. Mr Tam accepted the Society's point but said that the starting point should be the actual cost of construction.

AGENDA ITEM 6 – APPLICATION OF SECTION 61A

A6(a) Application of Section 61A to Section 9A Cases

The Society asked to clarify the application of section 61A to section 9A cases.

The CIR noted the purpose of section 9A is strike down disguised employment arrangements. When it is established that a Type I arrangement exists, the income may be charged to salaries tax irrespective of whether it was derived before or after the appointed day (18 August 1995). In particular, if any other provision of the IRO, such as section 61A, renders income derived prior to the introduction of Section 9A as chargeable to salaries tax, that income will be assessed.

In applying section 9A, each case is considered on its own facts. Those involving contracts for services will be assessed under profits tax whilst those for employer-employee relationships are assessed under salaries tax. The three commonly applied tests (control, integration and economic reality) are considered in conjunction with section 9A and the criteria set out in DIPN No. 25.

A6(b) Section 61A When Company Wound Up After Obtaining Tax Clearance

The HKSA asked to clarify the IRD policy on application of section 61A when companies have already been wound up after obtaining tax clearance.

Mr Luk advised that all companies applying for tax clearances prior to winding up are expected to make candid disclosures of all relevant aspects of their tax affairs. Failure to disclose involvement in tax avoidance arrangements which are subsequently struck down by section 61A will nullify the tax clearance. He said that if necessary, applications will be made to the Courts to have these companies revived. He commented that such a situation is rare and, to date, involved only one case.

The Society asked whether IRD would take action against the liquidator of a company that had been wound up where the tax clearance was subsequently revoked. Mr Luk noted that whilst this would always be determined by the facts of individual cases, it was likely to happen only in very rare circumstances.

AGENDA ITEM A7 – PENALTIES UNDER SECTION 82A

A7(a) Penalty Guidelines

The Society suggested that consideration should be given to issuing some guidance on the circumstances under which section 82A will be applied and a penalty imposed.

The CIR responded by saying the sections 80 and 82A are mutually exclusive but both sections only apply where the offence was committed without reasonable excuse. The penal provisions of section 82 only apply where there is a willful intent to evade tax. She said taxpayers' offers to compound offences are welcome.

What constitutes a reasonable excuse is determined by the facts of individual cases. Whilst it is not possible to compile a list of "reasonable excuses" that would apply to all circumstances, guidance is available from published Board of Review decisions. The CIR pointed out that lodgment of a return subsequent to the issue of an estimated assessment does not mitigate the offence of failing to lodge the return by its due date. However, the period by which the return was late will have a bearing on the scale of the penalty applied. Taxpayers may appeal to the Board of Review in respect of penalties imposed.

In response to a question from the Society, the CIR advised that if the accounts lodged are signed by the auditor but only one director, that would be in order PROVIDED THAT the auditor has certified the accounts as being true and correct.

A7(b) Guidelines Should Be Issued On Quantum Of Penalty

The HKSA asked for guidelines to be issued on the quantum of penalty that will be imposed in various circumstances.

The CIR drew attention to the considerable number of Board of Review decisions which consider penalties imposed in various circumstances. Guidance should be taken from the Board's published decisions.

AGENDA ITEM 8 – PROPERTY TAX

It was suggested by the Society that consideration be given to allowing the apportionment of rental income to be specified by the taxpayers in a joint-tenancy. The Society considered that even though legally a property may be jointly-owned in equal shares, the financial input from the joint-tenants may be very different. Rental income should be able to be apportioned to reflect the economic reality, provided the apportionment is applied consistently by the joint owners.

The CIR responded that when a property is owned by persons as joint owners, each joint owner has an equal share in the equity of the property. If a jointly owned property is let to derive rental income, the legal entitlement to the income accrues to each of the joint owners in the same ratio as their ownership of the property. IRD can only assess a person on income to which he or she has a legal entitlement. Assessments could not be maintained against a recipient in respect of income in excess of his or her joint ownership share of the total rent received. The only exception to this rule is for jointly owned properties where one

joint owner occupies his share of the property and the other joint owner lets his half out for rental income. Here, only the joint owner letting out his share of the property would be assessed to property tax.

To allow property taxpayers to arbitrarily divide income between themselves would result in a significant administrative burden for IRD and encourage tax avoidance. The situation raised by the Society can be addressed by the owners registering their ownership as tenants in common and specifying each owners' ownership ratio to reflect their respective contributions to the purchase price.

AGENDA ITEM A9 – TAX IMPLICATIONS OF SSAP 24

The Society wished to know the tax implications of the change in accounting policy under SSAP 24. In particular, it questioned the tax treatment of unrealized profits.

Mr. Tam advised that there are no specific tax provisions as to how the assessable profits are to be ascertained. Generally accepted accounting practices should usually be followed to ascertain the profits assessable for tax purposes. If the gains or losses in the fair values of securities are recognized in the profits and loss account, they are also regarded as profits or losses for tax purposes.

Whether a gain or loss is of a revenue or capital nature is determined by reference to the totality of the facts. Intention is only one of the factors to be considered. Equally, the classification of the securities in the accounts is not, in itself, conclusive in deciding whether a gain or loss is on the capital or revenue account. For taxpayers which are not financial institutions, Mr. Tam said IRD will generally follow accounting practices.

The Society indicated that the reason for concern was primarily about revenue items, issues of timing, the treatment of unrealised gains and how to deal with back year returns. The CIR indicated that if questions about the tax implications of SSAP 24 were to arise frequently, then IRD would need to establish guidelines for such cases. The Society was invited to provide IRD with some possible examples for consideration in order to continue the dialogue.

AGENDA ITEM A10 – ELECTRONIC COMMERCE

The Society asked for IRD's current view on the tax treatment of e-commerce. It wished to how IRD envisaged dealing with future developments.

Mrs Lau advised IRD has established a working group to study e-commerce and evaluate its impact on the tax system. It is presently assembling overseas views and reviewing research from international forums such as the OECD and overseas taxation authorities; liaising with, and collecting information from, e-commerce related agencies in Hong Kong; monitoring e-commerce developments within Hong Kong to assess their impact on the tax system; evaluating whether current tax principles and practices fit the e-commerce environment and monitoring compliance in Hong Kong.

To ensure Hong Kong's approach to is consistent with that of our major international counterparts, we must await the development of international standards. She was unable to provide in-depth information but said areas of particular interest included the allocation of taxing rights and the classification of income arising in Hong Kong.

The HKSA pointed out that Hong Kong had particular concerns that were not shared by other jurisdictions and that other places were focussing on issues such as “permanent establishment”, the taxing point for VAT etc. Mrs Lau said that the underlying issues were issues of common concern. For now, she thought, there would continue to be linkages to Hong Kong if businesses wanted to establish goodwill here. Therefore, in the immediate future, the potential loss for loss of revenue was not an undue cause for concern.

AGENDA ITEM A11 – PUBLICATION OF STATUS OF APPEALS

The HKSA suggested that after the Board of Review, the Court of First Instance or the Court of Appeal had handed down a decision and the period for appeal has expired (or an appeal has been lodged), IRD should publish the status of the case on its internet home page. Posting of relevant judgements or summaries of them, it said, would also be very useful.

The CIR said IRD is prepared to publish information in respect of the status of appeals against Board of Review decisions AFTER the case stated had been transmitted to Court; appeals against decisions of, and the expiration of the appeal period for, decisions of the Court of First Instance and the Court of Appeal. She suggested the following table as an example of how the information should be presented –

Status of Tax Cases as at 29 February 2000

Taxpayer's Name	Issues under Appeal	Court	Current position
Wong Ning Investment Co. Ltd.	(a) Profit on property, whether capital or trading (b) Application of Sharkey v. Wernher principle	CFI	Taxpayers appeal heard on 22-23.11.99. Awaiting decision.
S. Babu Loganathan	Validity of section 82A assessment	CFI	CIR has appealed against Board's decision. Case set down for hearing on 15.03.00
Aust-Key Co. Ltd.	Valuation of properties	CFI	Taxpayer has appealed against Board's decision. Case set down for hearing on 21.07.00
Secan Limited, Ranon Limited	Whether interest included in trading stock has been deducted	CA	CIR's appeal dismissed by CA on 16.02.00. Appeal period not yet expired

Board of Review decisions are published quarterly. Since the time lag between the handing down of decision and their publication it is not great, summaries of the decisions will not be posted on the internet. For Court decisions, IRD will examine the feasibility of posting the head-notes of decisions to be published in Hong Kong Tax Cases prior to publication. It is estimated that it may be possible to release the summaries about three months after a decision becomes final.

AGENDA ITEM A12 – SPEEDING UP PROCESSING OF ASSESSMENTS

A12(a) Refunds of Tax

The Society said cases had arisen where it has taken over 6 months to assess returns and refund tax when no inquiries had been made. It proposed that if there were no outstanding inquiries, IRD issue the Notice of Assessment for tax refund cases within 2 months of lodgment of the return.

The CIR said that as a practical matter of fact, IRD does not know whether any return will result in a refund until the assessment process is completed. She also reminded members that the holdover system was available to taxpayers when reduced profits were anticipated. Once an assessment is determined to be a refund case, IRD's performance pledge for refunds would be adhered to.

A12(b) Delays in Replies to Correspondence

The HKSA drew attention to two cases where it said IRD had taken almost one year to respond to replies to queries. It requested the CIR to speed up the process.

Mr Tam advised the cases cited were not typical. The cases cited had been examined and delays had occurred in both the tax representatives' offices and within IRD. In the one case the outstanding action rested with IRD and remedial action had been instituted. For the other, further action will be taken by IRD once information requested from the tax representative had been advised. The CIR pointed out that there was also an IRD performance pledge for written replies to queries.

A12(c) Time Limit for Submitting Holdover Applications

The Society said that there are occasions where the time between receiving the notice of assessment and the deadline for submitting a holdover application was as little as 9 working days. It suggested IRD consider issuing the notice of assessment at least 7 weeks before the payment due date. This would provide for a minimum of 3 weeks for preparation of the holdover application.

The CIR commented this was a familiar topic and had been discussed on numerous previous occasions. The IRD position remained unchanged. She reminded members that for "M" accounts, holdover applications need only to be supported by management accounts for 8 months, up to the end of November. She also said that most taxpayers would be in a position to know their trading results and could anticipate, in advance, a need to apply for a holdover of provisional tax.

The Society asked whether around the Christmas holiday period, IRD would accept 7 months' management accounts. The CIR said that, very exceptionally, in large, urgent cases, acceptance of 7 months' accounts might be accepted if sufficiently justified.

AGENDA ITEM A13 – ADMINISTRATION WITHIN IRD

A13(a) Electronic Transactions Ordinance

The Society wished to know the implications of the introduction of the Electronic Transactions Ordinance on IRD. In particular, it asked when IRD anticipated being able to handle on-line filing.

Mrs Lau advised that the Electronic Transactions Ordinance provides the legislative backing for the conduct of electronic transactions in Hong Kong. IRD is responding to the changes. Services that will become available electronically from October 2000 will include applications business registrations and branch registrations for sole proprietors; applications for copies of business registration certificates; purchase of tax reserve certificates and interactive tax inquiries.

Within Unit 1, the Electronic Service Delivery project will allow the following to be accepted electronically, notification of change of profits tax correspondence address, lodgment for block extension applications and the filing of profits tax returns (where attachments are not required).

In April 2001, it is planned to introduce a system of electronic filing for property tax returns and tax returns for individuals that satisfy specified criteria. These criteria will include the complexity of the return, whether supporting documents are required and whether the signatures of both the husband and the wife are required for personal assessment or joint assessment elections. Filing will be done via the Internet or at kiosks to be established under the Government's Electronic Service Delivery Scheme.

A13(b) Documents Accepted by Fax

The CIR was requested by the Society to provide an updated list of returns and documents that would be accepted by fax.

The Society was advised that the list was last updated in October 1997. The list is available from IRD's home page.

A13(c) Voice Mail System

The Society requested the CIR to consider extending the voice-mail system to assessors.

The CIR said the proposal had been examined by IRD in 1998. However, the present PBX in Revenue Tower cannot be upgraded to provide the necessary additional capacity in a cost efficient manner. The suggestion will be revisited, she said, towards the end of 2003 when the present PBX is scheduled for replacement.

AGENDA ITEM A14 – PERFORMANCE PLEDGES

A14(a) Performance Pledges Not Met

The HKSA wished to know what recourse a taxpayer had where a performance pledge was not met.

The CIR advised that a complaint could be lodged with the IRD Complaints Officer. She said full details of how to make a complaint are given on the back page of IRDs Performance Pledge booklet.

A14(b) TRC Refunds

The Society suggested IRD consider introducing a performance pledge relation to the redemption of tax reserve certificates.

The CIR advised that a Performance Pledge already existed for the redemption of TRCs. The targets are set out in the current Performance Pledge booklet. These are –

Between Months Of	Standard Response Time	Performance Target
July & December	Within 10 working days	98%
January & June	Within 14 working days	98%

Copies of the IRD Performance Pledge are available from IRDs Enquiry Service Centres.

Agenda Item A15 – LODGEMENT OF TAX RETURNS

The Society wished to discuss the latest lodgment statistics for 1998-99 profits tax returns.

The CIR provided the following statistics -

A. Lodgment Comparison for Corporations and Partnerships – 1996/97 to 1998/99

	<u>Y/A 1996/97</u>	<u>Y/A 1997/98</u>	<u>Y/A 1998/99</u>	Comparison 1997/98 and <u>1998/99</u>
Bulk issue (on 1 April)	<u>139,000</u>	<u>153,000</u>	<u>151,000</u>	-1%
Cases with a failure to file by due date:-				
- 'N' Code	2,200	2,200	2,000	<-1%
'D' Code	5,000	5,100	5,000	-2%
'M' Code	<u>10,200</u>	<u>10,000</u>	<u>9,000</u>	-10%
	<u>17,400</u>	<u>17,300</u>	<u>16,000</u>	
Compound offers issued	<u>7,100</u>	<u>7,400</u>	<u>6,900</u>	-7%
Estimated assessments issued	<u>6,200</u>	<u>5,400</u>	<u>4,600</u>	-15%

B. 1998/99 Detailed Profits Tax Returns Statistics

	<u>'N'</u>	<u>'D'</u>	<u>'M'</u>	<u>Total</u>
Total returns issued	<u>19,000</u>	<u>42,000</u>	<u>108,000</u>	<u>169,000</u>
Failure to file on time	2,000	5,000	9,000	16,000
Compound offer issued	900	2,500	3,500	6,900
Estimated assessments issued	700	1,600	2,300	4,600

C. Represented Corporation and Partnership Returns – Lodgment Patterns

Code – Due Date	Lodgment Standard	Actual Performance	
		<u>1997/98</u>	<u>1998/99</u>
D – 31 July	100%	80%	80% *
M – 31 August	25%	15%	15%
M – 30 September	55%	23%	23%
M – 31 October	80%	43%	43%
M – 14 November	100%	84%	85% **

* 41% lodged within a few days around 31 July 1999 (37% for 1997/98)

** 31% lodged within period 1-15 November 1999 (28% for 1997/98)

D. Tax Representatives with Lodgment of 85% or Less of 'M' code Returns as at 15.11.1999

The CIR said 1,368 tax representatives have 'M' code clients. Of these, 590 firms were below the average performance of 85%. The analysis of the firms, based on size, is:-

	Current Year's Performance					Previous Years Performance			
	No. of clients per firm	Total No. of firms	No. of firms below the average of 85%	No. of non-compliance cases	% of total non-compliance cases	Total No. of firms	No. of firms below the average of 84%	No. of non-compliance cases	% of total non-compliance cases
Small size firms	100 or less	1,178	525	3,434	62%	1,128	556	3,711	62%
Medium size firms	101 - 300	176	62	1,705	31%	174	58	1,822	31%
Large size firms	over 300	14	3	299	7%	18	4	446	7%
Totals		<u>1,368</u>	<u>590</u>	<u>5,438</u>	100%	<u>1,320</u>	<u>618</u>	<u>5,979</u>	100%

AGENDA ITEM B1 – DISCREPANCIES DETECTED BY FIELD AUDIT

Mr D'Souza advised that the Field Audit Section had again prepared the statistics in Table 1 to demonstrate the more common types of discrepancies detected between 1 January 1999 and 31 December 1999. This information, he said, may be of assistance to the HKSA's members in identifying potential problem areas within their clients' accounts.

Table 2 is more specific in nature. It sets out details of how some of the discrepancies uncovered by IRD auditors between 1 January 1999 and 31 December 1999 were detected. They all relate to corporation cases.

Table 1

Completed Corporation Cases Between 1 January 1999 to 31 December 1999

Unqualified Auditor's Report

Nature of Discrepancy	No. of Cases	Discrepancy Amount ⁽¹⁾ (\$)	Tax Undercharged ⁽¹⁾ (\$)
Sales omitted	35	43,666,997	6,730,746
Purchases overstated	6	8,379,819	1,425,989
Closing stock understated	7	2,483,006	227,238
Gross profit understated	30	56,726,214	8,609,538
Expenses over-claimed	46	26,339,365	3,945,724
Technical adjustments	27	11,628,631	1,549,428
Other	55	26,383,147	3,641,725
TOTALS	141⁽²⁾	\$175,607,179	\$26,130,388
(1) The amounts shown against each item are only for the year audited. Previously, these analyses were based on the total discrepancy for all years audited			
(2) In one case there may be more than one type of discrepancy			
Additional Statistics:			
	Total No. of Cases	Total Discrepancy (All Years)	Tax Undercharged (All Years)
	<u>141</u>	<u>\$660,358,902</u>	<u>\$102,472,761</u>

Qualified Auditor's Report

Nature of Discrepancy	No. of Cases	Discrepancy Amount ⁽¹⁾ (\$)	Tax Undercharged ⁽¹⁾ (\$)
Sales omitted	28	33,634,740	4,673,761
Purchases overstated	9	11,464,489	1,569,644
Closing stock understated	6	6,735,926	1,045,733
Gross profit understated	14	16,952,270	2,728,047
Expenses over-claimed	19	6,161,740	896,096
Technical adjustments	20	11,276,851	1,340,145
Other	27	18,302,442	2,114,437
TOTALS	58⁽²⁾	\$104,528,458	\$14,367,863
(1) The amounts shown against each item are only for the year audited. Previously, these analyses were based on the total discrepancy for all years audited			
(2) In one case there may be more than one type of discrepancy			
Additional Statistics:			
	Total No. of Cases	Total Discrepancy (All Years)	Tax Undercharged (All Years)
	<u>58</u>	<u>\$374,638,988</u>	<u>\$53,445,726</u>

Table 2

Nature of Discrepancy	Amount (\$)	How Discrepancy Detected	Discrepancy for year audited (\$)	Total Discrepancy (all years) (\$)	Tax Under-charged (all years) (\$)
Expenses Over-claimed	270,000	Increase in share capital entered in the "staff messing" account	1,052,207	1,221,387	201,529
Technical Adjustment (Profits Tax paid in PRC)	32,823	Tax representative should be aware that this item is not deductible			
Technical Adjustment (Exchange loss arising from translation of bank balance)	595,161				
Purchases overstated	971,322	Back year purchases recorded for a second time as purchases and credited to accounts payable. Unsettled amounts were transferred to director's current account	1,296,755	1,806,092	298,003
Technical Adjustment (Overdraft interest – banking facilities secured by director's fixed deposit)	244,034	Disclosed in the notes to the accounts but not added back in tax computation	5,962,103	25,859,740	4,309,331
Technical Adjustments (Overdraft interest)	58,297	Per banking facilities approval letter, overdraft facilities secured by director's fixed deposit	1,677,113	8,645,890	1,389,048
GP understated due to sales cut-off and closing stock understatement	170,227	Proper audit of Accounts Receivable and stock take should detect such understatement	170,227	1,554,280	258,075
Profits excluded due to cash basis adjustment	2,197,550	Auditor disclosed the use of cash accounting basis in a note to the accounts but the basis was not accepted by the auditor	5,442,670	28,678,402	4,054,621
Closing Stock Understated	323,451	Understatement in respect of goods-in-transit	363,286	627,784	97,590
Totals	\$4,862,865		\$15,964,361	\$68,393,575	\$10,608,197

AGENDA ITEM B2 – PENALTY POLICY FOR INVESTIGATION AND FIELD AUDIT CASES

Mr D'Souza said that it may be helpful to HKSA members if IRDs procedures for imposing penalties were re-visited. He explained the basis for imposing penalties are -

- Only the Commissioner and the deputy commissioners may impose penalties
- The Commissioner has formally delegated certain, clearly defined, powers to assistant commissioners and other ranks
- There is strict monitoring and control over the exercise of delegated authority
- Assessors must achieve a reasonable basis of settlement of audit and investigation cases. In the negotiation processes, they are not permitted to negotiate either the basis under which penalty will be imposed or its quantum
- In their meetings with taxpayers, assessors are required to advise them of the possibility of penalties being imposed. Such explanations are never a commitment to taxpayers on quantum of any penalty that may be subsequently imposed.
- Taxpayers have the right to make an offer to compound an offence in lieu of being prosecuted. Alternatively, they may await CIRs decision on the appropriate penalty action under section 82A.
- Taxpayers must make an explicit request to compound offences. Assessors will not raise the issue for discussion.

IRD has noted a trend for tax representatives to try and negotiate a settlement of the case per se and the compound penalty at the same time. These are two separate issues which cannot be “packaged” together. Only after the omitted income has been determined, can consideration of the penal aspects commence.

Mr D'Souza reminded the Society that notwithstanding that assessors cannot consider penalty issues until the assessments are settled, they cannot outrightly refuse to accept compound offers made by taxpayers in the interim. In such situations, if a tax representative fails to finalize an audit or investigation because his “package” settlement proposal is not accepted, estimated assessments based on the assessor's findings will be issued. This may prolong the final settlement of the case.

AGENDA ITEM B3 – TECHNICAL ADJUSTMENTS AND PENALTIES

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

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

- commercially unrealistic and involves elements of dishonesty etc.
- involves the use of artificial devices or arrangements; or

- employs tax avoidance arrangements to conceal taxable transactions (including the supply of incomplete or incorrect information).

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

As regards service companies, Mr D'Souza said identical policies apply to Type I and II arrangements. Penalties will be imposed where the –

- arrangements are artificial
- arrangements have no substance
- services were, in substance, performed by the employee in his personal capacity and not the service company
- employers are controlled by the employees and there has, in effect, been no change of the employer-employee relationship.

When management fees are disallowed, penalties will be considered where the “payment” of the fees is artificial or fictitious, or where the arrangement between the taxpayer and service company is a sham.

AGENDA ITEM B4 – MERGER OF UNIT 4 AND FIELD AUDIT GROUP

The CIR advised that to improve operational effectiveness, the Investigation Unit and Field Audit Group will be merged in April 2000. The merged operation, to be known as the Field Audit and Investigation Unit, will be under the management of the Assistant Commissioner, Unit 4 and overseen by DCIR(Operations). It was hoped to achieve synergy and enhance efficiency and flexibility.

Taxpayers and their representatives will not notice any immediate changes in way field audit and investigation cases are conducted. In the longer term, the Department will be looking to achieve productivity gains and enhanced compliance through an enlarged audit coverage.

AGENDA ITEM B5 – COMPLAINT ON THE INVESTIGATION AND HANDLING OF AUDIT AND INVESTIGATION CASES

Mr D'Souza advised that few complaints are received in connection with the way auditors and investigation staff conduct their duties. With the increased taxpayer coverage now being achieved by IRD, the overall situation is regarded as satisfactory.

He went on to say that IRD strives to maintain a high level of cooperation and spirit of goodwill in its working relationship with tax representatives and their clients. If taxpayers or their representatives encounter particular problems with auditors and investigation officers in specific cases (other than the efficiency of the officer in detecting errors in returns) they should, first, try to resolve the issues with the officer concerned. If a mutually acceptable accommodation cannot be reached with the case officer, tax representatives could then speak to the Chief Assessor, who may be able to assist. Mr D'Souza noted that an objective approach to problem resolution is best.

AGENDA ITEM B6 – PROFITS FROM CROSS-BORDER MANUFACTURING

Mr D'Souza drew attention to two incorrect methods for apportioning profits that had been frequently noted in the course of field audit work. The first involved taxpayers with cross-border manufacturing activities. Initially production was done by a PRC party under processing agreements and overall profits were assessed in 50/50 basis. Subsequently the taxpayer established a wholly owned corporation to be the manufacturing arm of the group with the taxpayer becoming the groups trading arm. However, notwithstanding the change in the taxpayer's principal activity from manufacturing to trading, its profits continued to be apportioned on a 50/50 basis. He asked tax representatives, in apportionment cases, to verify annually that the apportionment of profits remained appropriate.

The second problem involved the application of the 50/50 basis of apportionment. All items of income and expenditure were apportioned without having regard to the nature of the income per se. He pointed out that only manufacturing income could be apportioned. Certain other categories of income, such as commissions and consultation fees, may be received for services rendered wholly in Hong Kong. These categories of income are fully assessable and apportionment is inappropriate.

Mr D'Souza reminded tax representatives that Part E of the Profits Tax Return requires taxpayers to disclose details of business dealings with closely connected non-resident persons. In cross-border manufacturing, Hong Kong companies buying goods from a wholly owned enterprise in the Mainland must complete Part E of the return. Failure to make a disclosure will result in penalties being applied to any tax undercharged. In the future, if tax computations are incorrect and the tax representative concerned is unable to demonstrate a reasonable excuse for the incorrect computation, penalty actions against tax representative may be considered.

AGENDA ITEM B7 – VALUATION OF CLOSING STOCK

Mr D'Souza drew the Societys attention to valuation issues detected in relation to closing stock. Field Audit officers have found taxpayers adopting the 'net realizable value' method of stock valuation for closing stock with some slow-moving stock items written down to a 'Nil' value. The 'net realizable value' of the stock was determined by the directors' opinion rather than in accordance with SSAP No. 22 (which is accepted by IRD and cited in DIPN No. 1(A)). Two examples of the stock valuation problems uncovered are –

- Closing inventories consisting of durable goods (such as metal parts and building materials) remaining unsold at the end of the year written down to either a 'Nil' value, or a token value
- The 'hindsight' of the directors on the decline of the market was accepted by the tax representative as the basis for valuing the 'net realizable value, with no attempt being made by the company's auditor to verify the accuracy and correctness of the directors' valuation.

He asked tax representatives to objectively apply the 'net realizable value' method of stock valuation. A directors opinion of the value of stock on hand is, in its own right, valuable. However, it must be capable of verification by reference to objective factors. He added that directors' valuations not prepared in accordance with standard accounting practices and principles will not be accepted.

AGENDA ITEM B8 – RECORD KEEPING BY PROFESSIONAL ACCOUNTANTS

This item, Mr D'Souza noted, also arose at last meeting and it is regrettable such an unacceptable situation had to be brought up again. Professional accountants have been audited and found not to be maintaining sufficient business records to comply with section 51C of the IRO. In addition, one professional accountant was found to have claimed a management fee paid to a service company he also owned. Upon examination, the arrangement was a sham and no service agreement existed.

Professional accountants, he said, have no excuse for failing to fully comply with the relevant provisions of the IRO. Heavy penalties will be imposed when offences concerning professional accountants' own tax affairs are detected.

AGENDA ITEM B9 – PROGRESSIVE LODGEMENT OF "M" CODE RETURNS

The CIR pointed out that the progressive lodgment rates for "M" code returns by end of August, September and October were substantially below standard again. She requested tax representatives to take adequate measures to improve their lodgment rates this year. This will assist IRD in meeting its work schedules and performance pledge commitments.

AGENDA ITEM B10 – INCOMPLETE COMPLETION OF TAX RETURNS

The CIR advised the meeting that, in far too many cases, supporting schedules (e.g. commission payments), documents and information listed in the Block Extension Letters were not submitted together with returns. This she said, created unnecessary work for all and delayed the issue of assessments.

AGENDA ITEM B11 – ELECTRONIC LODGEMENT OF BLOCK EXTENSIONS

The facility to electronically lodge block extension applications was introduced May 1997 and there were 342 registered users as at 23 Feb 2000. She said that tax representatives are encouraged to use this facility more widely in the future as it is environmentally friendly and enhances efficiency.

AGENDA ITEM B12 – FONT SIZE OF ACCOUNTS AND SUPPORTING SCHEDULES

Some accounts and supporting schedules that lodged with returns are printed in very small (size 8 and smaller) font sizes. This makes the examination of the schedules unreasonably difficult. The CIR requested tax representatives to use a reasonable size font on schedules submitted to IRD.

AGENDA ITEM B13 – EXTENSION OF BLOCK EXTENSION SCHEME

The CIR advised that for the forthcoming year, it is planned to extend the block extension scheme arrangements to include "review" returns issued during the year. She hopes this new arrangement will assist tax representatives in better managing their lodgment programmes.