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TAX BULLETIN

2004

**Annual Meeting between
the Inland Revenue Department and
the Hong Kong Institute of Certified Public Accountants**



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

2004
ANNUAL MEETING BETWEEN
THE INLAND REVENUE DEPARTMENT AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

(N.B. As the meeting took place before the change of name to the Institute, references in the main body of the minutes are still to the “Hong Kong Society of Accountants”)

Preamble

As part of the Institute’s regular dialogue with the Government to facilitate tax compliance, improve procedural arrangements and to clarify areas of interpretation, representatives of the Institute met the Commissioner of Inland Revenue (“CIR”), and members of her staff in January 2004.

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

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Full Minutes

The 2003/04 annual meeting between the Hong Kong Society of Accountants' Taxation Committee and the Commissioner of Inland Revenue was held on Wednesday 14 January 2004 at the Inland Revenue Department.

IN ATTENDANCE

Hong Kong Society of Accountants (the Society)

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

Inland Revenue Department (IRD)

Mrs Alice Lau	Commissioner of Inland Revenue
Mr Tam Kuen-chong	Deputy Commissioner of Inland Revenue (Technical)
Mr Luk Nai-man	Deputy Commissioner of Inland Revenue (Operations)
Mr So Chau-chuen	Assistant Commissioner of Inland Revenue
Mrs Jennifer Chan	Assistant Commissioner of Inland Revenue
Mr Chan Cheong-tat	Assistant Commissioner of Inland Revenue
Mr Wong Ching-ping	Senior Assessor (Special Duties)

Mrs Alice Lau (CIR) welcomed the Society's representatives. She apologised for having to change the date of the meeting owing to unforeseeable circumstances. She reiterated that she and her colleagues always treasured the opportunity to meet representatives of the Taxation Committee of the Society with a view to clarifying policy and practice of broad common interest, as this would facilitate the smooth conduct of business between the IRD and accounting practitioners/taxpayers. Having

gone through the questions posed by the Society this year, CIR observed that some of them were related to matters specific to assessments made on certain taxpayers. Therefore, only remarks of general nature, without going into the details of the cases, would be made. She suggested that the process of assessments could be expedited if matters of similar nature were related to assessing officers of the IRD in the course of the year without waiting for the annual meeting. Mr Lui replied that the Society would take the comments of CIR into account in preparing the proposed agenda for next year's meeting.

PART A - MATTERS RAISED BY THE SOCIETY

AGENDA ITEM A1 - INTERPRETATIONAL ISSUES

Departmental Interpretation and Practice Notes

A1(a) DIPN 1 – Long term building contracts

The Society referred to paragraph 8 of DIPN 1 which stated that in relation to long term building contracts, the IRD was prepared to grant a concession to re-open earlier years where profits were assessed, if an overall loss situation had eventuated on completion of the contract.

Further, in a post-meeting note to Agenda Item A1(i) (Profits on Long-term Building Contracts and Loss Carry-back) of the minutes of the 1999 Annual Meeting, it was stated:

“The CIR has since confirmed that the concession in DIPN No.1 (Revised), which is intended to give relief for losses that would otherwise lapse upon cessation of the trade or business, applies to all taxpayers irrespective of whether they are individuals, partnerships or corporations.”

The Society was of the view that according to the above note, it appeared that the concession was intended to apply where a loss is made in later years and could not be recouped in the future. In the situation where a company undertook a single project, the company ceased business after the completion of the contract and a (small) profit arises in relation to the project as a whole, the Society considered that losses arising in the later years of the project should be allowed to be offset against the profits of the earlier years of the company. This treatment would appear to be in accordance with the intention of the concession.

The Society considered that an anomaly would arise where the carry back of losses was limited to an overall loss situation, as highlighted by the large difference in the amount of tax payable depending upon whether a project made an overall net loss of HK\$1 or an overall net profit of HK\$1.

The Society therefore asked the IRD to clarify whether the concession would apply to a single project where losses had been incurred in the final or later years, or whether it would only apply to the situation where an overall loss had arisen in relation to the project as a whole.

Mr So replied that paragraph 8 of DIPN 1 should not be read in isolation, as paragraphs 6 and 7 of the DIPN made it clear that cases qualifying for the concession provided in paragraph 8 were those where there was a loss on a contract as a whole i.e. "an overall loss" case. "An overall loss" referred to a case where the total cost was larger than the total revenue. In other words, the concession would not be extended to projects where there were losses incurred in the later years or final year but remained in an overall profit situation. The answer to the question of the Society was therefore the concession would only apply to the latter situation but not the former.

CIR added that there was a further condition for the concession in that the contract had to be the only one undertaken by the taxpayer and the business ceased on completion of the contract.

AI(b) DIPN 10 – Time apportionment claims

The Society referred to the confirmation by the IRD at the 2003 Annual Meeting that in the greater majority of cases the question of Hong Kong or non-Hong Kong employment would be resolved by considering only the three factors mentioned in DIPN 10. In practice, the Society noted that this did not appear to be the case. The Society therefore asked whether the IRD could provide more specific guidance as to the type of cases in relation to which it was considered appropriate to look beyond the three factors.

The Society pointed out that paragraph 4 of DIPN 10 – The Charge to Salaries Tax, set out three so called "Geopfert tests" which the IRD had said would be used in the majority of cases to determine the locality of employment. However, the Society noted that increasingly IRD staff appeared to be not using these tests and instead using other "facts" to review time claims.

The Society explained various areas of concern which, as explained below, had arisen over the last year culminating in an unpublished Board of Review decision.

DIPN 10 states that in examining where an employer is resident, the term "resident will be given its ordinary meaning. In this context a corporation will be regarded as being resident outside Hong Kong if it has its central management and control outside Hong Kong." However, more and more often the Society observed that assessors were not applying this test. Rather they were referring to whether the employer had "a place of residence" in Hong Kong. The Society noted that this approach had been adopted in at least one determination at the Deputy Commissioner level, where in

dealing with a Hong Kong branch of a Cayman Islands company it was stated:

“The Hong Kong office has a business presence in Hong Kong. It has registered as an overseas company under the Companies Ordinance. It is clear that it has a place of residence here in Hong Kong.”

At a similar level of authority within the IRD, the following factors were also considered to be relevant in the case of an expatriate who was coming to Hong Kong to work for a Hong Kong branch of an overseas company:

"The taxpayer's application for a Hong Kong employment visa was sponsored by the Hong Kong office. The contract also provided that the taxpayer was based in Hong Kong. He was provided with quarters in Hong Kong."

The Society did not see the relevance of the provision of quarters in Hong Kong in the determination of the source of employment under either the Geopfert tests or the totality of facts. It therefore sought clarification of the position.

In an unpublished Board of Review case the Commissioner's representative argued that the three tests set out in DIPN 10 should be disregarded and that the IRD should apply the totality of facts test. The Board went further than this and stated that it could find no justification that the totality of facts test was disregarded in the Goepfert case. The Board stated:

"On the contrary we are of the view that McDougall J. in the Geopfert case approved the application of so called totality of fact test in determining the issue where the source of income of the employment is located."

The Board also referred to the comments by the Chairman of Board of Review, Mr Turnbull in the case D40/90:

"Apparently the Commissioner has promulgated tests to be studied when deciding if employment is located outside Hong Kong. We can find no direct justification for what the Commissioner has promulgated following the Geopfert decision".

Finally the Board stated that although the contract of employment was negotiated outside Hong Kong, as the expatriate had to obtain a work visa to work in Hong Kong, the contract of employment was only concluded when the Hong Kong branch of the overseas company submitted the application for a work visa to the Hong Kong Immigration Department.

The Society was of the view that the logical extension of the above comments by the IRD and the Board seemed to be that no expatriate who required a work visa to work for a Hong Kong branch of an overseas company would qualify for a time claim, and thus section 8(1A) of the Inland Revenue Ordinance (IRO) would seem to be redundant.

In view of the above the Society asked for the Commissioner's comments on the application of DIPN 10 and in particular:

- a. The future application of the three tests set out in paragraph 4 of DIPN 10 in the light of the Board's comments and the IRD's apparent reluctance to use these tests or argue these tests at the Board;*
- b. the substitution of the test of whether a company is "resident" in Hong Kong by the test as to whether the company has "a place of residence in Hong Kong"; and*
- c. the Board's view that where an expatriate without a permanent ID card requires an employment visa, the contract of employment cannot be treated as concluded until the employment visa is applied for in Hong Kong.*

In reply, Mrs Chan informed the meeting that there was no change in policy and the IRD had all along been using the three tests in its fact-finding process. On the second question, Mrs Chan said the short answer was where a company had a place of residence in Hong Kong, it would be regarded as a resident of Hong Kong. As regards the Board's view in the case referred to by the Society, it was understood to be a specific case. As the case was unpublished and in the absence of full facts, Mrs Chan suggested that it would not be fair for the IRD to comment on the case. However, according to her understanding, in the case referred to by the Society, the taxpayer's appointment depended on his obtaining a visa sponsored by the Hong Kong office. Mrs Chan said that whether a taxpayer had a permanent ID card or not alone should not determine the source of his employment. Rather, the crucial point was whether the taxpayer had entered into a legally binding employment contract with a Hong Kong company.

Mr Southwood expressed concern about the decision in the unpublished Board of Review case that a contract of employment could not be treated as concluded until after the employment visa had been applied for in Hong Kong. As an employment visa was required for all foreign employees who did not have a permanent ID card, he asked whether this meant that IRD took the position that such an employment contract could not be concluded anywhere other than in Hong Kong, especially given that since such contracts usually contained a caveat to the effect that the offer of employment was dependent upon an employment visa being obtained. In response Mrs Chan commented that in deciding whether an employment was a foreign one or not, it was crucial to clarify from the employment contract under which the employee was actually employed. Mr. Tam added that applicants for work visas needed to be consistent in the representations that they made to different government departments.

The Meeting further discussed the residence test of a corporation. In DIPN 10, it is stated that a corporation will be regarded as being resident outside Hong Kong if it has its central management and control outside Hong Kong. Mr Southwood pointed out that if a company established a branch in Hong Kong, it would not follow that the company was resident in Hong Kong. He said that in the case of a major US

corporation, for example, it could not be argued that its central management and control were in Hong Kong merely on the basis that it had a branch in Hong Kong. The company might also have a subsidiary in Hong Kong. He gave the example of two employees working in New York who were transferred to Hong Kong – one to work for the subsidiary and one for a branch. If the IRD now maintained that because the company had a branch in Hong Kong it was resident here, then this would mean that there would be no difference in the treatment of the two employees for tax purposes, which appeared to represent a change in practice by IRD. It would also suggest that section 8(1A) of the IRO was superfluous, which did not seem to be correct. The CIR indicated that this would be taking an overly extreme view. If there was only one employer and that employer was foreign, then this might suggest non-Hong Kong employment. The IRD accepted that some expatriates in fact had non-Hong Kong employment. The process remained a question of fact-finding.

Mr Lui said that there was a difficulty with multi-national companies, for which Hong Kong served as a regional hub. It was natural for employees to have a Hong Kong base, but it would not be fair to conclude that all employees should be regarded as having Hong Kong employment based on this fact. The IRD often seemed to be looking beyond the central management and control test, which was giving rise to uncertainty. CIR replied that what constituted management and control was a question of fact to be ascertained in each case and the IRD would look at all surrounding circumstances before arriving at a conclusion. Mr. Tam said that there could be central management and control where a company carried on business. The test was not limited to where the board met. If a branch was a substantive set-up in Hong Kong, it may be regarded as resident in Hong Kong even though its head office was incorporated outside Hong Kong.

Mr. Lui explained that there was a general perception amongst the HKSA's Taxation Committee members that it was becoming more difficult to succeed in claims for offshore employment, which is why the Society had raised the subject for the second successive year. The CIR replied the IRD would continue to make its position clear internally and to train staff in relation to dealing with time-apportionment claims. Cases were uplifted onto the IRD's intranet and it was hoped that training and education would ensure a consistent approach.

AI(c) Guidance on transfer pricing

This Society referred to the 2003 Annual Meeting in which CIR indicated that “there was no imminent need to provide more information on transfer pricing, in addition to that already available in DIPN 11A, DIPN 15 and DIPN 22”. The guidance that can be found in these DIPNs on transfer pricing is contained in DIPN 11A. Paragraph 42 of DIPN 11A provides “... the Field Auditor reviews the inter-company pricing policies of the parties concerned and related material, including any analyses that have been carried out for the purpose of determining the prices at which goods are

bought or sold, or at which services are provided. In carrying out the review, the Field Auditor takes into account pertinent circumstances of the parties concerned, including the contractual terms, the characteristics of the goods or services, the economic situation, the business functions carried out, risks borne and the business strategy.”

The Society commented that this guidance might be of limited practical use, as it had not stipulated the methods that were acceptable to the IRD. In view of the increasing number of cross-border transactions, the Society considered that there was a need for more practical guidance on transfer pricing, as provided in many other jurisdictions. The Mainland tax circular “Taxation Administration Rules for Business Transactions Between Associated Enterprises (Guo Shui Fa No. 59 (1998))” was a good example. The circular stipulated three acceptable pricing methods: Comparable Uncontrolled Price (CUP), Resale Price and Cost Plus.

In relation to transfer pricing issues, CIR said that although the number of cross border transactions was increasing, there had not been any substantial increase in the number of transfer pricing cases since the last meeting. Most cases involved onshore and offshore profits rather than the transfer pricing issues. The matter was therefore only of interest to a small group of taxpayers or practitioners rather than affecting the public at large. Usually the IRD would collect data on issues of a growing trend. Data on transfer pricing cases had therefore not been kept by the IRD as the number of cases was not that many.

Mr So explained that the general practice was to apply the arm's length principle to controlled dealings among connected parties. The choice of the most appropriate method in dealing with transfer pricing issues should be based on a practical weighing of the facts, with supporting evidence and circumstances on the nature of the activities being examined, the quality and reliability of the data, the extent and reasonableness of any assumption and the degree of comparability that exists between controlled and uncontrolled dealings. Depending on the facts and circumstances of each case and without restricting the use of other methods, such as the profit split method, Mr So said that the IRD would consider using international rules on transfer pricing. The three traditional transaction methods, namely CUP, resale and cost-plus, endorsed by the OECD for use under the arm's length principle would also be accepted by the IRD in determining the arm's length price, margin or profit for connected party transactions. Overall, Mr So advised that the IRD would not dispute the use of any method under the arm's length principles adopted by international bodies. Mr So concluded that the IRD maintained the view that the existing guidance for transfer pricing was sufficient for the present purposes.

CIR referred to Guo Shui Fa No. 59 (1998) and commented that as far as the IRD was aware, it followed Article 9 of the OECD Model Tax Convention. The IRD also followed the arm's length principle adopted in Article 9 where necessary. This is consistent with the decision in *Petrotim Securities Ltd. v Ayres*, 41 TC 389.

AI(d) DIPN 34 – Exemption from Profits Tax (Interest Income) Order 1998

The Society referred to the IRD’s policy on adjustments for expenses attributable to interest income exempt from tax as stated in paragraph 8:

“The Department’s policy as regards adjustments for expenses attributable to the earning of interest income is only to require an adjustment for expenses to be made where there is a direct link between the expense in question and the interest income in question. Where the link is merely indirect or incidental, adjustments to expense deductions are not usually required to be made. Assessors do, however, reserve the right to make adjustments in specific situations where the particular facts of individual cases indicate that such adjustments are appropriate in the circumstances.”

The Society noted that, in practice, assessors were increasingly seeking to attribute general administrative expenses, which were indirect and incidental in nature, to the earning of exempt interest income. In some cases, assessors had sought to make the adjustment in accordance with Inland Revenue Rule (IRR) 2C.

The Society therefore asked the IRD to provide guidance on the following:

- (i) Examples of circumstances where it would be considered appropriate for assessors to make adjustments rather than to follow the IRD’s stated policy of not adjusting for indirect or incidental expenses; and*
- (ii) whether an adjustment calculated in accordance with IRR 2C was appropriate?*

Mr Tam replied that the existing guidelines on expenses apportionment had been clearly spelt out in section 16(1) of the IRO as well as Inland Revenue Rules 2A and 2C. Rule 2C referred to disallowance of expenses of supervision and management of an investment portfolio of sufficient substantial value. The conditions for invoking Rule 2C were: -

- (i) the interest income was derived from an investment portfolio,
- (ii) the portfolio was, in the opinion of the assessor, sufficiently substantial,
- (iii) if there was not a more practical and suitable basis available in the circumstance of the case for arriving at the expenses adjustment.

Mr Tam enquired the specific problems envisaged by the Society. In reply, Mr Lui said that the Society only had a general feeling that adjustment cases were on the increase and wanted to enquire whether there had been a change in policy. Mr Tisman supplemented that if the question was not clear enough, the Society would be happy to clarify the point for the IRD to follow up later on. Ms Law suggested that the question could be directed at cases where a valid apportionment basis had been accepted by the IRD and consistently applied but a new assessing officer changed it to another valid basis. CIR replied that in some cases, assessing officers might need to review and see if a change of operation called for a change of previously agreed basis.

It could be that the new basis should have been applied at an earlier date. However, the endorsement of senior officers would be required to re-open assessments where there had been a change of opinion in respect of the same facts, and cases would not generally be re-opened where the amounts involved were small. In any event, Mr Tam confirmed that the IRD still adhered to its view expressed in earlier meetings on finalization of assessments under section 60.

A1(e) DIPN 38 – Employee share option benefits

- (i) *The Society referred to paragraph 51 of DIPN 38 which stipulated that the IRD would allow a person departing from Hong Kong to elect to have the salaries tax liability associated with a share option to be ascertained on the basis of a notional exercise of the option. It enquired if the IRD could clarify the following practical application of this election:*
- (a) *When the final tax return had to be submitted for the IRD to consider the election? If, for example, the submission of the tax return were delayed because, say, the employer’s return was submitted late, or the employee’s return was submitted late for other reasons, would the IRD accept the election?*
 - (b) *The tax liability under this election was to be calculated on the basis of the gain that would have been realised if the option had been exercised “the day before the date of submission of the person’s salaries tax return for the year of assessment in which he/she permanently departs from Hong Kong”. In practice, and subject to (a) above, how should this be applied if the return was submitted after the employee had permanently departed from Hong Kong; e.g., should the day before permanent departure from Hong Kong be used?*
 - (c) *If the employee advised the employer the election had been made, were the employer and the employee still required to report the actual exercise?*
- (ii) *The Society noted that paragraph 35(viii) contained a formula to calculate the assessable amount of the gain of a person with a non-Hong Kong employment granted conditional share option rights, subject to a vesting period during which services were rendered both in and outside Hong Kong and wished to clarify the following issue:*
- (a) *Should the formula be strictly applied, i.e., days spent rendering services in Hong Kong during the vesting period or was it the IRD’s practice to attribute vacation days into the formula?*
 - (b) *In respect of conditional awards, the practice note had not addressed the situation where the source of income, i.e., the location of the employment, changes during the vesting period. For example, an employee could be granted conditional rights whilst he was regarded as holding a Hong Kong located employment but the rights could partially vest whilst he*

was regarded as holding a non-Hong Kong located employment (e.g., if the employee is transferred to another group company overseas). The Society asked the IRD to confirm that the practice in respect of conditional awards vesting in respect of a non-Hong Kong located employment would apply to the second part of the vesting period.

CIR informed the Society that the IRD had been reviewing on a continuous basis its DIPNs, having taken into account the latest development. DIPN 38 was in the course of updating. Any comments/input from the Society were welcome and they could be sent to the IRD through e-mail or other means. They would then be addressed in the revised DIPN.

As to when the final tax return had to be submitted for electing the concession in paragraph 51 of DIPN 38, CIR said that a person who was about to depart from Hong Kong would normally be required to submit a final tax return within a short time after the return was issued to him or her for completion. This was to ensure that the tax liability could be ascertained and settled before his or her departure from Hong Kong. After all, election for the deemed exercise of the option had to be made in the final tax return. Normally 3 months was considered a reasonable period for both the taxpayer and the IRD to finalize the tax liability for the taxpayer who had departed Hong Kong permanently.

As regards whether the employer and the employee were required to inform the IRD of the actual exercise after electing for the deemed exercise, CIR informed the Society that the employer was still required to advise IRD of the actual exercise by way of Employer's Return, IR 56B. Normally, a tax return would not be issued to the employee who had departed Hong Kong permanently. In the unlikely event that a return had been sent to the employee for the year in which the actual exercise took place, the employee could return the return form to the IRD for cancellation with the advice that the gain had been assessed.

In addressing the question on whether vacation leave should be attributable to the formula in paragraph 35(viii) of DIPN 38, CIR commented that the intention for the formula was to calculate the chargeable income derived from services rendered in Hong Kong including leave pay attributable to such services, as provided in section 8(1A)(a) of the IRO. Vacation days attributable to services rendered in Hong Kong should therefore be taken into account in ascertaining the taxable portion of the share option gain in the formula. The formulae for calculating leave days attributable to services in Hong Kong was the same as one used for time-basis claims under section 8(1A)(a).

As regards conditional grant of option involving Hong Kong employment and non-Hong Kong employment in the vesting period, CIR pointed out that paragraphs 39 and 40 of DIPN 38 dealt with conditional grant in a Hong Kong employment situation and paragraph 46 dealt with conditional grant in a non-Hong Kong employment situation. The IRD's view was that the vesting period should be split into a period for Hong

Kong employment and another for non-Hong Kong employment. The chargeable gain for each of these two periods could be computed according to the rationale in the abovementioned paragraphs.

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

- (a) *The Society referred to paragraph 16 which suggested that weekend days preceding a business trip would be treated as a holiday part of the journey and the costs, if paid by an employer, would be taxable income of the employee.*

The Society expressed concern that it might be common for executives to arrive at a destination on a weekend ahead of business meetings to be held in the following Monday or Tuesday. This was especially so for a long-haul business trip so as to enable them to shake off the jetlag and better prepare themselves for the business meetings.

The Society therefore considered that in these circumstances treating the travelling costs incurred by the employer for the weekend as taxable holiday benefits of the employee would not be fair. It would like the IRD to clarify its assessing practice on this point.

- (b) *The Society referred to example 5 (b) – in the middle of a 10-day business trip the employee went for sightseeing in an afternoon and the related costs reimbursed by the employer were treated as non-taxable on the basis that the sightseeing session could be regarded as being incidental to the business trip.*

On the basis that the sightseeing was not to accompany clients, and the costs and purpose of it were separable from the business trip, prima facie, the Society considered that it should have been caught by the amended legislation. It therefore asked the criteria in determining whether or not such activities would be regarded as merely incidental to a business trip and asked the IRD to further clarify the rule for this purpose as there was concern that members of the Society might not be able to advise clients on this point with any confidence.

- (c) *The Society further referred to example 10 – the merit trip organized for staff in view of the company's record profits. The Society was of the view apparently this was a gratuitous and non-contractual benefit which might lack continuity and expectation. In paragraph 11 of DIPN 16, it was recognized that:*

“It also accepted that benefits resulting from expenditure by an employer for a non-contractual reason, for example, on compassionate ground – escaped chargeability if lacking the elements of expectation and continuity. The Privy Council's position concerning such benefits reflected the Department's pre-Glynn practice.”

As gratuitous award of non-contractual holiday benefits especially on a group basis is a popular means by which an employer fosters morale and team spirit amongst its workforce, the Society asked the IRD to further clarify the tax

treatment of this sort of benefits that were not convertible into cash by employees. The Society questioned if they had to be contractual or at least with some elements of expectation and continuity before they fell within the ambit of the amended legislation.

Regarding travelling costs on weekend days preceding a business trip, Mrs Chan replied that a pragmatic approach would be taken by the IRD. For a long-haul trip which was solely for business purposes, the IRD would normally accept the day immediately before the date of the meeting as spent for the business purpose. Therefore, the relating costs would not be taxable.

In respect of the question on sightseeing on one afternoon in a 10-day business trip, Mrs Chan explained that example 5(b) was meant to reiterate the view stated in paragraph 14 of DIPN 41 – “In cases where a trip is taken partly for business and partly for holiday, the IRD will look at the immediate purpose of the trip; if a holiday was merely incidental to a business trip, the IRD will refrain from taxing the benefit.” In the example 5(b), Mr. Ng went for the 1-afternoon sightseeing “when he was free”. IRD had taken a pragmatic approach and would not seek to tax the amount reimbursed by the employer on the consideration that the unplanned and brief sightseeing session was merely incidental to but not the immediate purpose of the 10-day business trip.

Ms Florence Chan raised the question of whether employers would be expected to decide on the inclusion of the benefits in the employers’ returns. Both CIR and Mrs Chan considered that the employers should be in a better position to judge whether the costs incurred were for the employees’ holiday benefits and if they were, the costs had to be included in the employers’ returns.

Mrs Chan said example 10 served to illustrate the situation where an amount paid by an employer for purchasing a packaged tour not convertible into money was included as the employee’s assessable income according to the newly introduced section 9(2A)(c). Under the new section 9(2A)(c) of the IRO, salaries tax would be chargeable on an employee in respect of “any amount paid by an employer in connection with a holiday journey”. As such, holiday journey benefits not convertible into cash would be taxable and the practice in DIPN 16 would have no relevance to taxation of holiday journey benefits, which would be different from other benefits in kind.

As a separate note, Mrs Chan informed the Society that DIPN 16 had recently been updated, taking into account the tax implication of changes in legislation relating to taxation of holiday benefits.

Inland Revenue Rules

A1(g) Inland Revenue Rule 2C – Investment Portfolios

The Society understood that IRR 2C was aimed at disallowing certain expenses incurred by an investment portfolio holding company in monitoring its investment portfolio, where there was no likelihood of assessable profits arising from that investment portfolio.

In this connection, the Society would like the IRD to define the scope of the term “investment portfolio” and provide specific guidance as to the criteria for the types of investment portfolios to which IRR 2C should apply. For example, whether a company holding 100% owned subsidiaries which were each independently managed would be considered to have an “investment portfolio” for the purposes of IRR 2C.

Mr Luk replied that an investment portfolio, in the context of Rule 2C, generally included securities and other similar investments which did not generate income chargeable to profits tax. An independently managed wholly-owned subsidiary would, generally, not be considered to be part of the investment portfolio, for the purpose of Rule 2C, unless the facts were sufficient to warrant adjustments under that Rule. Other adjustments, such as that on funding cost, might nevertheless be appropriate.

AGENDA ITEM A2 – IMPROVING THE LEVEL OF CERTAINTY AND CONSISTENCY

A2(a) Re-opening prior years’ assessments by the IRD as a result of a change in practice

- (i) *The Society observed that before the Secan case, the IRD accepted there could be a difference in accounting treatment and taxation treatment as illustrated by the deduction of prepaid expenditure. As explained in DIPN 40, starting from the year of assessment 2002/2003, prepayments are no longer deductible in the year they are paid. The Society took it to indicate that the IRD had changed its practice in accepting taxation treatment which deviated from commercial accounting principles as from the year of assessment 2002/2003.*

The Society understood that unrealized gains or losses in trading securities were not taxable or deductible as long as these had been consistently treated for taxation purposes despite the fact that Statement of Standard Accounting Practice (SSAP) 24 required proper accounting treatments for such gains and losses in income statement since 1999. However, a member firm had come across a case where an IRD assessor sought to tax the unrealised gains derived in prior year by issuing an Additional Assessment to the taxpayer. The Society referred to the 2000 Annual Meeting in which CIR indicated (under Agenda Item A9) that if questions about the tax implications of SSAP 24 were to arise

frequently, the IRD would need to establish guidelines for such cases.

The Society sought to clarify whether the IRD would:

- (a) re-open assessments prior to the year of assessment 2002/2003 insisting on using the accounting treatment under SSAP 24 to deal with unrealized gains or losses in trading securities for taxation purpose; and*
 - (b) issue guidelines on the tax implications of SSAP 24.*
- (ii) The Society pointed out that taxation of unrealized mark-to-market accounting profits would increasingly become more of an issue when Hong Kong adopts IAS 39 locally, possibly in one or two year's time. Under IAS 39, all derivative contracts, irrespective of their purposes, have to be marked to market at each balance sheet date through profit and loss accounts, unless a special hedge accounting treatment can be adopted in certain circumstances. As such, the Society asked for IRD's preliminary view on this.*

Mr So responded by saying that for the banking and securities industry, the practice of mark-to-market had been accepted by the IRD for many years, long before SSAP 24 came into force. The tax computation followed the accounting treatment and there had not been any problem.

For other types of business, Mr So noted that after SSAP 24 came into force in 1999, trading securities were also marked to market. The tax computations should not exclude the gain or loss recognised in accordance with SSAP 24. However for years prior to SSAP 24, some taxpayers excluded the unrealized gains or losses in their tax computations. This was normally accepted by the IRD if consistently applied. Assessments made in accordance with the practice before SSAP 24 came into effect would not be re-opened.

Mr So emphasised that after SSAP 24 became effective in 1999, the tax treatment had to follow the accounting treatment. This point was discussed at item A9 of the minutes for 2000 Annual Meeting.

Ms Florence Chan pointed out that under the alternative accounting treatment of SSAP 24, "non-trading securities" would be marked to the market through the reserve instead of the profit and loss account. She enquired, if the "non-trading securities" were, however, regarded by the IRD as actually held for trading purposes, would the IRD tax the gains or allow the losses, even though they were not reflected in the profit or loss account of a taxpayer?

Also under IAS 39, taxpayers had a one-time choice of reporting the gains and losses arising from changes in the fair value of "available-for-sale" financial assets, either (a) in the profit and loss account for the period in which they arose, or (b) directly in the equity account until the asset was sold. She also enquired as to the IRD's view on the proper tax treatment of such financial assets.

As regards IAS 39, Mr So indicated that the Secan decision would still be followed, as reflected in the statement of Mr Tam appearing on page 12 of the minutes for 2000 Annual Meeting viz “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”. Mr. So pointed out that the points made by Ms Chan needed to be explored in detail. He promised to contact Ms Chan after the meeting to further discuss the matter.

A2(b) Agreeing offshore profits claims – offshore trading

The Society noted that uncertainty had been experienced with offshore trading profits claims agreed by the IRD in situations where an assessor taking on a case did not allow the offshore trading claim agreed by the assessor previously handling the case. In view of the number of Provisional Assessments raised, requests for Tax Reserve Certificates, and requests to take the case to the Board of Review, and given also that the four Advance Tax Rulings (Nos. 9 – 12) published this year did not seem to have indicated clearly the stance that the IRD would take in these cases, the Society requested clarification from the IRD on the matter.

CIR clarified that most business operations underwent changes over time to respond to changes in the business environment. Since the validity of "offshore" claims depended very much on the mode of the actual business operations, they needed to be reviewed periodically and the position updated to ensure that the relevant profits were derived outside Hong Kong. This was necessary in order to monitor the self-compliance rate of the taxpaying public and to prevent abuse of the assessing system.

Concerning the raising of assessments, CIR said that the IRD was only empowered to raise additional assessments within six years. Within this time-frame, an assessing officer would only re-open an assessment on discovery of additional facts which would lead to a change of opinion. However, even if there was no discovery of additional facts, a change of opinion might also occur. In such cases, “change of opinion” meant that an assessor has concluded that, on the basis of the law and facts, it would not have been possible to have arrived at the original view. The endorsement of an Assistant Commissioner was required for raising assessments in such change of opinion cases. Ms Yvonne Law asked if change of opinion included change in the basis of apportioning expenses. CIR and Mr So both answered in the affirmative.

A2(c) Use of Macau offshore companies and prosecution under the common law

The Society referred to a newspaper article published in the Sing Tao Daily on 11 July 2003 discussing the impact of the revised SSAP 12 on the use of the Macau offshore companies (“MOCs”) for tax planning purposes and suggested that the IRD could

prosecute a defendant for tax evasion under the common law. The Society would appreciate clarification on the following matters:

- (i) the position that the IRD would take with respect to MOCs; and*
- (ii) how the IRD would apply section 61A of the IRO and, in particular, the “sole and dominant” test.*

The Society understood that the IRD had recently prosecuted a taxpayer under the common law. The Society would like to know:

- (i) the circumstances in which the IRD would adopt this approach rather than relying on the provisions in Part XIV (Penalties and Offences) of the IRO; and*
- (ii) whether there had been a change in the IRD penalty policy.*

CIR informed the Society that the IRD had been following the development of MOCs since their inception. The IRD saw no difference between tax schemes involving MOCs and other schemes of similar nature. It had been the IRD’s priority in closely monitoring the development of tax schemes aiming at avoiding or evading Hong Kong tax.

As regards the application of section 61A, CIR said that there was no hard and fast rule. It would depend on the facts, circumstances and available evidence of each case.

On penalty policy, Mr Chan said that over the years, the IRD had reviewed its penalty policy with reference to the decisions in Board of Review and Court cases. The IRD had uploaded a revised penalty policy statement to the IRD Homepage on 1 December 2003. Insofar as prosecution was concerned, Mr Chan said there had been no change in the departmental practice.

Mr Chan further explained that section 82A penalty was normally preferred to criminal sanctions unless it was inadequate in reflecting the gravity of the criminal conduct as revealed by the evidence. Under such circumstance, prosecution would have to be initiated as a matter of public interest and to generate a significant deterrent effect. Lastly, Mr Chan commented that as the IRD administered IRO, the CIR would only sanction prosecution for offences under section 80 or 82 of the IRO. Section 84(2) of the IRO made it clear that prosecution under criminal offences was the prerogative of the Secretary for Justice. Common Law charges were therefore laid at the initiative of the Secretary for Justice in appropriate circumstances. CIR added that so far there was only one case prosecuted under Common Law and fewer than 10 prosecution cases in all per year. Mr Lui asked if it would become the trend in future for each case to be considered for prosecution under Common Law. Mr Chan replied that this would depend on the evidence available. In any event, CIR stressed that this was not within the prerogative of the IRD. When the IRD lay charges under the IRO, the evidence would be given to the Department of Justice and it was they who decided whether or not to pursue a prosecution under the Common Law.

A2(d) Expense apportionment

The Society noted that for some years, some IRD assessors had insisted that expense apportionment (say for onshore/offshore cases) should be made on a gross profit basis, whilst other assessors considered that a turnover basis should be used. It appeared that, however, some assessors were now applying one method or another without due regard to the taxpayer's suggestion as to the method, which might more appropriately reflect the commercial reality in a particular case.

The Society would like clarification on the IRD's policy on the basis for expense apportionment.

CIR informed the Society that the choice of a basis of expense apportionment would depend on the nature of the taxpayer's business and the mode of operation. As such, both gross profit and turnover bases would be considered. It was therefore hard for the IRD to specify a particular basis to be used. Mr So said that in general an assessing officer would not accept a proposed basis if the result appeared to be disproportionate to the other relevant factors. It would be up to the taxpayer to demonstrate that the basis proposed was most appropriate for the particular situation. There always existed the appeal channel if the taxpayer disagreed to the basis used by the assessing officer.

A2(e) Section 39E application to a Hong Kong taxpayer's plant and machinery used by its wholly-owned subsidiary company in the Mainland

On the basis that the IRD was satisfied that the plant and machinery owned by a Hong Kong taxpayer, which was being used free of charge by the taxpayer's wholly-owned contract manufacturer in the Mainland, was for the production of the taxpayer's chargeable profits in Hong Kong, the Society questioned if the taxpayer's tax depreciation claims would still be denied under section 39E of the IRO on the grounds that the plant and machinery was being used predominantly outside Hong Kong.

If so, the Society asked how this would be reconcilable with the practice that taxpayers could claim tax depreciation allowances (albeit on a 50:50 apportionment basis) in respect of plant and machinery used by their Mainland contractors under typical processing agreements.

Mr Tam explained that the arrangement of allowing the Mainland entity to use the plant and machinery appeared to fall within the provision of section 39E of the IRO. As the plant and machinery were used by that entity outside Hong Kong, no depreciation allowances could be given. For contract processing arrangement cases referred to in DIPN 21, the IRD had by concession allowed 50:50 apportionment of assessable profits. In so doing and also as a concession, the provision of section 39E might not have been strictly applied. Such concession, however, would not be applied in other cases, such as "import processing", where the taxpayer was regarded as a trader.

AGENDA ITEM A3 – TREATMENT OF “HYPOTHETICAL TAX” IN RELATION TO TAX EQUALISATION PACKAGES

The Society understood that a number of multinational groups had tax equalisation policies in place in respect of their employees. Under such policies, the company assumed responsibility for all actual home and host location taxes on employment income whilst the international assignee “paid” a hypothetical tax (i.e., a notional deduction, generally based on the tax that would have been paid had he remained at the home location). Often, under the terms of the expatriate assignment, in order to exercise the stock options, the employee was required to “pay” hypothetical tax. This hypothetical tax was not an actual tax liability or a payment towards the employee’s actual tax liability. The hypothetical tax effectively formed part of the consideration payable to exercise the stock option and the actual home and host tax (i.e. salaries tax) paid by the employer was added to the employee’s assessable income as a benefit-in-kind. The Society asked the IRD to clarify the tax treatment of the hypothetical tax paid by the employee, as follows:

- (i) Should the hypothetical tax be deducted in calculating the stock option gain subject to salaries tax (as part of the consideration paid by the employee to exercise the option or as an adjustment to correctly determine the assessable amount)?*
- (ii) Should a tax credit be claimed against the actual salaries tax payable; or*
- (iii) Should it be netted off from the benefit-in-kind arising from the actual tax paid by the employer?*

Mr Tam replied that, as he understood it, the “hypothetical tax” deducted by the employer represented the difference of the tax borne by the employer and that they would have been paid by the employee if based at home. Such deduction was not consideration for the option and was not deductible for salaries tax purposes.

As regards the second question of the Society, Mr Tam said that tax credit for foreign tax paid against the Hong Kong tax payable was available under section 50 of the IRO only when there was an arrangement between Hong Kong and that foreign tax jurisdiction having effect under section 49, i.e. when there was an Avoidance of Double Taxation Arrangement. However, section 8(1A)(c) of the IRO might be applicable in excluding income derived from outside Hong Kong if foreign tax had been paid on such income.

On whether the amount could be netted off tax borne by the employer, Mr Tam commented that this involved a factual matter – the actual amount paid by the employer to discharge the tax liability of the employee would constitute the employee’s assessable income.

AGENDA ITEM A4 - SSAP 34 – EMPLOYEE BENEFITS

(i) *The Society noted that SSAP 34 on Employee Benefits prescribed the accounting and disclosure requirements for employee benefits. SSAP 34, effective for accounting periods beginning on or after 1 January 2002, contained transitional provisions for the accounting of defined benefit plans. Under these transitional provisions, on first adopting SSAP 34, an enterprise should determine its transitional liability at that date as:*

- *the present value of the defined benefit obligation at that date; minus*
- *the fair value of the plan assets at that date; minus*
- *any past service cost that should be recognised in later periods.*

Where the transitional liability was more than the liability that would have been recognised at the same date under the enterprise's previous accounting policy, the Society noted that the resulting loss might be recognised as a prior period adjustment under SSAP 2. The accounting entries would be as follows:

*DR Opening Retained Earnings
CR Provision for Employment Costs (B/S)*

When the contributions were actually made, the expense would not be debited to the profit and loss account as the accounting entries would be as follows:

*DR Provision for Employment Costs (B/S)
CR Cash (B/S)*

Based on the above understanding, the Society asked the IRD to confirm:

- (a) *Whether a tax deduction would be available where a negative adjustment was made to opening retained earnings upon adoption of SSAP 34.*
 - (b) *If the answer to (a) were in the affirmative, in which year of assessment such negative adjustments would be made to the computation of the assessable profits of the taxpayer.*
 - (c) *If the answer to (a) were negative, whether a tax deduction would be available when the contributions were actually made, notwithstanding that an amount was not expensed through the profit and loss account.*
- (ii) *Further, where the fair value of the assets of a plan exceeded the present value of the defined benefit obligations of the plan at the transitional date (say on 1 January 2002 for a company that closes its accounts on 31 December and first adopted the SSAP for its accounts ended 31 December 2002), the Society noted that there would be a prior year adjustment to the year ended 31 December 2001 recognizing the initial surplus assets of the plan as follows:*

DR Pension scheme assets
CR Retained Earnings

This initial recognition of pension assets would be amortised to the profits and loss accounts of the company when the company incurred additional obligations for its employees under the scheme. The accounting entries in the year 31 December 2002 and thereafter would be as follows:

DR Retirement expenses
CR Pension scheme assets

The Society would like the IRD to clarify:

- (a) Whether the initial recognition of scheme asset would be taxable.*
- (b) If the answer to (a) were in the affirmative, the year of assessment in which the prior year adjustment would be taxed.*
- (c) If the initial scheme assets were very large (say because of very good investment returns of the scheme assets in the past), whether the IRD would entertain the argument that the prior year adjustment in large part represents non-taxable investment returns of the scheme? Alternatively, whether the taxpayer would be allowed to stick to the previous taxation basis, i.e. despite the P&L figures, only claim tax deductions when actual contributions to the scheme were made. In this case, the taxpayer with large initial surplus assets were fully utilised to meet its future additional obligations under the scheme.*

Mr So replied that the negative adjustment made to the opening retained earnings was not deductible as the adjustment was made through the equity account. According to the principle laid down in *CIR v Secan Ltd*, the tax treatment should follow the accounting treatment provided that the latter was in accordance with the prevailing generally accepted principles. As the provision was not charged to the Profit and Loss account and was not treated as an operating expense of a company, the adjustment was not deductible. Mr So further clarified that where the transitional liability for defined benefit plan related to an occupational retirement scheme, section 17(1)(j) specifically prohibited from deduction any provision made other than for the payment of regular contributions.

As the answer to the first question was negative, the second question was irrelevant.

On the Society's third question, Mr So pointed out that a tax deduction under section 16A, subject to the provisions of section 17(1), of the IRO would be available when the contributions, other than regular contributions, were actually made to the plan established under a recognized occupational retirement scheme or a mandatory provident fund scheme. The deduction of this special payment would be deducted over a 5-year period starting from the year of payment. In reply to a question raised by Ms Yvonne Law, Mr So said that any provision for the payment was by law

disallowed under section 17(1)(j) of the IRO. As regards the positive adjustment made to the opening retained earnings, Mr So confirmed that it would not be regarded as taxable income. However, the company should be aware of its tax liability under section 15(1)(h) of the IRO in cases where the future economic benefits derived from the asset took the form of a cash refund.

AGENDA ITEM A5 – PROVISION OF INFORMATION TO IRD

A5(a) Section 51(4) of the IRO

The Society understood that under section 51(4) of the IRO, the IRD could give a written notice to a person to require the production of information about a taxpayer. The compliance with such request might often involve considerable time and resources. The Society would like to know if the IRD would consider reimbursing the costs involved in the same way the IRD reimbursed banks for the cost of providing copies of bank statements.

Mr Chan replied that it was not within the ambit of the IRD. The Government's legal position being that where its request for copies of documents etc. was backed up by statutory provisions which did not provide for the payment of charges, the Government had no obligation to pay any charges whatsoever for the copying of the documents. IRD was therefore not authorized to concede any payment for complying with a notice under section 51(4). Mr Chan explained that the payments made by the Government to banks were ex-gratia in nature, given that banks were in a peculiar position in that they were requested to provide copies of documents relating to third parties on a regular and onerous basis. It was therefore a concessionary arrangement between the Secretary for Financial Services and the Treasury and the Hong Kong Association of Banks.

A5(b) Form IR56M

According to the IRD website, IR56M is a form used for filing information in respect of payments in excess of \$25,000 to agents, brokers, consultants, entertainers and freelance resident artists/sportsmen, writers, etc. or \$200,000 to sub-contractors who are not, strictly speaking, employees of any person. If any employer is noted, in the past year's return, as having been engaging the services of such non-employees, IR56Ms will be enclosed with the BIR56A and IR56Bs to him for completion.

The Society pointed out that section 52(2) of the IRO empowered the IRD to require employers to furnish information on remuneration, etc. in relation to employees. However, the wording of section 52(2) did not seem to apply to IR56M payments.

The Society enquired the basis for the obligation to complete IR56M.

CIR explained that the notice in BIR 56A only required an employer to give particulars stated in IR 56B in respect of its employees. It did not cover IR56M. IR 56M was designed to facilitate companies to return amounts paid to persons other than employees, such as sub-contractors, agents, freelance artistes, etc. Although IR 56M forms were sent during the bulk issue, the measure was to facilitate its completion by employers. Requests for completion of IR 56M were sent under cover of IR 6036A carrying the title "Remuneration paid to persons other than employees". Such requests were sent under section 51(4)(a) of the IRO.

A5(c) Furnishing information on companies having tax losses

The Society understood that previously, the IRD issued a tax return once every 3 years rather than on an annual basis for those companies having tax losses. In the current year, a member of the Society had been requested by the IRD to provide information in respect of those companies that had not received any tax return in the previous years but which had filed a tax return in the current year, including previous years' balance sheets, auditors' report, detailed profit and loss account, and tax computations.

The Society would like to know if the IRD has adopted a new approach in such cases.

CIR replied that this was probably a case where the current year return filed by the taxpayer showed assessable profits for the current year, but the taxpayer at the same time claimed the set off of losses in previous years. Normally back years returns would be issued to the taxpayers for completion in such cases, in order to ascertain the allowable losses to be brought forward to the current year. However if the back years were time-barred, no back year returns would be issued. Instead, the taxpayer would be asked to supply accounts and tax computations etc. for the time-barred years. The purpose was the same, i.e. to ascertain the allowable losses to be brought forward. There had therefore been no change in policy.

A5(d) Policy on provision of information in respect of review

The Society noted that, in certain cases, particularly those relating to MOCs, the tax representative was required to present the whole case again to the reviewing assessor, even though he had previously explained the whole case to the assessor who originally handled the case.

The Society would like to seek confirmation as to the IRD's policy on handling cases in this regard and whether there had been any change in the policy.

CIR clarified that there were circumstances, whether or not they involved MOCs, where an assessing officer might undertake a review of how certain transactions of a taxpayer were to be taxed even though enquiries had been issued relating to back-year

returns. One of the purposes was to find out whether or not there had been any changes in the mode of operations of a taxpayer. If it was shown that there had been no significant change in the taxpayer's operations, then normally the case should not be re-opened.

A5(e) Submission of published annual report in tax filing

The Society noted that a published annual report was an acceptable document for the purpose of fulfilling the reporting obligation of a listed company to its shareholders under the Companies Ordinance and asked whether the IRD would accept published annual report without the actual signatures of the directors and the auditor for the purpose of filing a profits tax return.

Mr Luk said that the compliance requirement had long been established and was in no way considered to be onerous. For published annual accounts, Mr Luk clarified that the IRD would accept signed copies of printed accounts in the case of multi-national or public companies which had their accounts printed for distribution to shareholders etc. However, detailed accounts were also required. In case of printed accounts without signature of directors and auditors (i.e., only with printed signatures but without manual signatures), the IRD would accept them provided they were certified true copies by an authorized person such as the auditors. Upon enquiry from Mr Lui, Mr So confirmed that the practice relating to printed accounts mentioned above was confined to multi-national and public companies. Ms Yvonne Law asked, in the case of overseas companies whether copies of accounts certified true by a CPA firm would be accepted. Mr So replied that the certified copy would be accepted provided the directors' signatures appeared on it. Ms Chan mentioned that IRD always accepted certified copies of accounts. Mr So clarified that this was acceptable only when there were directors' signatures on the copy.

AGENDA ITEM A6 - PENALTY POLICY FOR VOLUNTARY DISCLOSURE OF UNDERSTATEMENTS WHERE TAXPAYER DOES NOT KEEP PROPER BOOKS AND RECORDS

If a taxpayer who had not kept proper books and records admitted that the profits reported for past years had been understated, and voluntarily informed the IRD of the possible understated income quantified by using an indirect method, the Society asked if the level of penalty that normally applied in full voluntary disclosure cases would apply to the taxpayer, assuming that the IRD accepted the taxpayer's basis of calculating the understated income.

Mr Chan referred the Society to the following guidelines in DIPN 11 (Revised) "Element of Tax Investigation": paragraphs 5 – 7 gave an account of IRD's practice with respect to full voluntary disclosure; paragraphs 22 – 49 provided guidance as to how a tax representative should go about preparing revised profit statements and

paragraphs 28 – 46 applied to cases where accounting records were incomplete or unreliable. In the circumstances, Mr Chan was of the view that the taxpayer could use Assets Betterment Statement or other indirect methods to quantify the profits. Provided that the disclosure was full, the lower level of penalty under “Full Voluntary Disclosure” should apply. The emphasis was that the disclosure had to be in full. Any attempt to make a nominal or partial disclosure would be a serious aggravating factor. Further, Mr Chan said taxpayers should also be reminded that penalty would be imposed for the failure to comply with section 51C of the IRO, in addition to the penalties on incorrect returns. The penalty demand notes now quoted the category of penalty being applied. This appeared to be effective as the number of appeal cases had decreased.

AGENDA ITEM A7 - ASSESSMENT PROCEDURES

A7(a) Assessing provisional tax after reporting cessation of business

The Society noted that in certain cases when cessation of business had been reported in the tax computation and on the Form BIR51 (section 4.4), provisional tax was still assessed on the basis on the current year profit. It was suggested that this might result in an unnecessary burden for the taxpayer who would have to lodge a subsequent holdover claim on the provisional assessment.

The Society enquired the standard procedure adopted by the IRD in such cases.

CIR replied that in usual circumstances, the IRD would not demand provisional tax payment for the ensuing cessation year if cessation has been reported in current year's tax return or in the tax computation. In any event, the IRD would remind assessing officers to follow the policy.

A7(b) Tax credit claim

The Society noted that some members had experienced the situation where the IRD had not taken into account a tax credit claim on the assessment after all the required information had been duly provided on filing the return. The claim was immediately granted upon a follow-up request.

The Society asked the standard procedure adopted by the IRD in such cases.

CIR commented that the number of cases claiming tax credits, as observed by the IRD, was by no means significant. To support the claim of tax credit, the taxpayer had to check the box for "Relief from Double Taxation" (Box 7.1) and complete the amount of "Foreign tax paid to be claimed as tax credit" (Box 9.13 and Box 9.11) on the return forms BIR51 and BIR52 respectively. When these data had been input, the return would be referred to the assessing officer for detailed examination. However, if the return had not been completed properly, namely Box 7.1, 9.13 or 9.11 had not been

completed in the BIR Form, the case might escape the attention of officers notwithstanding that a tax credit claim had been made in the body of the return or computation.

In support of tax credit claim, CIR said that a taxpayer was required to submit evidence of payment of tax in the specified territory showing the nature, amount of income taxed and computation of tax paid. In practice, tax receipts issued by the specified territory were regarded as acceptable evidence to substantiate the claim.

AGENDA ITEM A8 - PHASING OF DUE DATES FOR MULTIPLE PROFITS TAX DEMAND NOTES

The Society noted that the present IRD practice was to have due dates spread out over a period when there were several salaries tax demand notes issued at the same time. This apparently was not the practice for profits tax demand notes. To relieve the financial burden on taxpayers, the Society suggested that, when more than one assessment was issued by the Profits Tax Unit (Unit One) at the same time, consideration should be given to spreading out the due dates over intervals of at least four weeks so that only one demand note was due in each month.

CIR explained that the present arrangement in case of salaries tax demand notes was to avoid undue hardship to the taxpayers. If a Unit One taxpayer was really having a financial problem in meeting the tax payment, the taxpayer could approach the IRD Collection Section for instalment payment arrangements. For objection cases, the tax practitioners should approach the assessing officers so that if, for example, tax reserve certificates were required, the date for purchasing the certificates could be phased in view of the financial problem. Strictly speaking, the taxpayer, in particular corporations, should have already enjoyed a deferral in tax payment. There was no reason why a further deferral in due dates should be given for these back-year cases.

AGENDA ITEM A9 - OBJECTION PROCESS

In an objection case involving a 50/50 claim in respect of the years of assessment 1999/2000 and 2000/01, the Society understood that the taxpayer had provided all the information requested by the IRD and had bought Tax Reserve Certificates for the tax in dispute. However, it seemed that nothing more was heard from the IRD between August 2002 and October 2003, until the taxpayer was advised by a letter, dated 30 October 2003, that the case had been forwarded to a senior assessor at the Appeals Section.

The Society asked whether there were particular reason(s) for the lack of progress in this case.

CIR said that the IRD was not prepared to comment on individual cases. However, assessing officers had from time to time been reminded to accord greater priority to objection cases and ensure better communications with taxpayers or their tax representatives on the progress of objections. Tax practitioners could always contact the assessing officers to find out the progress of the cases.

AGENDA ITEM A10 – POSSIBLE LEGISLATIVE CHANGES

A10(a) Section 16(1) of the IRO

The Society said that a member had expressed concern that while her client's royalty income earned overseas was taxed, based on the principle of the TVBI case, her client could not use the foreign withholding taxes paid as a credit against the Hong Kong tax payable on its royalty income. The tax deduction relief under section 16(1) of the IRO, if applicable, might be inadequate.

The Society asked if the IRD would consider taking the initiative to amend the law in this respect or support any such proposals to change the law.

Mr Luk explained that in determining whether a foreign tax was deductible under section 16(1) of the IRO, the question to be answered was whether it was a charge on earnings or a charge on profits. As explained in DIPN 28, only a charge on earnings would be deductible. He went on explaining that a tax credit for foreign tax paid against the Hong Kong tax payable would be available under section 50 only when there was an arrangement between Hong Kong and that foreign tax jurisdiction having effect under section 49, i.e. when there was an Avoidance of Double Taxation Arrangement (“DTA”). It was considered more appropriate to deal with the tax credit within the DTA context, which involved “gives and takes” between contracting parties with the aim of promoting inter-party flow of investments. Mr Luk also intimated that Hong Kong had successfully concluded a DTA with Belgium and was in the course of negotiating more DTAs.

CIR added that it might not be easy to conclude further DTAs due to the low tax rate of Hong Kong. Besides, the article on exchange of information had been a concern of the business community. Having said that, CIR noted that the business community had changed their stance towards the inclusion of a more recent OECD version of exchange of information article in the Hong Kong model of DTAs.

A10(b) Section 16(2) of the IRO

The Society noted that in comments submitted on the Inland Revenue (Amendment) Bill 2000, a proposal was put forward that s16(2)(e) of the IRO should be extended to cover loans raised to finance the purchase of “prescribed fixed assets” and expenditure on building refurbishment, which were eligible for a deduction under s16G and 16F, respectively, of the IRO. The Society asked for the IRD’s view on such an amendment.

CIR explained that the proposal of extending the scope did not fall within the purview of Inland Revenue (Amendment) Bill 2000, which involved the introduction of anti-avoidance provisions. “Prescribed fixed assets” and expenditure on building refurbishment had already been accorded favourable tax treatments. As such, the IRD did not consider that there were grounds for further amending section 16(2)(e) as suggested, though it was a matter of policy.

AGENDA ITEM A11 – PROGRESS ON DOUBLE TAX AGREEMENTS

The Society asked in the light of the recent signing of a Double Taxation Agreement (DTA) with Belgium, what plans there were for further DTAs with other jurisdictions.

CIR referred the Society to her earlier reply at item A10(a).

AGENDA ITEM A12 – CLOSING DOWN IRD OFFICES IN KOWLOON AND THE NEW TERRITORIES

The Society noted that some members had indicated that taxpayers and practitioners operating in Kowloon and in the New Territories had experienced considerable inconvenience in filing tax returns or collecting return forms after the IRD closed down its service centres in these areas.

It asked whether the IRD would consider other ways of enhancing its services to taxpayers and practitioners working in these areas.

CIR explained that the closing down of the offices in Kowloon and the New Territories was due to cost consideration. However, she drew the attention of the Society to the fact that taxpayers and practitioners did not have to call at IRD's office to file tax returns or to collect duplicate returns. The IRD encouraged taxpayers and practitioners to make use of its various electronic services, being part of the Government’s e-service programme. Further, CIR disclosed that the IRD was in the process of reorganising Unit Two and the Headquarters Unit for the purposes of providing better services to taxpayers and tax practitioners.

AGENDA ITEM A13 – TAX REPRESENTATIVES’ SEMINAR

The Society referred to last year’s annual meeting (agenda item B7) in which CIR explained that given, in particular, that there would not be any significant changes in the design of tax returns for 2002/03, the IRD did not see the need to conduct a conventional “tax representatives’ seminar”. Instead the IRD would communicate to tax representatives through an “E-seminar” and updating of Q&As for the completion of tax returns on the IRD website.

The Society was interested in knowing the feedback the IRD received on this new arrangement and whether the intention was to dispense permanently with the conventional form of seminar.

CIR said that this practice was conducive to a more transparent tax administration. At the same time, it was considered more cost-effective from the perspective of both the tax representatives and the IRD. Therefore, the IRD would continue with this practice in the foreseeable future. She further informed the Society that communication through “E-seminar” and updating of Q&As for the completion of tax returns on the IRD website had been well received.

AGENDA ITEM A14 – LODGMENT OF TAX RETURNS

The Society would be happy to discuss with the CIR the latest lodgment figures.

Referring to Table A, Mr So commented that there were fewer tax returns issued in the year of assessment 2003/04. Since the base was smaller, there were correspondingly fewer compound offers and estimated assessments issued. As regards the lodgment performance, Mr So commented that performance for “D” code returns improved due to the postponement of filing date by two weeks to 1 September 2003 because of SARS. As for ‘M’ code returns, the lodgment performance was the same. Therefore the IRD would continue to encourage further improvement in the lodgment of ‘M’ code returns. In respect of Table D, Mr So pointed out the performance of small size firms had deteriorated, but this could be due to the increase in the population of small size firms in 2002/03.

For ‘D’ code accounts, CIR reminded the Society that there was no change in the extended due dates for 2003/04 tax returns, i.e. “D’ code returns would be due on 16 August 2004 and “M’ code accounts on 15 November 2004.

The Society requested for postponement of the “M’ code returns lodgment date for loss cases for the year of assessment 2002/03. This was due to the early arrival of Chinese New Year. Mr So agreed to consider the request and informed the Society later on. [Post-Meeting Note: The IRD subsequently announced on 26 January 2004 that the filing date for ‘M’ code loss returns for the year of assessment 2002/03 would be extended from 31 January 2004 to 14 February 2004.]

A. Lodgement Comparison from 2000/01 to 2002/03

	<u>Y/A</u> <u>2000/01</u>	<u>Y/A</u> <u>2001/02</u>	<u>Y/A</u> <u>2002/03</u>	Comparison 2001/02 and <u>2002/03</u>
1. Bulk issue (on 1 April)	145,000	149,000	143,000	-4%
2. Cases with a failure to file by due date: -				
'N' Code	1,800	1,700	1,600	-6%
'D' Code	4,000	4,400	3,300	-25%
'M' Code	<u>8,700</u>	<u>8,100</u>	<u>7,800</u>	-4%
	14,500	14,200	12,700	-11%
3. Compound offers issued	7,000	7,200	6,000	-17%
4. Estimated assessments issued	3,700	3,500	3,300	-6%

B. 2002/03 Details Profits Tax Returns Statistics

	<u>'N'</u>	<u>'D'</u>	<u>'M'</u>	<u>Total</u>
Total returns issued	17,500	43,000	98,500	159,000
Failure to file on time	1,600	3,300	7,800	12,700
Compound offers issued	800	1,700	3,500	6,000
Estimated assessments issued	500	900	1,900	3,300

C. Represented Profits Tax Returns – Lodgement Patterns

<u>Code</u>	<u>Lodgement</u> <u>Standard</u>	<u>Actual Performance</u>	
		<u>2002/03 PTRs</u>	<u>2001/02 PTRs</u>
D - 15 August	100%	-	81%
D - 31 August	100%	86% ⁽¹⁾	-
M - 31 August	25%	14%	14%
M - 30 September	55%	20%	21%
M - 31 October	80%	39%	41%
M - 15 November	100%	84% ⁽²⁾	84%

⁽¹⁾ 26% lodged within a few days around 1 September 2003 (35% lodged within a few days around 15 August 2002 for 2001/02 PTRs)

⁽²⁾ 32% lodged within the period 1-15 November 2003 (33% for 2001/02 PTRs)

D. Tax Representatives with Lodgement Rate of less than 84% of 'M' code Returns as at 15.11.2003

1,602 T/Rs have 'M' Code clients. Of these, 735 firms were below the average performance rate of 84%. An analysis of the firms, based on size, is: -

	No. of clients per firm	<u>Last Year Performance</u>				<u>Current Year Performance</u>			
		Total No. of firms	No. of firms below the average of 84%	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	1,469	697	4,435	77%	1,391	637	4,087	73%
Medium size firms	101 - 300	122	37	1,306	22%	135	42	1,380	25%
Large size firms	Over 300	11	1	50	1%	15	2	102	2%
		<u>1,602</u>	<u>735</u>	<u>5,791</u>	<u>100%</u>	<u>1,541</u>	<u>681</u>	<u>5,569</u>	<u>100%</u>

AGENDA ITEM A15 - ANNOUNCEMENT OF URGENT AND RELEVANT MATTERS PRIOR TO FINALISATION OF THE MINUTES

The Society referred to the 2003 Annual Meeting where CIR confirmed that there was no objection to the Society's proposal to release information on some of the more urgent and relevant matters prior to finalization of the minutes. The tax deadlines for 2003/04, for example, were announced in the Society's TechWatch publication, within a month after the Annual Meeting.

Given the importance of making members aware of any significant changes in a timely manner, and given that some issues might be more time-sensitive than others, the Society made a similar request this year, to be able announce to members of the Society certain more urgent and relevant matters discussed at this Annual Meeting, in advance of publication of the minutes.

CIR replied that the IRD has no objection to the Society's suggestion, as the prior announcement did serve the purpose. However, this would be subject to the IRD's prior agreement on the more urgent and relevant matters to be announced.

PART B – MATTERS RAISED BY IRD

Agenda Item B1 – Discrepancies detected by field audit

As in the past, the IRD prepared a table at the Appendix to demonstrate the specific problem areas detected in tax audit of corporations for the year ended 31 December 2003 with comparative figures for the years 2001 and 2002.

Mr Chan informed the Society that FA teams uncovered discrepancies in 183 corporation cases, 145 of which carried clean auditors' reports. The discrepancies in these clean report cases accounted for 80% of the total discrepancy detected in corporation cases completed during the year. This represented a decrease of 8% over the percentage for the previous year. However, the following figures were causes for concern:

- ✧ The average understatement per case had increased from \$7.7M to \$9.6M (an increase of \$1.9M or 25%).
- ✧ In 2003, IRD recovered tax of \$213M from corporations carrying clean auditors' reports [*145 cases*]. Comparing with \$160M for 2002 [*129 cases*], there was an increase of \$53M or 33%.

Mr Chan pointed out that the number of cases involving understatement of sales was increasing, 32 cases found this year as against 17 in last year, albeit the amount of discrepancy had decreased (\$16.9M v. \$18.8M) [for one year only, i.e. the audit year]. Although IRD had not identified any specific cases with apparent discrepancy detectable through statutory audit, it was noted that in a majority of the cases involving understatement of sales, IRD was able to detect discrepancy by simply casting the sales ledgers and the sales invoices. Besides, there was a threefolded increase in the amount of discrepancy for purchases overstated (from \$6M to \$20M). This was the figure for one year only, i.e. the audit year.

Lastly, Mr Chan said that "technical adjustments" was becoming a major item attracting IRD auditors' attentions. The discrepancy for the audit year, i.e. one year only, was increased from \$3.6M in 2001 to \$11.2M in 2002, and further increased to \$25.4 M in 2003. He asked the Society to remind its members that penalties might be imposed on technical adjustments if there was no reasonable excuse for failing to make adjustments for apparently disallowable items.

Agenda Item B2 – Incorrect classification of fixed assets in depreciation schedules

Mr Luk informed the Society that IRD assessing officers came across a number of cases where depreciation allowances have been incorrectly claimed in respect of (a) the initial purchase of spare parts; and, (b) electrical wirings forming part of the business premises. Tax practitioners were reminded to exercise care in classifying assets entitled to depreciation allowances when the relevant schedule was prepared.

Agenda Item B3 – Supporting schedules

Mr Luk pointed out that some tax practitioners were supplying less information than necessary in their supporting schedules, in particular those relating to exchange gain or loss. This gave rise to difficulties for assessing officers to decide on whether the exchange gain or loss was of a capital or revenue nature. The assessment process would be expedited if sufficient information could be provided with the return so that the need to raise queries could be obviated

Agenda Item B4 – Slow reply to assessor's enquiries

Mr Luk said the IRD noted that some replies to assessing officers' enquiries were slow. As a result, finalization of the assessments was held up. If a reply to simple and straightforward queries could be provided in a timely manner, rather than lodging a series of applications for extension on a "monthly basis", the case could certainly be settled earlier.

Agenda Item B5 – Date of next annual meeting

CIR suggested fixing the date for the 2005 annual meeting. After discussion, the date was fixed on 21 January 2005 Friday. The Society was urged to adhere to the 6-week deadline for submission of their proposed agenda as previously agreed, so that the IRD could have sufficient time for preparing responses.

Analysis of Completed FA Corporation Cases with discrepancies uncovered for the years ended 31 December 2001, 2002 and 2003

Auditor's Report = Unqualified	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
Sales omitted	11	17	32	27,406,649	18,813,616	16,892,243	4,244,385	2,423,898	2,561,569
Purchases overstated	7	5	7	10,710,316	5,993,825	19,936,197	1,530,702	1,018,809	3,119,654
Closing stock understated	4	3	1	1,186,821	7,927,960	298,503	175,183	1,289,435	69,838
Gross profit understated	32	33	45	71,679,646	106,396,797	130,484,373	11,682,074	17,024,166	17,600,635
Expenses over-claimed	42	42	46	15,683,318	39,091,650	20,994,539	1,687,279	6,040,345	2,940,470
Technical adjustments	30	26	41	3,560,472	11,211,149	25,385,266	447,817	1,820,124	3,153,671
Other	65	56	53	12,656,113	35,284,856	47,891,513	2,227,129	5,823,082	6,606,954
TOTAL	191*	182*	225*	\$142,883,335	\$224,719,853	\$261,882,634	\$21,994,569	\$35,439,859	\$36,052,791
TOTAL NUMBER OF CASES	132*	129*	145*						
AVERAGE AMOUNT PER CASE				\$1,082,450	\$1,742,014	\$1,806,087	\$166,626	\$274,728	\$248,640
Cases involving >1 discrepancy items	(32%) 42*	(26%) 34*	(39%) 57*						
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2001	2002	2003	2001	2002	2003
Other statistics for the above cases: TOTAL AMOUNT				\$604,517,394	\$995,828,266	\$1,391,729,119	\$91,730,208	\$159,513,970	\$212,999,802
AVERAGE AMOUNT PER CASE				\$4,579,677	\$7,719,599	\$9,598,132	\$694,926	\$1,236,542	\$1,468,964

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Auditor's Report = Qualified	Number			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
Sales omitted	8	5	6	9,246,059	1,857,111	8,152,108	557,182	300,966	1,250,459
Purchases overstated	4	5	2	6,224,164	3,452,760	2,566,865	956,076	564,737	410,699
Closing stock understated	1	2	2	3,199,310	5,574,913	288,327	437,587	887,060	46,132
Gross profit understated	11	5	7	22,407,626	13,228,053	20,839,244	3,152,089	2,137,019	3,495,251
Expenses over-claimed	10	8	13	5,488,148	4,999,188	5,826,223	735,731	763,867	828,407
Technical adjustments	5	5	8	3,818,223	1,729,746	1,243,841	554,117	430,995	160,684
Other	15	17	20	8,416,850	3,419,966	49,970,477	1,566,124	554,621	7,887,255
TOTAL	54*	47*	58*	\$58,800,380	\$34,261,737	\$88,887,085	\$7,958,906	\$5,639,265	\$14,078,887
TOTAL NUMBER OF CASES	32*	26*	38*						
AVERAGE AMOUNT PER CASE				\$1,837,512	\$1,317,759	\$2,339,134	\$248,716	\$216,895	\$370,497
Cases involving >1 discrepancy items	(47%) 15*	(38%) 10*	(29%) 11*						
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2001	2002	2003	2001	2002	2003
Other statistics for the above cases: TOTAL AMOUNT				\$250,632,791	\$135,392,518	\$356,418,294	\$35,017,925	\$22,242,599	\$54,438,501
AVERAGE AMOUNT PER CASE				\$7,832,275	\$5,207,405	\$9,379,429	\$1,094,310	\$855,485	\$1,432,592

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TOTAL NUMBER OF CASES 164 155 183

				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2001	2002	2003	2001	2002	2003
Other statistics for the above cases: TOTAL AMOUNT				\$855,150,185	\$1,131,220,784	\$1,748,147,413	\$126,748,133	\$181,756,569	\$267,438,303
AVERAGE AMOUNT PER CASE				\$5,214,330	\$7,298,199	\$9,552,718	\$772,854	\$1,172,623	\$1,461,411