



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 11 (REVISED)

FIELD AUDIT AND INVESTIGATION

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

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Commissioner of Inland Revenue

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INTRODUCTION

The background

The Inland Revenue Department (the Department) is entrusted with the power to collect tax revenue through the administration of various provisions of the Inland Revenue Ordinance (the Ordinance). To achieve this objective, the Department has to collect revenue efficiently and cost-effectively, and promote compliance through the rigorous enforcement of law.

2. The effective operation of Hong Kong's simple tax system requires a high degree of compliance by taxpayers. It is the primary duty of every taxpayer to file accurate returns to the Department. The lodgement of an incorrect return, without reasonable excuse, is an offence under the Ordinance. The Department views tax evasion very seriously and this is evidenced by the inclusion in the Ordinance of provisions which allow the imposition of heavy penalties.

Tax evasion

3. Though the Ordinance does not contain a definition of "tax evasion", the concept of "evasion" involves some deliberate act on the part of the taxpayer. The most quoted statement is that of Dixon J in *Denver Chemical Manufacturing Co. v. FCT*, 4 AITR 216, at page 222:

" I think it is unwise to attempt to define the word 'evasion' it means more than avoid and also more than a mere withholding of information or the mere furnishing of misleading information. It is probably safe to say that some blameworthy act or omission on the part of the taxpayer or those for whom he is responsible is contemplated. An intention to withhold information lest the Commissioner should consider the taxpayer liable to a greater extent than the taxpayer is prepared to concede, is conduct which if the result is to avoid tax would justify finding evasion."

4. It is the Department's view that the term "evasion" includes the following:

- (a) deliberate non-lodgement of a return;
- (b) deliberate understatement of income or over-claiming of deductions;
- (c) understatement of income or over-claiming of deductions owing to ignorance of taxation obligations (even if without any conscious intention to undermine compliance or to understate assessable income); and
- (d) overly aggressive tax planning.

5. The Field Audit and Investigation Unit within the Department is primarily responsible for the audit and investigation of cases where tax evasion is suspected. Broadly speaking, the purpose of field audit and investigation is to secure maximum possible voluntary compliance through a balanced program of audit and investigation. The three main objectives are:

- (a) to recover back taxes;
- (b) to provide a deterrent to tax evasion by the imposition of penalties, either administratively or through the institution of prosecution action; and
- (c) to educate taxpayers on the need to file proper and correct returns.

6. This practice note is to provide general guidance for taxpayers and their representatives who are involved in field audit and investigation. As the Department is committed to combating tax evasion strenuously, and because heavy penalties may be imposed, where evasion is involved a taxpayer may find it advisable to obtain professional assistance to put his tax affairs in order. It should be kept in mind that the degree of co-operation exhibited by a taxpayer in a field audit or investigation case will generally have a bearing on the amount of penalty imposed. It is in the taxpayer's own interests not to "sit back" and leave it to the Department's officers to build up the necessary statements from which the true profits can be ascertained. The taxpayer, if lacking the relevant skills in taxation matters, should recognise that it is sensible to engage the services of a representative to carry out the work entailed.

ASSESSMENT PROGRAMME

Submission of tax return

7. Under section 51(1) of the Ordinance, a written notice may be given to any person requiring him within a reasonable time stated in such notice to furnish a return of assessable profits. The annual exercise can be summarised as follows:

Corporations and other taxpayers

- (a) In early April, the profits tax returns are issued to corporations and other taxpayers who are required to report their assessable profits in the returns.

Individuals

- (b) In early May, Individual Tax returns are issued to individuals who are required to report in their returns the assessable profits derived from their sole proprietorship businesses.

8. For all taxpayers, if their businesses generate gross income exceeding the amount specified by the Department, usually in the notes of the return, supporting documents, including a copy of the accounts (audited accounts if the taxpayer is a corporation) and a tax computation with supporting schedules showing how the amount of assessable profits is arrived at, are required to be submitted with the completed tax returns. If the gross income does not exceed the specified amount, supporting documents need only be submitted when required later.

ASSESS FIRST AND AUDIT LATER

The Assess First Audit Later (AFAL) system

9. Since April 2001, in order to streamline the assessing procedures, the Department has used a computerised AFAL system for screening tax returns for automated assessment and selecting cases for post assessment audit and investigation. Data in the returns submitted by taxpayers are first input into the AFAL system. The AFAL system screens out the returns which meet the pre-set criteria for automated assessment. A certain percentage of these automated

assessments are then selected based on additional criteria for audit and investigation by assessing officers.

10. Returns not meeting the pre-set criteria for automated assessment are screened manually by assessing officers to determine whether they should be subject to in-depth examination prior to assessment.

Three tier audit system

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

12. Under the AFAL system, a customised computer-assisted case selection program has been devised. Depending on the facts of each case, cases selected will be allotted to the assessing officers to conduct “desk audit”, to the field auditors to conduct “field audit” or to the investigators to conduct an in-depth “investigation”. The audit trilogy has enhanced the effectiveness in identifying high-risk cases for audit and investigation, thereby minimising the risk of revenue leakage due to tax evasion and avoidance.

Post assessment audit and investigation

13. The AFAL system has been built on an analytical solution adopted by the Department to select cases for post assessment audits and investigations. After providing parameters to chosen criteria via the application interface, the required numbers of cases can be selected online. Additional selection criteria can be added to the case selection functions via the application interface, in response to compliance trends and emerging business practices.

14. By automating the screening of tax returns, the AFAL system facilitates the identification of potential high yield tax avoidance and evasion cases, and provides an effective means to measure tax compliance and ultimately promote voluntary compliance. The AFAL system enables the deployment of more resources to audit and investigation work. This approach brings about improved voluntary tax compliance and more effective enforcement.

ASSESSMENTS RAISED BY FIELD AUDITORS/INVESTIGATORS

Assessments and additional assessments

15. Section 59(2)(a) of the Ordinance provides that where a person has furnished a return under section 51, the Assessor may “accept the return and make an assessment accordingly”. Post assessment audits and investigations are to identify possible unassessed or under-assessed cases and selection of cases is either based on risk areas or by random checking.

16. In field audits and investigations, it is necessary that additional assessments will be issued after clarifying with the taxpayers. If circumstances warrant, all in-time years would be considered. The power of the Assessor to raise assessments under section 60 of the Ordinance in field audits and investigations has been confirmed in court judgements. In *Lam Soon Trademark Ltd v. CIR*, 6 HKTC 768, Bokhary PJ at the Court of Final Appeal observed that the Assessor’s duty to make assessment is laid down in section 59 and the duty is to assess every person who is in the Assessor’s opinion chargeable with tax under the Ordinance. Bokhary PJ further ruled that the additional assessments raised after a tax audit were justified in terms of section 59 even that the taxpayer was originally assessed in respect of the same profits on another basis.

17. The Commissioner’s power to review assessments previously raised has also been confirmed in *Interasia Bag Manufacturers Ltd v. CIR*, 6 HKTC 655. At the Court of First Instance Hartmann J concurred that assessments previously issued were subject to the power of the Commissioner to review in tax audits because the Commissioner had a duty to collect taxes and the power to issue additional assessments under section 60.

18. In *Nam Tai Trading Co Ltd v. Commissioner of Inland Revenue*, [2006] 2 HKLRD 459, Chu J recognised that the tax liability for one year was always to be treated as inherently a different issue from that of liability for another year. In field audits and investigations, assessments are often re-opened because of additional information coming to light. In practice, reopening a back year assessment due to a change of opinion, which is rare, would require the approval of an Assistant Commissioner.

Protective assessments

19. A field audit or investigation can be a time consuming exercise and could possibly take more than a year to complete. In *Re Chia Tai Conti-Hong Kong Ltd*, 6 HKTC 688, Yam J recognised that, in a complex tax audit case, further investigation and requests for information would be required after information and documents have been provided by the taxpayer. In order to protect the revenue, it is often necessary for Assessors to raise estimated assessments during the course of investigation, particularly in the following circumstances:

- (a) to meet the 6 year time limit for raising back year assessments under section 60 of the Ordinance;
- (b) in deceased cases (under section 54 of the Ordinance, where the person died on or after 11 February 2006, no assessments in respect of a period prior to his death shall be made after the expiry of 3 years immediately after that year of assessment);
- (c) where the taxpayer is about to leave Hong Kong; or
- (d) where there are indications that the taxpayer is delaying the investigation process.

20. Estimated assessments may be raised on a person under alternative heads of charge (e.g. in his or her personal capacity, as a trustee, and as an agent) as a protective measure, based on the Assessor's judgement in respect of the information available to him. The practice of making alternative assessments in a situation where the Assessor may have insufficient information to do otherwise was endorsed by the court in *Nina T. H. Wang v. CIR*, 3 HKTC 483. In law, the Assessor is not obliged to disclose the basis of the assessment per the judgement in *Mok Tsze Fung v. CIR*, 1 HKTC 166. If he considers it appropriate, the taxpayer should lodge a notice of objection to a protective assessment in order to keep the matter open and accordingly protect his interests.

21. As was indicated earlier, it is in the taxpayer's interests to take the initiative and have the representative prepare revised financial statements with a view to facilitating finalisation of the field audit or investigation. However, it has to be stressed that the representative is expected to reply promptly to any

query from the field auditor or investigator in the interim (i.e. he should not defer replying until after revised financial statements are completed).

AUDIT TRILOGY

Desk audit

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

Field audit

23. The Department commenced to conduct field audits of taxpayers' businesses in June 1991 when it set up a Field Audit Group. In April 2000, the Field Audit Group and the Investigation Unit were merged to form the present Field Audit and Investigation Unit. Field audit action is normally initiated when irregularities or indications of non-compliance with the requirements of the Ordinance are detected.

24. Field auditors ascertain the correctness of returns not only by examining books of account and records, but also by visiting taxpayers' business premises. This approach provides a more thorough understanding of business operations and hence facilitates the detection of cases where tax evasion or avoidance is involved. At the same time, it gives the Department's enforcement activities a more visible presence, and consequently encourages the lodgement of correct returns.

25. Field audit work is normally focused on the most recent year of assessment for which a tax return has been submitted. Where appropriate and when agreed with the taxpayers, field auditors will project the discrepancies for back years based on the field audit findings. Other quantification methods may

also be employed for ascertaining the amount of understatements of profits for the years involved.

Investigation

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

FULL VOLUNTARY DISCLOSURE

Extent of disclosure

27. A taxpayer should make a full voluntary disclosure as soon as he notices that his tax affairs are not in order. Although no general undertaking can be given for such cases in relation to the basis on which penalty or additional tax would be imposed, or whether prosecution action would be taken, it is the practice of the Commissioner to be influenced where a person has made a full confession in respect of any offence to which he has been a party, has facilitated investigation and has provided correct returns accompanied by detailed supporting statements. It is important to note, however, that any attempt to make a nominal or partial disclosure (e.g. in the hope that the Department would not take the matter further) would be regarded as a serious aggravating factor.

28. It is assumed in this practice note that the taxpayer has made an admission, at least in general terms, that his tax returns have been incorrect, and has instructed a representative to prepare revised statements of profits or income for each year of assessment under consideration. Paragraphs 30 to 80 below are intended to provide guidance as to how the representative should go about preparing the revised statements and liaise with the Department in relation to the field audit or investigation. However, the paragraphs are not intended to have application where omissions are readily identifiable and can be easily quantified (e.g. the omission of profit on the sale of a property, the omission of salary from part-time employment and simple understatements of

the value of stock in trade). In such a case, a simple statement showing the rate and extent of the omissions will suffice.

29. Paragraphs 56 to 80 below discuss ways in which the representative may go about ascertaining the amounts by which assessable profits for the years concerned have been understated. At this point, however, it is appropriate to provide a broad outline of procedures generally followed by the Department in relation to field audit and investigation cases.

FIELD AUDIT AND INVESTIGATION PROCESS

Case selection

30. The activities of the Field Audit and Investigation Unit are largely targeted at areas where non-compliance is apparent. Rigid case selection criteria are not generally applied. To a certain extent, field auditors and investigators are guided by their experience and knowledge in selecting cases through the application functions provided under the AFAL system. Cases may also be selected on a random basis as a means of promoting voluntary compliance. However, it can be said that a field audit or investigation is normally initiated where characteristics or indications of non-compliance, such as the following, are present:

- (a) the auditors' report in respect of the accounts of an incorporated business is heavily qualified;
- (b) a business has an unreasonably low turnover or profit percentage (having regard to factors such as the nature of the business, its location and type of customers);
- (c) persistent failure to lodge, or late lodgement of, tax returns;
- (d) failure to keep proper business records; and
- (e) failure to provide material information requested by an Assessor.

31. Furthermore, where results of audits or investigations indicate that compliance problems are prevalent in a particular trade or industry, field audits

or investigations on a project basis are generally undertaken in respect of the trade or industry concerned.

Notification

32. A taxpayer selected for field audit or investigation will normally be notified by letter in the first instance. In the letter, the taxpayer will be informed of the year of assessment to be considered initially. The taxpayer is requested to contact the field auditor or investigator to arrange a mutually convenient time and place for the initial interview. The taxpayer is also advised that his representative may attend the initial interview and any subsequent interview.

33. When the taxpayer responds to arrange the initial interview, the field auditor or investigator normally requests details of the nature of the books and records maintained by the taxpayer. The taxpayer may then be advised of the books and documents to be produced at the initial interview.

Instructions to representatives

34. At the outset, the taxpayer should give unambiguous instructions to his representative to the effect that he is to ascertain the true assessable profits of the taxpayer and report the results to the Department. The representative should at the same time impress upon the taxpayer that:

- (a) he must have complete information on all financial transactions and full access to all bank accounts and other financial records;
- (b) he will require explanations from the taxpayer and must receive full co-operation;
- (c) the taxpayer must disclose in what direction his tax returns have been incorrect and what methods of concealment or omission have been adopted; and
- (d) the field audit and investigation cannot be limited to the declared methods of concealment or omission (see paragraph 38).

35. The representative should at an early stage compile:
- (a) a list of the business books of the taxpayer;
 - (b) a list of the taxpayer's bank accounts in operation in Hong Kong or overseas, both business and private (including those held on behalf of the taxpayer in the name of another person);
 - (c) a list of properties, investments, business assets and other assets owned by the taxpayer, including any such item acquired on behalf of the taxpayer in the name of another person (e.g. his spouse or another nominee) in Hong Kong or overseas;
 - (d) a list of bank accounts which have been closed and particulars of properties etc. which have been sold in Hong Kong or overseas during the period covered by the investigation;
 - (e) a summary of all tax returns submitted to the Department and of the assessments made, together with copies of the relevant returns and notices; and
 - (f) a list of the names of all members of the taxpayer's family.

Initial interview

36. At this stage, the field auditor or investigator seeks to gain a thorough understanding of the taxpayer's business operations and personal affairs. Towards this end, the field auditor or investigator will invite the taxpayer to attend an initial interview.

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

38. It is important to note that a field audit or investigation would not normally be limited to the particular points disclosed by a taxpayer at the initial interview. The taxpayer may not have disclosed all the irregularities in his tax affairs, because he may not remember, or may still be reluctant to reveal the full extent of the understatements involved. In the latter situation, the Department would take a serious view in relation to any deliberately incomplete disclosure.

39. As a token of co-operation, the taxpayer may at the initial interview estimate the amount of understatement and offer on a voluntary basis to place a deposit with the Department sufficient to cover the estimated liability. Such action is taken into consideration as a mitigating factor when penalties are assessed. It is, therefore, advisable for a taxpayer to make an effort to review his tax returns before attending the initial interview. The purpose of the deposit is not in any way for payment of monetary penalty and that the acceptance of the deposit placed by a taxpayer would not preclude the Commissioner from exercising her vested power to institute prosecution against the taxpayer.

40. The Ordinance contains in section 4 strict secrecy provisions to protect the confidentiality of information relating to taxpayers. Accordingly, although a taxpayer may invite any person to assist or accompany him at an interview, he must provide the Department with written acknowledgement of consent to the presence of the third party. If the taxpayer engages a practitioner as his representative, a written notice of appointment should be provided to the Department.

41. After the interview, a record of the interview will be prepared by the field auditor or investigator and issued to the taxpayer for comment or confirmation. The taxpayer is requested to inform the field auditor or investigator in writing as soon as possible if he does not agree with the contents of the record of interview. In such a circumstance it is in the taxpayer's own interests to respond accordingly as the record may be referred to in later proceedings.

Gathering records and information

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

43. A notice may also be issued under section 51(4)(a) by the field auditor or investigator requesting further particulars, with supporting documents, in respect of the taxpayer's business and personal financial matters. The taxpayer is required to submit a reply within "a reasonable time". In this regard a period of one month is generally specified in the notice. Written requests for short extensions of time to comply will normally be allowed. Where only part of the information requested by the field auditor or investigator is readily available, that part should be provided without delay; if necessary an extension of time can be requested in respect of the remainder.

Performance pledge

44. A performance pledge in respect of the Department's processing of field audit and investigation cases has been in effect since 1 April 1998. The Department is committed to honouring the pledge as far as possible. For the purposes of the pledge, a field audit or investigation is regarded as having commenced when either a substantive reply to the written enquiry of the field auditor or investigator or the required business books and records are received by the Department. The taxpayer and his representative can clearly play an important role in achieving early finalisation of an audit or investigation case by providing prompt and full replies to the enquiries raised by the field auditor or investigator during the course of field audit or investigation.

45. During a field audit or investigation, it is sometimes necessary to make enquiries of third parties (e.g. the taxpayer's bankers, stockbrokers, suppliers and customers) in order to clarify the nature of transactions. Section 51(4)(a) of the Ordinance provides the field auditor or investigator with the relevant authority. However, to avoid causing embarrassment, the field auditor or investigator will normally seek information from the taxpayer in the first instance. To minimise the need for extensive third party enquires, the taxpayer should respond promptly (including documentary evidence if it is appropriate or required) to any request for information from the field auditor or investigator.

FIELD VISIT AND FIELD WORK

Reasons for field work

46. The initial interview in relation to a field audit case is attended by at least two field auditors and is normally conducted at the business premises of the taxpayer. It affords the field auditor an opportunity to obtain background information pertinent to the audit, including details of:

- (a) the size and nature of the taxpayer's business;
- (b) the method of operation of the business;
- (c) the accounting and book-keeping procedures used within the business;
- (d) the personal financial affairs of the taxpayer and associated persons; and
- (e) the taxpayer's personal and family living expenses.

It is also sometimes necessary, at the initial or a subsequent interview, for the field auditor in charge of the case to meet the operational staff or key personnel of the taxpayer's business, in order to obtain or confirm information concerning its operations.

47. Apart from seeking information relating to the above matters at the initial interview, the field auditor requests the taxpayer to identify his signature and state whether tax returns previously submitted were correct. The field auditor also advises the taxpayer of the penalty provisions of the Ordinance which may apply where a person has failed to comply with his taxation obligations.

48. One of the objectives of a field auditor's initial field visit is to gain an early understanding of the accounting system used by the taxpayer for recording and processing transactions. At the same time, the field auditor assesses the adequacy of the accounting system as a basis for the preparation of financial statements.

49. Field auditors are aware of the need to complete any audit work carried out during a field visit as quickly as possible, in order to minimise any disruption to a taxpayer's business. In fact, it is often more convenient for all concerned if part of the work entailed in the field auditor's in-depth review is carried out within the Department, rather than at the taxpayer's business premises.

50. The field auditor aims to complete small simple audit cases within fourteen working days of the initial interview. Such cases are, however, more the exception rather than the rule. It is more common for a case of average complexity to take a period of three to six months to complete. That said, the speedy progress of a field audit case depends to a large extent not only on the complexity of the taxpayer's business affairs, but also on the support and co-operation of the taxpayer and his representative. In this regard, it is a considerable help to the Department if all information and records required by a field auditor are made readily available. Where a taxpayer's returns are defective, full disclosure of the irregularities or omissions by the taxpayer or his representative should be made at the earliest possible time. However, it is clearly unacceptable for a taxpayer or his representative to submit an unrealistic proposal in the hope that the matter will not be pursued. All proposals and revised accounts or statements are subject to detailed examination and any substantial discrepancy uncovered would be taken into consideration when penalties are considered.

Examination of books and records

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

52. As was mentioned above, a taxpayer is usually asked to provide for examination accounting books together with supporting source documents. In the latter regard, papers detailing matters such as trial balances, year-end adjustments, and stock lists are useful to the field auditor. The field auditor examines the material with a view to checking whether transactions have been properly recorded and whether returns previously submitted are in accordance with the relevant records. During the course of checking the business books, the field auditor generally pays special attention to the following:

- (a) sales account;
- (b) purchases account;
- (c) director’s or proprietor’s current account with the company;
- (d) any account with an abnormal balance;
- (e) any temporary account; and
- (f) any account with a long outstanding balance.

53. In the course of checking movements in a director’s current account with a company (or a proprietor’s/partner’s current account in respect of a sole proprietorship/partnership business), it is usually necessary for the field auditor to have access to statements and passbooks in respect of bank accounts operated by the person concerned and his immediate family members.

54. Records and documents are examined to check whether they support the entries in the accounts. Further checks are made with third parties or other sources of information if there is any doubt as to the genuineness or reliability of the business records. Where the field auditor is of the opinion that it is necessary to verify the taxpayer's records or other information with an independent third party, he may visit the third party concerned to obtain the required verification. In such a case the field auditor issues to the third party a notice under section 51(4)(a) of the Ordinance which requires the person to furnish relevant information.

55. It is sometimes claimed that an absence of records is the result of inadvertent loss or destruction. In such cases, estimated assessments generally have to be raised and consideration is given to the question of whether the circumstances warrant invoking the penalty provisions of the Ordinance. As a matter of course, the Department considers initiating prosecution action in any case where records have not been kept or documents have been falsified.

SETTLEMENT METHODS

Quantification of understatements in field audit and investigation

56. In view of the multiplicity of circumstances, under which understatements occur, it is not practicable to lay down hard and fast rules as to the computation of understatements that could be applied to all field audit and investigation cases. The method of evasion may, for example, vary from a simple under-valuation of stock to a complex scheme involving the creation of false accounting entries and supporting vouchers. The discussion below should be regarded as providing broad outlines of different methods which, depending on the circumstances of the taxpayer, can be utilised to assist in the quantification process. In practice, the respective methods can be adapted to take into account the circumstances of the taxpayer under consideration.

57. A key element in determining the appropriate method of quantification to be used is the reliability of the taxpayer's books and records. If they are reliable, a "direct" approach can be used, whereas if they are incomplete or unreliable, an "indirect" method will be called for.

58. Experience has shown that one of the common areas for irregularities and errors is in relation to the recording of details in respect of trading stock figures (e.g. profits have to be adjusted due to understatements in respect of the quantity or valuation of closing stock). For this reason, if the business of a taxpayer involves trading stock, the stock records and valuation policy are invariably examined for the purpose of assessing the accuracy of the reported closing stock figures. If warranted, the field auditor or investigator may also attend the physical stocktaking of the taxpayer. Such attendance may help ascertain whether proper steps and procedures have been taken to ensure the accuracy of the figures reported. For information concerning trading stock taxation aspects, reference can be made to Departmental Interpretation & Practice Notes No. 1.

Complete books and records available

59. As a result of the introduction of more detailed record keeping requirements in 1995, the likelihood of a field audit or investigation being undertaken by way of an examination of the taxpayer's books and records has increased. Where books and records are properly kept, there is little difficulty in ascertaining the correctness of the income reported by the taxpayer and the expenses charged in the accounts. Thus, transactions that are not reflected in the accounts can be readily identified by a reconciliation of the amounts reported in the tax return with the entries recorded in the books. This direct method of quantifying understatements should be adopted where circumstances permit.

60. In such circumstances, the representative should prepare revised financial statements on the basis of the books and records. These statements together with the books and records should then be submitted to the field auditor or investigator for verification. It will, of course, be necessary to satisfy the field auditor or investigator that the records are reliable and have not been manipulated. In this regard, it will be necessary to provide the field auditor or investigator with an analysis of the Drawings Account of the taxpayer, or, in the case of a company director, of his Current Account and Loan Accounts, if any. An analysis of these accounts should be made along the lines described in paragraphs 64 to 71 below. Details should also be provided in respect of each Loan, Debtor or Creditor Account in the name of a

member of the taxpayer's family. The extent of scrutiny undertaken will depend on the circumstances of the case.

Books and records incomplete or unreliable

61. The Department's experience has been that, because of the inadequacy or even complete absence of records, it is often not possible to construct revised accounts on conventional lines. For such cases, the back duty assessments generally have to be based on indirect methods. Indirect methods are founded on an investigation of the taxpayer's personal affairs. There is no single "best" indirect method of quantification; the method used depends on the circumstances of the case. One commonly used method involves the preparation of an Assets Betterment Statement (the "Capital Computation Method of Estimating Profits" mentioned in Accounting Guideline 1 - Preparation and Presentation of Accounts from Incomplete Records issued by the Hong Kong Institute of Certified Public Accountants). Others include the Bank Deposits Method, the Business Economics (Percentage Computation) Method, and the Projection Method. Each is discussed in turn below.

Assets Betterment Statement Method

62. Preparation of an Assets Betterment Statement (ABS) is generally the most comprehensive indirect means of quantifying an understatement of profits where the books and records in respect of a period are inadequate or are not available. The method may also be applied to quantify understated employment income in Salaries Tax cases. A specimen format of an ABS is at Appendix A.

63. In essence, the function of an ABS is to disclose the correct taxable profits or income of a person by adding to the person's yearly asset increase (i.e. the excess of net assets in any one year over the previous year) all expenditure of a non-allowable nature. Receipts which are of a capital nature or otherwise not assessable are deducted from the sum of these items to arrive at the betterment profits (adjustments are also made if necessary in respect of any applicable depreciation allowances or balancing charges). This can be summarised simply by the following formula:

**Betterment Profits = Increase in Net Assets + Disallowable Expenditure
- Non-taxable Receipts**

64. The preparation of an ABS entails making a detailed analysis of the taxpayer's Drawings Account or company Current Account, Loan Accounts, and bank accounts (or accounts held with similar institutions) which show deposits or withdrawals of money. The accounts of the taxpayer's immediate family members, such as his spouse and dependent children, should also be reviewed and analysed if appropriate. The analysis should, of course, cover every item and be in chronological order. The closing date for each year of the ABS should correspond with the business accounting date. The results of the analysis may be categorised as follows:

Lodgements -

- (a) transfers with note of origin (e.g. from another bank account);
- (b) capital receipts with brief note of origin (e.g. sale of property);
- (c) income receipts with note of source;
- (d) other identified receipts with brief description;
- (e) unidentified receipts by specific cheques; and
- (f) unidentified receipts by cash.

Withdrawals -

- (a) transfers with note of destination;
- (b) capital payments with brief description (e.g. purchase of shares);
- (c) personal payments with note of nature (e.g. school fees, household expenditure);
- (d) other identified payments with brief description;
- (e) unidentified payments by specific cheques; and
- (f) unidentified payments by cash.

65. During the course of the initial analysis referred to above, it may not be possible to immediately identify all the items which may be numerous. However, many of these will be cleared as further accounts are analysed and further information is obtained.

66. Concurrently with the initial analysis, it is useful to prepare three schedules:

- (a) an annual Assets Statement which can be completed as the assets emerge;
- (b) a Statement of Personal and Living Expenditure on which identified items can be entered as they emerge; and
- (c) a Statement of Income, to be completed as each item is identified.

67. The Asset Statement of an individual proprietor should include all his business and private assets and liabilities. In the case of a partner, the Asset Statement would contain the balances of his capital and loan accounts in respect of the partnership. For a shareholder, it would include his shares and the balances of his current and loan accounts.

68. Once the initial analysis is completed, it is desirable to set out the first draft of the ABS along the lines of Appendix A. The representative should then consider the following questions:

- (a) Has everything possible been done to trace the origin of all money which has been lodged or has appeared in banks or elsewhere?
- (b) Has everything possible been done to find the destination or purpose of all money which has been withdrawn from banks or elsewhere?
- (c) Have all assets been identified from which income has been received?
- (d) Have the full cost and the means of payment of each asset been ascertained?

- (e) Has the application of the disposal proceeds of each asset sold been ascertained?
- (f) Has the application of all known income been ascertained?
- (g) Has all of the income from assets which should have been productive of income been identified?
- (h) Have all items of expenditure normally paid by cheque or through bank accounts (e.g. tax, life assurance, school fees, electricity, gas and rates) been traced?

Addressing the above issues may further dispose of unidentified items, or lead to other accounts being revealed, and accordingly necessitate revision of the draft ABS.

69. At this point the representative should consider whether the amounts brought out by the analysis accurately reflect personal and household expenditure. Any untraced items in paragraph 68(h) above would have to be brought into account, as would any exceptional items of expenditure (e.g. holidays, doctors, bills and gifts). When reviewing the adequacy of private expenditure shown on the ABS, it is pertinent to consider the following points:

- (a) What domestic expenditure has normally been required?
- (b) Are there regular cheques or other bank payments (e.g. by direct debit) for the relevant categories of domestic expenditure, or have some purchases been paid in cash?
- (c) What other domestic or personal expenditure has been paid in cash?
- (d) Do the ABS figures adequately reflect the cash expenditure on the items in question? If not, the deficiency requires explanation.

70. Finally, it is necessary to consider the character of the remaining unidentified lodgements and the unidentified withdrawals. This involves consideration of factors such as the explanations provided by the taxpayer, the nature of the business of the taxpayer and the method of accounting on which the original accounts were based. A decision must be taken on the basis of all

available material. However, in the absence of evidence to the contrary, it should be presumed that unidentified withdrawals were not in respect of deductible expenditure and they therefore have to be included as additions in computing the Betterment Profits per Appendix A. For unidentified lodgements, it cannot be accepted that they were of a capital nature or otherwise non-taxable and accordingly cannot qualify as deductions in computing the Betterment Profits unless there is supporting evidence. It should be kept in mind that the Board of Review has pointed out that the assertion of a fact is not evidence (see *D20/89, 4 IRBRD 285*). Furthermore, the status of the ABS has been explained by the Board of the Review (see *D28/88, 3 IRBRD 312*) and the duty is on the taxpayer to produce all the documents he considered relevant to support his claim (see *D6/92, 7 IRBRD 88*).

71. When the matters referred to in paragraphs 69 and 70 have been resolved, the representative should make appropriate final amendments to the draft ABS. The overall result can then be examined in the light of probabilities concerning, for example, known profit trends.

Other indirect methods

72. Although an analysis of the kind outlined above for an ABS should in any event be carried out as far as is reasonably practicable, in some circumstances it may be concluded that an ABS cannot be satisfactorily completed. In such a case consideration should be given by the representative to using another indirect means of quantifying omitted profits. In this regard, three of the more commonly used methods are the “Bank Deposits Method”, the “Business Economics (Percentage Computation) Method” and the “Projection Method”. These methods are not mutually exclusive and may be used in combination. They may also, of course, be used as means of gauging the accuracy of an ABS where completion of one has been possible.

Bank Deposits Method

73. The Bank Deposits Method is a means of ascertaining gross receipts, which can be used where it is established in the course of the analysis that most of the taxpayer’s income is deposited into bank accounts. In adopting this approach, it is vital to ensure that coverage extends to all bank accounts in

which business receipts have been deposited, including those held by nominees of the taxpayer.

74. For wholly or partly cash trade businesses, it is worthwhile to prepare a monthly summary of the bank deposits to help ascertain if there are any other bank accounts which have not been detected (e.g. this may be apparent if there are marked fluctuations in monthly deposits). If cash deposits are found to be missing or if there is a significant decrease in the amount of cash deposits in a certain part of the period under review, the income for the year concerned may be projected. An adjustment for the amount of cash receipts directly used for payment of business and personal expenses is required. With regard to the corresponding expenses, if the amounts charged in the accounts have been understated, adjustments for expenses under-claimed should also be made to ascertain the correct profits. It is generally acceptable to apply the “average” or “representative” gross profit ratio to the total bank deposits to quantify the understatement of gross profits (see paragraph 76). In doing so, it should always be borne in mind to exclude those deposits, such as rebates, commission, sale of scrap, etc., which are entirely assessable. However, unidentified deposits are usually included on the assumption that they are ordinary business receipts.

75. In *G Deacon & Sons v. CIR*, 33 TC 66, assessments to include unexplained bank deposits as taxable profits were upheld based on circumstantial evidence. A format for determining taxable profits using the bank deposits method is at Appendix B.

Business Economics (Percentage Computation) Method

76. This method involves the application of percentages or ratios (considered typical of business operations similar to those of the taxpayer) to particular known amounts, for the purpose of computing figures required to determine the taxpayer’s assessable profits. For example, by reference to similar businesses or situations, appropriate percentages can be identified to help determine the taxpayer’s sales, cost of sales, gross profits or even net profit. Likewise, by the application of typical percentages to established figures, individual items of income or expenses may be determined.

77. These percentages may in some instances be determined by examination or analysis of the taxpayer's accounts or records. Gross profit ratio may be determined by comparing purchase invoices to sales invoices, and by analysing price lists and other similar data. A representative sample should be chosen on a random basis. The sample size should be as large as is reasonably practicable. In addition, any change in the taxpayer's operations or business environment (e.g. changes in the strategy, product lines, trend, location or major customers and suppliers of the business) should be taken into account when calculating the average gross profit ratio.

78. The cases of *Brittain v. Gibbs*, [1986] STC 418 and *Coy v. Kime*, [1987] STC 114 show that a business model is just as acceptable as a way to calculate profits, where accounts are shown to be unreliable. In *Brittain v. Gibbs* the taxpayer was a self-employed painter and decorator and a model based on the estimated number of hours worked in a given year multiplied by the likely hourly charge was considered. It was held by Vinelott J that where the accounts were not satisfactory estimate for each year could be made. The appellant in *Coy v. Kime*, a London cab-driver, failed to keep details of each fare that he took but instead recorded estimated daily takings. Two different methods were used to estimate likely profits: (a) by using the Family Expenditure Survey published by the Department of Employment to estimate the likely income based on the knowledge of the cab driver's household and its costs; (b) by preparing a business model on a fuel to takings ratio.

79. In *Kudehinbu v. Cutts*, [1994] STC 560, the estimated assessments raised on a self-employed taxi driver, computed by reference to the amount of petrol used and the inferred mileage covered, were upheld. In *Gamini Bus Co Ltd v. CIT*, [1952] AC 571, the Privy Council held that estimated assessments on a bus company based on the ratio of expenditure on petrol and oil to net profit of comparable companies were properly raised. The following simple examples illustrate the computation of additional profits by the percentage computation method:

Example 1 - Gross profit on sales

Net sales (determined from books or by other means)	\$500,000 =====
Gross profit rate (as determined)	30%
Gross profit as computed	\$150,000
<u>Less: Gross profit per accounts</u>	<u>50,000</u>
Additional profits (Discrepancy)	<u>\$100,000</u> =====

Example 2 - Percentage on cost (Mark-up)

Cost of sales of goods	\$300,000
Mark-up @ 33 $\frac{1}{3}$ % of cost	<u>100,000</u>
Sales as computed	\$400,000
<u>Less: Sales per accounts</u>	<u>300,000</u>
Additional profits (Discrepancy)	<u>\$100,000</u> =====

Projection Method

80. Where the representative is confident that the taxpayer's assessable profits have been correctly determined for a particular year of assessment, the relevant figure may be used for the purpose of estimating assessable profits for years where profits have been understated (provided that a more accurate means cannot readily be used). In such circumstances, this method can be a useful means of expediting the settlement of a field audit or investigation. However, care should be taken to ensure that the basis of projection is reasonable and can be supported by reliable primary data. Any changes in the taxpayer's operation or business environment should also be taken into account.

Example 3 - Omitted sales based on projection

Sales omitted, deposited in the private bank accounts of a director, were added back to the profit of the audit year. Sales omitted in other years were obtained by extrapolating from the percentage of sales omitted in the audit year.

Example 4 - Overclaimed expenses based on projection

Salaries payable to relatives of the director and entertainment expenses were charged in the accounts of the audit year. No services had been provided by the relatives and the accrued salaries were never paid while the entertainment expenses were the private expenses of the director. The proportion of salaries and entertainment expenses, which had been denied deduction, was computed and the results were extrapolated to other years since sums of the same nature were similarly charged in the accounts.

FINALISING AN AUDIT OR INVESTIGATION

Basis formulated by field auditors/investigators

81. When a basis of settlement has been formulated by the field auditor or investigator, it is conveyed to the taxpayer and arrangements are then made for a settlement interview to be held. At the interview, the field auditor or investigator explains to the taxpayer the findings and the method of computation of the discrepancies (i.e. the understated/omitted assessable profits or income). The taxpayer's representative can play an active role in explaining computational and technical aspects to the taxpayer. The taxpayer and the representative are invited to submit for consideration any opinions or suggestions they may have in relation to the proposed basis and computation. Any contentious issues are generally discussed at the interview with a view to reaching a mutually acceptable settlement.

Basis formulated by representatives/taxpayers

82. Having quantified the omitted profits, the representative or the taxpayer should submit a proposal for settlement, together with revised financial statements if possible, to the Department for consideration. The proposal should be accompanied by a report detailing the basis on which it has been prepared. This should also include details of:

- (a) the materials the representative has taken into consideration;
- (b) the way he has done in regard to business books, and personal finances;
- (c) the extent to which he has failed to obtain verification in any direction; and
- (d) the treatment he has adopted in regard to unidentified or doubtful items.

The representative's detailed analyses and workings should also be made available for examination by the field auditor or investigator. Where it has been possible for the representative to prepare an ABS, his report should be supplemented by the respective schedules setting out the annual Assets Statement, Statement of Personal and Living Expenditure, and Statement of Income (see paragraph 66 above), together with any supplementary statements the particular case has required.

83. A certificate signed by the taxpayer should accompany the proposal, confirming that, to the best of his knowledge and belief, the proposal constitutes a full disclosure of all his profits chargeable to tax under the Ordinance. The taxpayer should be made aware that penalty is separately considered under the provisions of the Ordinance.

Interim interview

84. During the course of the field audit or investigation, the field auditor or investigator will keep in contact with the representative and the taxpayer. Interviews will be arranged, as and when necessary, to discuss the progress being made, the findings, and the basis of quantification of the assessable profits. Through the process of exchanging opinion and information, a settlement agreement by compromise may be reached. Where a settlement cannot be agreed, the field auditor or investigator will raise appropriate estimated assessments so that the taxpayer may follow up his case in accordance with the objection and appeal provisions of the Ordinance.

Settlement agreement

85. Where agreement is reached on discrepancies, the taxpayer is asked to sign a settlement form in the presence of a witness, usually the taxpayer's representative. The settlement form specifies, for each year of assessment concerned, the amount of additional assessable profits or income (i.e. the difference between the profits originally returned and the profits agreed following the audit). There is usually a supplement to the form setting out the detailed computation of the adjustments proposed by the field auditor/investigator and agreed by the taxpayer on settlement.

86. The settlement form only covers the taxpayer's basic tax liabilities for the years in question. It is clearly stated on the form that acceptance of the specified additional assessable profits or income does not conclude the whole matter and that the case will be put up to the Commissioner or a delegated senior officer for consideration of penalty action. In this regard, the field auditor or investigator reminds the taxpayer that any agreed understatement of profits or income may be subject to penalty action under section 80, 82 or 82A of the Ordinance.

87. Furthermore, where it has been established during the course of an audit that the taxpayer has failed to comply with other requirements laid down in the Ordinance (e.g. those concerning the keeping of proper books and records, or the requirement to inform the Commissioner of chargeability to tax), the taxpayer's attention is also drawn to relevant provisions.

88. Penalty action is taken in respect of a failure to comply with a requirement specified under the Ordinance where the person concerned has not had a reasonable excuse or has acted wilfully with intent to evade tax. What constitutes a reasonable excuse depends on the facts of the particular case.

ANTI-TAX AVOIDANCE

The objective

89. Since 1995, field auditors have been deployed to specifically work on tax avoidance cases. The simple objective behind the initiative was to

enhance the Department's ability to counter and deter the use of blatant and contrived tax avoidance schemes (i.e. those falling within the scope of the anti-avoidance provisions of the Ordinance).

Documentation

90. The approach adopted in tackling avoidance arrangements places considerable emphasis on the examination of legal and source documents. Although the existence of documentation does not necessarily establish the "genuineness" of a transaction, its absence is likely to cast doubt, depending to some extent on the nature of the transaction under consideration. Barma J in *The Officer Receiver v. Mak Wing Hung, HCMP 4189/2002*, ruled that a purported agency agreement was a sham and was designed to avoid the payment of profits tax. More particularly, where arrangements involve transactions between associated parties (e.g. where inter-company transactions are involved), obtaining a thorough appreciation or global view of the group concerned entails a detailed examination of their books and records.

91. As with normal field audit cases, field visits are undertaken in relation to cases involving the examination of possible avoidance arrangements. Again, such visits, and associated interviews and meetings with key personnel and operational staff, play an important part in relation to the field auditor obtaining a comprehensive understanding of the operations of a business.

92. Where transactions involve a related company incorporated overseas, field auditors commonly examine issues such as the following:

- (a) the deductibility of expenses or payments to the related offshore company;
- (b) the extent to which the Hong Kong company's expenses were incurred in the production of profits of the related offshore company;
- (c) the chargeability to Hong Kong profits tax of the profits of the related offshore company.

93. Pertinent to the above audit issues and accordingly to the determination of the profits tax liabilities of the parties concerned, is the fact that the Ordinance does not draw any distinction between companies incorporated in Hong Kong and those incorporated elsewhere. The legitimacy of examining an offshore company's business operations and other material for the purpose of deciding the applicability of section 14 is well illustrated by the case *CIR v. Orion Caribbean Ltd (in voluntary liquidation)*, 4 HKTC 432, handed down by the Privy Council on 23 June 1997. Information relating to the issue of whether an offshore company has derived assessable profits (or the quantum of such profits), including profits tax returns, supporting accounts, bank statements and underlying books and records, must be provided if requested, irrespective of the place of incorporation of the company concerned. Failure to provide full and complete information may lead to an estimated assessment being raised under section 59(2)(b) or 59(3) of the Ordinance. In such a case, the basis of determination of any subsequent objection or appeal would be dependent upon the provision of all necessary information.

94. Transactions may, of course, take place between a Hong Kong company and a related offshore company in circumstances under which profits derived by the latter are not subject to tax in Hong Kong. However, where this is alleged to be the case, the circumstances may warrant enquiries to ascertain whether the transactions in question were commercially realistic (i.e. on an arm's length basis). Accordingly, the Hong Kong company or indeed any party involved may be requested to provide detailed information concerning the basis and nature of the transactions. Any failure on the part of the Hong Kong company to provide information requested may adversely affect its own tax liability.

95. From time to time, field auditors come across cases where offshore companies chargeable to profits tax under section 14, 15(1)(a), 15(1)(b), 15(1)(ba), or 21A have failed to report their liabilities. It is emphasised that in the absence of a reasonable excuse, penalty action will be taken in respect of any failure to notify such chargeability. Representatives should ensure that their clients appreciate the circumstances under which liability can arise, and that they are fully aware of the risks they face if they do not comply with their obligations under the law.

Access to representatives' working papers

96. Situations will occasionally arise where the field auditor or investigator requires access to the working papers of a taxpayer's representative, to either reconcile accounts with the taxpayer's profits tax returns or to gain an understanding of the taxpayer's business. The Department recognises that competing interests may be involved. On the one hand, there is the desirability of respecting the confidentiality of the relationship between a representative and his client. On the other hand, this must be balanced against the public interest which lies in the Department having access to information, to facilitate the fair and efficient administration of the Ordinance.

97. For this reason, the Department has developed Access Guidelines, which have been formulated having regard to practices in overseas jurisdictions. For the purposes of the guidelines, a representative's working papers are divided into two broad categories, namely:

Accounting papers, which include -

- (a) traditional accounting records, such as documents of original record, ledgers, journals, profits and loss accounts and balance sheets;
- (b) documents prepared in connection with the inauguration, implementation and recording of transactions, where these explain the background, framework and purpose of transactions;
- (c) working papers which reconcile information in the taxpayer's records with the information contained in the tax return; and
- (d) the permanent audit file maintained by the taxpayer's auditor which serves to explain the basis of a taxpayer's organisation and operations.

Advice papers, which include –

- (a) papers containing advice given after completion of a transaction, if that advice did not affect the recording of the transaction in the books of account or tax return;

- (b) papers relating solely to transactions or arrangements that have not been and are not intended to be implemented; and
- (c) tax working papers which, in substance, express an accountant's opinion on matters contained in a tax return.

98. The distinguishing feature of accounting papers is that they detail matters of fact. Full and free access is required as they may explain the background, structure and purpose of a transaction. In essence, they are documents of record, rather than documents of advice.

99. On the other hand, notwithstanding the broad terms of the powers concerning access to information provided under the Ordinance, advice papers would not generally be sought in the absence of any suspicion of fraud or material evasion. However, the meaning of the term should be kept in mind, and in particular the fact that it does not extend to papers which contain information concerning the thinking behind the structure or purpose of a transaction in relation to its form or function. Such papers are accounting papers and they are subject, upon request, to production in accordance with section 51(4) of the Ordinance.

100. Under normal circumstances, a request for accounting papers would in the first instance be made to the taxpayer. Accordingly, whenever tax advice is given by a representative, the taxpayer concerned should also be advised to retain the relevant papers as they may be required for future production to the Department

Transfer pricing schemes

101. Field auditors have encountered instances where transactions between taxpayers and connected non-resident persons have not been carried out on an arm's length basis. Usually the arrangements take one or more of the following forms:

- (a) the taxpayer sells goods at a deflated price to the non-resident person;

- (b) the taxpayer purchases goods at inflated prices from the non-resident person;
- (c) the non-resident person provides various services to the taxpayer for substantial fees, which are not commensurate with the services; or
- (d) the taxpayer pays substantial royalties to the non-resident person.

102. In such a situation, 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. To facilitate an objective review, it is essential that the taxpayer provide the field auditor with all relevant documents for examination.

103. Where a taxpayer deals with a closely connected non-resident person on a non-arm's length basis, section 20(2) of the Ordinance provides authority for the situation to be addressed by the Department. The section has application where the course of business between a taxpayer and a closely connected non-resident person is so arranged that it produces to the taxpayer either no profits which arise in or derive from Hong Kong, or less than the ordinary profits which might be expected to arise in or derive from Hong Kong. The section provides that in such a situation the business done by the non-resident person in pursuance of his connection with the taxpayer shall be deemed to be carried on in Hong Kong, and that the profits of the non-resident person shall be assessed in the name of the taxpayer as if the taxpayer were the agent of the non-resident person. The cases *CIR v. Rico International Limited*, 1 HKTC 229 and *R v. Radofin Electronics (Far East) Limited*, 1 HKTC 1252 illustrate the kinds of situations in which section 20(2) may be applied. Apart from section 20(2), the Department may also apply the general anti-avoidance provisions or other provisions of the Ordinance relevant to the circumstances of the case to ensure that tax is not avoided.

104. Sometimes the non-resident person dealing with the taxpayer is a company incorporated in a tax haven which prohibits the company from carrying on business in the jurisdiction concerned. Where this is the case, the situation is obviously taken into account when the source of the taxpayer's profits in respect of transactions between the parties is considered (which generally entails considering where the operations have taken place which produced the relevant profits). By the same token, in considering the related issue of whether the non-resident person carried on a trade or business in Hong Kong, the Department has regard to all of the operations of that person, taking into account any restrictions that may have been placed on the non-resident's activities in other jurisdictions (see *CIR v. Orion Caribbean Ltd (in voluntary liquidation)*, 4 HKTC 432). The Department's views on the locality of profits are set out in some detail in Departmental Interpretation & Practice Notes No. 21.

105. The Department takes a serious view of any scheme which involves a taxpayer carrying on business in Hong Kong seeking to "book" Hong Kong profits to an offshore associate. Typically such cases involve circumstances where:

- (a) the non-resident person does not carry out substantial activity on its own in Hong Kong or elsewhere (e.g. it does not run an office or employ staff);
- (b) the taxpayer performs all the activities in Hong Kong which in substance give rise to the profits;
- (c) there is no commercial justification for the establishment of the non-resident person; and
- (d) the profits are merely "booked" in the accounts of the non-resident person.

The Department does not hesitate to apply the general anti-avoidance provisions of the Ordinance in relation to any such case. The imposition of penalties is considered if relevant facts are not disclosed as and when required. In the latter regard, opportunity is taken to remind taxpayers and their

representatives of the need, when completing tax returns, to accurately answer the questions concerning transactions for/with non-residents.

Finalisation of avoidance cases

106. After examining relevant documents and evaluating evidence collected from the taxpayer and third parties, the field auditor will form an opinion as to whether or not further assessments or additional assessments should be raised on the taxpayer. Where appropriate, such assessments will be made using similar methods as those applicable to normal field audit cases. The taxpayer is then notified by the field auditor of the proposed treatment and provided with an explanation of the basis used. The taxpayer or his representative may, of course, comment on or offer suggestions in relation to the proposal. Where an agreement is reached between the taxpayer and the field auditor as to the further or additional assessments required, it is reduced to writing and referred to a senior officer of the Department for approval.

107. If the taxpayer is unable to reach agreement with the field auditor, it becomes necessary to consider raising assessments under the anti-avoidance provisions of the Ordinance (e.g. sections 20(2), 61 or 61A). Any assessment or additional assessment raised in such circumstances (i.e. where no settlement agreement has been reached) is subject to the normal objection and appeal provisions of the Ordinance.

PENALTIES

Deterring tax evasion

108. One of the main purposes underlying the Department's field audit and investigation activities is to deter tax evasion. The deterrent effect could not be accomplished without the imposition of penalties. The provisions governing the imposition of penalties are contained in Part XIV of the Ordinance. Where requirements under the Ordinance are not complied with, the relevant provisions allow, depending on the nature of the matter involved, prosecution action under sections 80 and 82 or assessment to additional tax under section 82A. The Ordinance also provides in sections 80 and 82 that as an alternative to proceeding with a prosecution, the Commissioner may

“compound” the relevant offence (i.e. accept a monetary settlement instead of sanctioning the institution of a prosecution).

Prosecution

109. Prosecution proceedings are considered to be an important means of deterring tax evasion. Such action not only tends to encourage future compliance on the part of the taxpayer directly concerned, but also conveys an obviously instructive message to the wider community that evasion carries the risk of very serious consequences. It is the Department’s practice to initiate prosecution action whenever it is considered to be warranted. Where it is considered that the nature of a taxpayer’s offence would not warrant prosecution under section 82, consideration is given to charging the taxpayer under section 80. A decision as to whether or not to proceed with prosecution action depends on a number of factors. These include the seriousness of the offence, the degree of culpability of the taxpayer and, as already mentioned, the deterrent effect.

110. So far as is relevant, the maximum penalty under section 80 is a fine at level 3 for each offence and a further fine of treble the amount of tax which has been undercharged in consequence of the offence, or which would have been undercharged if the offence had not been detected.

111. The maximum penalty under section 82 is:

On summary conviction -

A fine at level 3 for each offence and a further fine of treble the amount of tax which has been undercharged in consequence of the offence, or which would have been undercharged if the offence has not been detected, and to imprisonment for 6 months.

On indictment -

A fine at level 5 for each offence and a further fine of treble the amount of tax which has been undercharged in consequence of the offence, or which would have been undercharged if the offence has not been detected, and to imprisonment for 3 years.

112. As has been mentioned above, the Ordinance provides that as an alternative to prosecution proceedings the Commissioner may compound any offence under section 80 or 82. To a certain extent, the power of compounding has been delegated to Senior Assessors and above. Accordingly, where the amount of assessable profits omitted has been agreed, the taxpayer or his representative may request the officer in charge of the field audit or investigation that any penalty in respect of the offence be settled by way of compounding.

Additional tax under section 82A

113. If no prosecution has been instituted under section 80(2) or 82(1) against the taxpayer in respect of the omission of assessable profits, the Commissioner may impose additional tax under section 82A of the Ordinance. The maximum penalty is 3 times the amount of tax which has been undercharged in consequence of the omission, or which would have been undercharged if the omission had not been detected.

114. Before making an assessment of additional tax, the Commissioner or Deputy Commissioner arranges for a notice to be given to the taxpayer stating the offence in respect of which he intends to assess additional tax. The taxpayer is then allowed a specified period of at least 21 days to make written representations with regard to the proposed assessment to additional tax. The Commissioner or Deputy Commissioner considers and takes into account any representations received during the specified period when determining the amount of additional tax. The taxpayer can appeal to the Board of Review against the assessment to additional tax if he is aggrieved by the assessment.

115. It should be noted that additional tax under section 82A of the Ordinance may only be assessed by the Commissioner personally or a Deputy Commissioner personally. For this reason, it is not possible for the field auditor or investigator to indicate the likely level of penalties. Accordingly field auditors and investigators have been instructed that at no time should they suggest that agreed assessments made under sections 59 and 60 of the Ordinance represent anything other than basic liability exclusive of penalties. Representatives acting on behalf of taxpayers should make this point clear to their clients to avoid the possibility of any misunderstanding.

Miscellaneous

116. In assessing penalties, factors taken into consideration by the Commissioner or delegated senior officers, as the case may be, include the gravity of the case, the loss suffered by the Revenue, the co-operation given by the taxpayer, the sophistication of the taxpayer's business, and the presence of any evidence to suggest that the irregularity or scheme was deliberate or designed to evade tax.

117. The Department makes no distinction between field audit, investigation and tax avoidance cases in relation to the imposition of penalties. A taxpayer who participates in a blatant or overly aggressive tax avoidance scheme, which breaches section 80 or 82A, will invariably attract penalty. The answer to the question of whether a particular case involves such a scheme must turn on the facts of the case. If it were to be concluded that a taxpayer had participated in a scheme, any attempt by the person concerned to conceal involvement (e.g. by providing incorrect or misleading information) would be likely to have a bearing on the penalty ultimately imposed.

118. Finally, the Department's field audit and investigation operations have proved to be an efficient and effective means of uncovering cases where taxpayers have failed to comply with requirements under the Ordinance. In the light of the results achieved, the scope, the scale of operations, the examination skills and the technical support of the Field Audit and Investigation Unit are under constant review. Taxpayers and their advisors should recognise that as a consequence of this on-going review, the probability of any case of tax evasion or avoidance being detected has increased. It should also be noted that where a case of non-compliance comes to the attention of the Department as a result of a full voluntary disclosure by the taxpayer concerned (i.e. prior to any field audit, investigation or other enquiry action being initiated by the Department), the disclosure is regarded as a favourable factor when the imposition of penalty is subsequently considered in relation to the case.

Specimen format of Assets Betterment Statement
Mr. ABC Trading as ABC & Co. ^(Note 1)

<u>Schedule</u> <u>No.</u> ^(Note 3)	Accounting Year End ^(Note 2)	Year <u>'X'</u>	Year <u>'X + 1'</u>	Year <u>'X + 2'</u>
		(\$)	(\$)	(\$)
	ASSETS			
	Cash at bank			
	Cash in hand			
	Landed properties			
	Net business assets (at cost) of sole proprietorship business(es)			
	Investment in partnership business(es)			
	- Capital			
	- Current accounts/Loans			
	Investment in private companies			
	- Share capital			
	- Current accounts/Loans			
	Quoted shares			
	Motor cars			
	Personal advances and loans	_____	_____	_____
	Total Assets	_____	_____	_____
	LIABILITIES			
	Personal loans and advances			
	Mortgaged loans for properties			
	Total Liabilities	_____	_____	_____
	Net Assets	_____	_____	_____
	Increase (decrease) in net assets	_____	_____	_____
	(when compared to the previous year)	(A)	_____	_____

Note

1. If the person carries on more than one business, the ABS should show the assets and liabilities of all his businesses.
2. The position should be compiled in respect of each of the year of assessment under review.
3. Fill in the Schedule No. and attach schedules in support. Schedules should be compiled for the individual items where necessary.

Schedule

No.

ADD :

- Inadmissible items adjusted in returns and tax computations of sole proprietorship business(es), excluding proprietor's salaries
- Taxes paid
- Legal expenses and stamp duties on acquisition of properties
- Decoration expenses on properties
- Rates on residence and rental properties
- Loss on sale of shares
- Loss on sale of properties
- Loss on sale of business investments
- Remittance outwards
- Interest Payments of private nature
- Overseas private trips
- Private and living expenses (estimated)
- Unidentified withdrawals from bank accounts
- Unidentified withdrawals from current accounts with business investment

(B)

DEDUCT :

- Profit on sale of properties
- Profit on sale of business investment
- Profit on sale of shares
- Employment income
- Rental income
- Bank interest
- Dividends
- Remittance inwards
- Depreciation allowances adjusted in tax computations
- Distributions from partnership business(es)
- Profits (Loss) of other sole proprietorship business(es) returned/assessed

(C)

BETTERMENT PROFITS* (A) + (B) - (C)

LESS :

Profits (Loss) Returned/Assessed of ABC & Co.

DISCREPANCIES

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* Note

The betterment profits will be used to compute the final assessable profits or losses in respect of the business(es) under review.

Specimen Format of Bank Deposits Method
Mr. XYZ trading as XYZ & Co. ^(Note 1)

<u>Schedule</u> (See Attached)	<u>Bank Name and A/C No.</u>	Year <u>'X'</u> (\$)	Year <u>'X + 1'</u> (\$)	<u>Total</u> (\$)
1	Summary of bank account analyses ending on the accounting date ^(Note 2)			
	Total Deposits			
2	<i>Less</i> : Interbank Transfer or Deposits			
3	Returned Cheques			
	Sales of Capital Assets			
	Rental Income			
	Other Non-business Deposits	_____	_____	_____
	Adjusted Total Deposits			
	<i>Add</i> : Unbanked Deposits for Expenses (Estimated)			
	<i>Add</i> : Debtors' Closing Balances	_____	_____	_____
	<i>Less</i> : Debtors' Opening Balances	_____	_____	_____
	<i>Less</i> : Reported Turnover	_____	_____	_____
	Unexplained Deposits (Additional Profits)	=====	=====	=====

Note

1. A separate schedule should be compiled for each business under review.
2. Summary should be prepared for each of the year of assessment under review.

Schedule 1 : Total Deposits Of Bank Accounts

Bank Name & A/C No. ^(Note 1) _____

<u>Month</u>	<u>Year 'X'</u>			<u>Year 'X + 1'</u>			<u>Total</u> (\$)
	<u>Cash</u> (\$)	<u>Cheque</u> (\$)	<u>Others</u> ^(Note 2) (\$)	<u>Cash</u> (\$)	<u>Cheque</u> (\$)	<u>Others</u> ^(Note 2) (\$)	
Apr							
May							
Jun							
Jul							
Aug							
Sep							
Oct							
Nov							
Dec							
Jan							
Feb							
Mar							

Note

1. The summary of all the bank accounts should be prepared (see para. 73). One Table should be prepared for each bank account.
2. Others include items such as Letters of Credit (L/C), Credit as Advised (Cr. Adv.), Telegraphic Transfer (T/T), Transfer, etc.

Schedule 2 : Interbank Transfer or Deposits

Bank Name & A/C No. ^(Note 1) _____

<u>Date</u>	<u>Source</u> ^(Note 2)	<u>Year 'X'</u>			<u>Year 'X + 1'</u>			<u>Total</u> (\$)
		<u>Cheque</u> (\$)	<u>Transfer</u> (\$)	<u>Cash</u> (\$)	<u>Cheque</u> (\$)	<u>Transfer</u> (\$)	<u>Cash</u> (\$)	

Note

1. A separate schedule should be prepared for each of the Bank accounts.
2. Fill in the Withdrawal Bank Account No.

Schedule 3 : Returned Cheques

Bank Name & A/C No. ^(Note 1) _____

<u>Date</u>	<u>Year 'X'</u> (\$)	<u>Year 'X+1'</u> (\$)	<u>Total</u> (\$)

Note

1. A separate schedule should be prepared for each of the bank accounts