

CHAPTER 1

**THE GOVERNMENT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION**

GENERAL REVENUE ACCOUNT

GOVERNMENT DEPARTMENT

Inland Revenue Department

Assessment and collection of profits tax

**Audit Commission
Hong Kong
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ASSESSMENT AND COLLECTION OF PROFITS TAX

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ASSESSMENT AND COLLECTION OF PROFITS TAX

Summary and key findings

A. **Introduction.** Profits tax is charged on individuals, corporations, partnerships, trustees and bodies of persons (hereinafter all referred to as “taxpayers”) in respect of assessable profits arising in or derived from Hong Kong. The Inland Revenue Department (IRD) assesses the profits tax of a taxpayer based largely on the tax return submitted annually by the taxpayer under the Inland Revenue Ordinance (paras. 1.1 and 1.2).

B. **Audit review.** Audit has conducted a review of the IRD’s profits tax assessment and collection activities (para. 1.5). The major audit findings are summarised in paragraphs C to G below.

C. **Need to improve the screening and examination of tax returns.** Prior to April 2001, tax returns were manually screened by taxation officers against pre-set criteria and further screened by assessing officers to identify those requiring examination. If during examination the assessing officer detected irregularities which he could not resolve, he was required to refer the examined case to the Field Audit and Investigation Unit. However, Audit noted that assessing officers might not detect the irregularities in some tax returns. Audit’s examination of a sample of 21 field audit cases in which the tax returns had already been screened by the manual system revealed that only in 3 cases the assessing officers had detected irregularities in their examination of the tax returns. In all these 21 cases, substantial understatements of profits were subsequently found by IRD field audit officers. In Audit’s view, failure of assessing officers to detect irregularities in a tax return can result in significant revenue loss because (a) only a small number of taxpayers are selected for conducting field audits and (b) even if the irregularities are subsequently detected by IRD field audit officers, back tax can only be charged on the understated profits for the past six years of assessment. Audit estimated that, in one of the cases in which the assessing officers had failed to detect the irregularities, the revenue loss amounted to \$54.8 million. In Audit’s view, there is a need for the IRD to review those cases in which assessing officers failed to detect the irregularities later revealed by IRD field audit officers, and to make arrangements for IRD field audit officers to share their experience with assessing officers on a regular basis (paras. 2.8, 2.9 and 2.11 to 2.13).

D. **Need to review the use of the Assess First Audit Later (AFAL) System.** Since April 2001, to streamline the assessing procedures, the IRD has used a computerised AFAL System for screening tax returns for automated assessment and selecting cases for post-assessment desk audit. Audit considers that there is a need to assess the effectiveness of different selection methods used for selecting tax returns from the AFAL System for examination in order to improve the selection process in future (paras. 2.4 and 2.16 to 2.18).

E. **Need to ensure that IRD officers exercise their discretion properly.** In exercising the discretionary powers under the Inland Revenue Ordinance, IRD officers have a duty to act with fairness and consistency. The IRD requires them to follow the procedures set out in the IRD's staff handbook and to state cogently in the file the reasons for exercising discretion to accord a particular treatment to a taxpayer. However, Audit found cases in which this requirement had not been complied with. Audit noted that in all the 10 cases in an audit sample of late submission of tax returns, the assessing officers did not state their reasons for not imposing compound penalties on, or instituting prosecution action against, the taxpayers. Moreover, in 6 of the 10 cases in an audit sample in which an unconditional hold over of tax was granted, the assessing officers did not state the reasons for exercising the discretion. In Audit's view, there is a need for the IRD to ensure that its officers comply with all the requirements stated in the IRD's staff handbook and act with fairness and consistency when exercising discretion (paras. 3.16 to 3.18).

F. **Need to implement measures to facilitate the assessment and collection of profits tax payable by non-residents.** At present, a person who has made payments to non-residents for services rendered in Hong Kong, other than payments of performance fee to non-resident entertainers or sportsmen, is not required by the Inland Revenue Ordinance to withhold a sufficient amount from the payments for settlement of the profits tax due by the non-residents. He is also not required to report such payments to the IRD. However, Audit's examination of 15 payments made in 2000-01 by 3 selected government departments to non-residents revealed that the IRD relied on the reporting of such cases by departments for identifying non-residents chargeable to profits tax. In 8 of the 15 payments, due to the non-reporting of the payments by the departments concerned, the IRD could not identify the non-residents for assessing and collecting the profits tax. In Audit's view, there is a need for the IRD to implement measures to facilitate the assessment and collection of profits tax payable by non-residents receiving payments for services rendered in Hong Kong (paras. 4.6 and 4.12 to 4.15).

G. **Need to learn lessons from profits tax write-off cases.** The total write-offs of profits tax increased from \$160 million in 1997-98 to \$396 million in 2001-02. Audit examined a random sample of 20 profits tax write-off cases in 2001-02 (paras. 5.4 and 5.5). In 16 of these cases, Audit noted that there was scope for improvement in the IRD's procedures, as follows:

- (a) **Corporations chargeable to profits tax not timely identified.** In 7 cases, the taxpayers were corporations engaged in property dealing. The time taken by the IRD to identify the cases ranged from 187 days to 1,377 days (average 705 days or almost two years). The taxpayers were untraceable when they were identified. Audit noted that 5 of these 7 cases involved overseas corporations. In Audit's view, the IRD should consider the feasibility of treating the overseas corporations in such cases as non-residents. This would enable the IRD to invoke section 20A of the Inland Revenue Ordinance to require the agent of an overseas corporation in Hong Kong (e.g. its solicitor) to withhold a sufficient amount of money out of the corporation's assets for payment of the tax (paras. 5.7 to 5.10);

- (b) ***Profits tax assessments and tax demand notes not timely issued.*** In 2 cases, it took up to four years for the IRD to issue the tax demand notes after receiving the tax returns from the taxpayers. In particular, 1 of these 2 cases was a corporation winding-up case. The assessing officer, as specifically required by the IRD's staff handbook, should have issued the tax demand notes as early as possible. In Audit's view, due to the delay in issuing tax demand notes, the IRD was unable to take timely recovery actions (paras. 5.11 and 5.12);
- (c) ***Delay in issuing assessments and taking recovery actions in objection cases.*** In 3 cases, the taxpayers objected to the IRD's profits tax assessments. In 1 of these 3 cases, there was delay in issuing the tax demand notes as the assessing officer did not issue the tax demand notes for three successive years of assessment until the assessment for a prior year had been finalised. In the other 2 cases, there was delay in taking actions to recover the unpaid tax after the taxpayers had failed to purchase tax reserve certificates, contrary to the condition of granting hold over of the tax under objection (paras. 5.15 and 5.16);
- (d) ***Charging order on property not timely obtained.*** In 1 case, due to the IRD's delay in obtaining a charging order on the taxpayer's property, the taxpayer successfully transferred it to his wife. The unpaid tax was written off as the taxpayer had no other sources of income or assets (paras. 5.18 and 5.19);
- (e) ***Departure prevention directions not timely obtained.*** In 2 cases, due to the IRD's delay in obtaining departure prevention directions, the taxpayers were able to leave Hong Kong without first paying their profits tax (paras. 5.20 and 5.21); and
- (f) ***Delay in issuing assessments in a bankruptcy case.*** In 1 case, the taxpayer was adjudicated bankrupt in late November 1999. The assessing officer, as specifically required by the IRD's staff handbook, should have issued all outstanding assessments at once. However, the assessing officer did not issue all the tax demand notes until late March 2000 (para. 5.23).

H. **Audit recommendations.** Audit has made the following main recommendations that the Commissioner of Inland Revenue should:

Examination of tax returns

- (a) conduct regular reviews to identify what lessons can be learned from the profits tax cases in which understatements of profits were detected by IRD field audit officers for improving the assessment procedures of the profits tax assessing units of the IRD (para. 2.21(a));

- (b) when the examination of tax returns for 2000-01 is substantially completed, conduct a review of the examination results based on different selection methods (para. 2.21(c));

Exercise of discretion by IRD officers

- (c) regularly remind IRD officers to:
- (i) exercise discretion fairly and consistently in accordance with the procedures stated in the IRD's staff handbook (para. 3.19(c)(i)); and
 - (ii) state in the file the reasons for exercising discretion to accord a particular treatment to a taxpayer, especially if the treatment does not comply with the procedures stated in the IRD's staff handbook (para. 3.19(c)(ii));
- (d) strengthen the in-house quality assurance work with a view to ensuring that IRD officers exercise discretion properly in the performance of their duties (para. 3.19(d));

Assessment and collection of profits tax payable by non-residents

- (e) for persons who have made payments to non-residents (other than entertainers and sportsmen) for services rendered in Hong Kong, consider requiring them (as in cases in which they have made payments to non-resident entertainers or sportsmen) to:
- (i) report to the IRD such payments (para. 4.16(b)(i)); and
 - (ii) withhold a sufficient amount of money from such payments for settlement of the profits tax due by the non-residents (para. 4.16(b)(ii));
- (f) provide all government departments with guidelines on withholding money from payments to non-residents for services rendered in Hong Kong, and regularly remind them to follow such guidelines so as to ensure that the profits tax due by such non-residents is properly assessed and collected (para. 4.16(c));

Write-off of profits tax

- (g) review regularly significant profits tax write-off cases with a view to improving the profits tax assessment and collection procedures, and the coordination between the IRD's assessing and collection sections (para. 5.25(a));
- (h) review the profits tax cases involving overseas corporations which have derived assessable profits from property dealing activities in Hong Kong to determine the feasibility of invoking section 20A of the Inland Revenue Ordinance to require the overseas corporations' agents in Hong Kong, such as their solicitors, to withhold a sufficient amount of money out of the assets held on their behalf, for payment of profits tax (para. 5.25(c));
- (i) take additional control measures to ensure that there is no undue delay on the part of assessing officers in issuing profits tax assessments and tax demand notes, especially in cases where the revenue is at risk (para. 5.25(d));
- (j) provide specific instructions to assessing officers for dealing with profits tax cases where the taxpayers have objected to the IRD's assessments to ensure that:
 - (i) recovery actions are immediately taken if taxpayers do not comply with the condition for granting hold over of the profits tax under objection (para. 5.25(e)(i)); and
 - (ii) current year's assessments are timely issued even though the taxpayer's objections to assessments issued in prior years may not have been finalised (para. 5.25(e)(ii));
- (k) improve the procedure for making application to the District Court for charging orders on properties belonging to taxpayers to ensure that such orders are promptly issued after the entry of judgement for unpaid profits tax (para. 5.25(f)); and
- (l) review the profits tax write-off cases in which there were delays in obtaining the departure prevention directions as identified by Audit and improve the relevant IRD procedures to ensure that departure prevention directions are timely obtained in warranted cases (para. 5.25(g)).

I. **Response from the Administration.** The Administration has generally accepted all the audit recommendations.

PART 1: INTRODUCTION

Background

1.1 Profits tax is charged on individuals, corporations, partnerships, trustees and bodies of persons (hereinafter all referred to as “taxpayers”) carrying on a trade, profession or business in Hong Kong, in respect of the assessable profits arising in or derived from Hong Kong from such trade, profession or business. Since 1998-99, the profits tax rate for corporations has remained at 16%, compared to that of 15% for unincorporated businesses.

1.2 The Inland Revenue Department (IRD) assesses the profits tax of a taxpayer based largely on the tax return submitted annually by the taxpayer under the Inland Revenue Ordinance (Cap. 112). An individual carrying on a sole proprietorship business is required to report his assessable profits, together with income from employment (subject to salaries tax) and rental income from solely owned properties (subject to property tax), in one consolidated return called an Individual Tax Return. Corporations and other taxpayers are required to report their assessable profits in a Profits Tax Return. Unit 1 of the IRD handles Profits Tax Returns and Unit 2 of the IRD handles Individual Tax Returns. After making the profits tax assessment, the IRD issues to a taxpayer a tax demand note stating the amount of profits tax payable and the due dates for payment.

1.3 The profits tax assessed by the IRD during the period 1997-98 to 2001-02 is shown in Table 1 below.

Table 1

Profits tax assessed by the IRD during the period 1997-98 to 2001-02

Year	Corporations	Unincorporated businesses	Total
	(\$ million)	(\$ million)	(\$ million)
1997-98	50,875	6,083	56,958
1998-99	39,217	7,007	46,224
1999-2000	30,911	5,176	36,087
2000-01	40,530	4,207	44,737
2001-02	43,264	5,574	48,838

Source: IRD's records

1.4 The IRD's profits tax assessment and collection activities are carried out by its assessing officers with the support of taxation officers, tax inspectors and common/general grade staff. For the year ending 31 March 2003, 591 man-years involving an expenditure of \$243 million will be used by the IRD for making 370,000 profits tax assessments.

Audit review

1.5 Audit has recently conducted a review of the IRD's profits tax assessment and collection activities. The audit has focused on the following areas:

- (a) examination of tax returns (see PART 2 below);
- (b) exercise of discretion by IRD officers (see PART 3 below);
- (c) assessment and collection of profits tax payable by non-residents (see PART 4 below);
and
- (d) write-off of profits tax (see PART 5 below).

PART 2: EXAMINATION OF TAX RETURNS

2.1 This PART examines the effectiveness of the IRD's examination of tax returns to determine whether there is room for improvement.

Requirements for submission of tax returns

2.2 Section 51(1) of the Inland Revenue Ordinance states that an assessor may give notice in writing to any person (Note 1) requiring him within a reasonable time stated in such notice to furnish a return of assessable profits. The IRD conducts an annual exercise as follows:

- (a) **Corporations and other taxpayers.** In early April, the IRD issues Profits Tax Returns to corporations and other taxpayers who are required to report their assessable profits in the returns; and
- (b) **Individuals.** In early May, the IRD issues Individual Tax Returns to individuals who are required to report in their returns the assessable profits derived from their sole proprietorship businesses.

For all taxpayers, if their businesses generate gross income exceeding \$500,000, 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 \$500,000, supporting documents need only be submitted when required by the IRD later.

Examination of tax returns

2.3 Prior to April 2001, the IRD used a manual system for selecting tax returns for examination prior to assessment, as follows:

- (a) **Summary acceptance cases.** The returns submitted by taxpayers were first screened by taxation officers. Simple returns meeting the IRD's pre-set criteria were summarily accepted for assessment. They were referred to as summary acceptance cases;
- (b) **Accepted cases.** Those returns which had not been summarily accepted for assessment were further screened by assessing officers. If they required no adjustments (or only simple and straightforward technical adjustments), they would be accepted for assessment without further in-depth examination by the assessing officers. They were referred to as accepted cases; and

Note 1: *As defined in section 2 of the Inland Revenue Ordinance and when referred to in this report, "person" includes a corporation, partnership, trustee or body of persons.*

- (c) **Examined cases.** For those returns which required in-depth examination to ensure their correctness (e.g. whether the expenses claimed by taxpayers were deductible), further information might have to be obtained from the taxpayers. They were referred to as examined cases. However, if the assessing officer detected irregularities in a tax return and could not deal with them, he was required to refer the examined case to the Field Audit and Investigation Unit for further action.

2.4 Since April 2001, in order to streamline the assessing procedures, the IRD has used a computerised Assess First Audit Later (AFAL) System for screening tax returns for automated assessment and selecting cases for post-assessment desk audit. Data in the returns submitted by taxpayers are first input into the AFAL System. The AFAL System screens out the returns which meet the IRD's pre-set criteria for automated assessment. A certain percentage of these automated assessments are then selected based on additional criteria for desk audit by assessing officers. Returns not meeting the IRD's 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.

2.5 The IRD's staff handbook states that a desk audit of an automated assessment case is basically the same as the in-depth examination of an examined case prior to April 2001. During the desk audit, the assessing officer should examine all aspects of the case to see whether the reported profits are correct, although special attention should be paid to any risk areas based on which a particular case is selected.

IRD field audit

2.6 The IRD 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 (Note 2). The IRD has provided IRD field audit officers with general guidelines on the selection of cases for field audit. In addition, IRD field audit officers use their judgement, experience and knowledge in case selection. Field audit action is normally initiated when IRD field audit officers detect in a tax return irregularities, or indications of non-compliance with the requirements of the Inland Revenue Ordinance. IRD field audit officers visit taxpayers' business premises and examine their accounting records to ascertain whether they have made correct returns of profits.

2.7 Field audit work is normally focused on the most recent year of assessment for which a tax return has been submitted. Additional assessments will be made and penalties will be imposed when discrepancies are detected. According to section 60 of the Inland Revenue Ordinance, additional assessments for a back year can be made within six years after the expiration of the year of assessment. Where appropriate and when agreed with the taxpayers, IRD field audit officers 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. The results of field audits of profits tax cases completed during the period 1999-2000 to 2001-02 are shown in Table 2 below.

Note 2: *In addition to field audits, the Field Audit and Investigation Unit conducts detailed investigations of cases where complex or substantial tax evasion is suspected.*

Table 2

Results of IRD field audits of profits tax cases

Year	Number of cases completed	Cases with understatement of profits detected by IRD field audit officers			Average understatement per case	Total back tax and penalties collected
		Number	Percentage	Total understatement		
	(a)	(b)	(c) = $\frac{(b)}{(a)} \times 100\%$	(d)	(e) = $\frac{(d)}{(b)}$	(f)
				(\$ million)	(\$ million)	(\$ million)
1999-2000	622	568	91%	5,518	9.7	1,141
2000-01	550	528	96%	5,098	9.7	1,179
2001-02	515	481	93%	5,479	11.4	1,139

Source: IRD's records

Note: In 2001-02, about 7% of the cases screened by IRD field audit officers were selected for field audit.

Audit observations on examination of tax returns

Tax returns with irregularities not selected by taxation officers/assessing officers for examination

2.8 Audit noted that, prior to the implementation of the AFAL System in April 2001, tax returns were manually screened by taxation officers against pre-set criteria and further screened by assessing officers to identify those requiring examination. In examining a tax return, the assessing officer was required to raise queries when irregularities were detected. If he could not deal with the understatement of profits, he was required to refer the case to the Field Audit and Investigation Unit (see para. 2.3(c) above). In 2001-02, the Field Audit and Investigation Unit conducted field audits on 34 such referral cases. There are no readily available figures on the number of referral cases not selected by the Field Audit and Investigation Unit for field audit. According to the IRD, field audit served a quality control role in relation to the manual system for selecting cases for examination by assessing officers. In this connection, Audit selected 30 field audit cases completed in 2001-02 in which substantial understatements of profits were detected by IRD field audit. Audit's examination found that in 21 cases (Note 3) substantial understatements of profits were detected by IRD field audit despite the fact that the relevant tax returns had already been screened by the manual system referred to in paragraph 2.3 above. The audit findings are shown in Table 3 below.

Note 3: In the other 9 cases, the assessing officers did not issue tax assessments for various reasons (e.g. tax returns not yet received) or state in the file whether they had examined the tax returns before issuing tax assessments.

Table 3

Understatements of profits in 21 IRD field audit cases completed in 2001-02

Work performed by assessing officers before IRD field audit	Number of cases	Average understatement of profits per case detected by IRD field audit officers
		(\$ million)
Summary acceptance cases	3	19.6
Accepted cases	7	59.2
Examined cases	11	157.5
Total	<u>21</u>	

Source: IRD's records

2.9 As shown in Table 3 above, the IRD field audit officers selected for field audit 10 cases which had already been processed by taxation officers as summary acceptance cases (3 cases) or by assessing officers as accepted cases (7 cases). The subsequent detection of substantial understatements of profits in these cases suggests that the prior screening work performed on these cases was inadequate.

2.10 **Audit considers that there is a need for the IRD senior management to critically review these 10 cases and other similar cases to ascertain why the taxation officers and assessing officers concerned had passed the relevant tax returns as summary acceptance cases or accepted cases. The review's findings would help the IRD set more effective selection criteria for selecting cases through the AFAL System for desk audit and improve the manual screening procedures for selecting tax returns for examination.**

Irregularities not detected by assessing officers through examination of tax returns

2.11 Table 3 in paragraph 2.8 above also indicated that there were 11 cases (more than 50% of the 21 completed field audit cases) which had already been examined by assessing officers (i.e. examined cases). Audit found that:

- (a) in 3 cases, the assessing officers detected irregularities in the tax returns and referred the cases to the Field Audit and Investigation Unit; and
- (b) in the remaining 8 cases, the assessing officers failed to detect irregularities in the tax returns. However, the Field Audit and Investigation Unit found the irregularities in them. For illustration purposes, the particulars of 3 of these 8 cases are given as Cases A, B and C below.

Case A

Assessing officers failed to detect the use of a debenture arrangement for tax avoidance

Case particulars

Corporation A, incorporated in September 1990 and a member of a group of corporations, issued debentures of \$1.4 billion in March 1991. Its accounts disclosed that the debentures were listed on an overseas stock exchange. However, the debenture holders were not disclosed.

Corporation A's first tax return for 1990-91 was examined by an assessing officer who raised a number of queries, none of which related to the debentures. For 1991-92 and 1992-93, Corporation A's tax returns were examined by another assessing officer who did not raise any queries. For 1993-94 and 1995-96, Corporation A's tax returns were accepted by different assessing officers without further examination. For 1994-95 and 1996-97 to 1998-99, Corporation A's tax returns met the IRD's pre-set criteria and were summarily accepted for assessment.

In March 2000, an IRD field audit officer noted the debentures issued by Corporation A from the official price lists issued by the overseas stock exchange. He then obtained and reviewed the group's consolidated accounts, and suspected that the debenture arrangement was a tax avoidance scheme, as the debentures seemed to have been taken up by other group members. After receiving the IRD field audit officer's advice, an assessing officer examined Corporation A's tax return for 1999-2000 and raised queries in September 2000 about the debentures before passing the case to the IRD field audit officer for follow-up action.

The field audit found that two overseas group members had subscribed the debentures in March 1991 and held them until March 2001. Corporation A claimed the debenture interest payments as deductible expenses in its tax returns. However, the two group members did not file tax returns to report the debenture interest receipts for assessment of profits tax. As a result of the field audit, the IRD raised additional assessments in May 2001 in which Corporation A's deductions of \$561 million for debenture interest payments for the period 1994-95 to 1999-2000 were disallowed. Corporation A was charged a back tax of \$90 million for the same period.

Audit observations

In Audit's view, if in the early nineties the assessing officers had raised queries about the debentures or reviewed the group's consolidated accounts, they could have detected the use of the debenture arrangement for tax avoidance.

Source: IRD's records

Case B

Assessing officers failed to detect the use of a tax avoidance scheme for reducing manufacturing profits

Case particulars

Corporation B, incorporated in December 1980, was a member of a group of corporations engaged in manufacturing business. Different group members were responsible for soliciting production orders in overseas countries, following up the orders in Hong Kong and manufacturing the products in China. Each group member recorded in its accounts the profits derived from its activities, after accounting for transactions with other group members. Some group members, including Corporation B, filed tax returns to report their profits for assessment of profits tax, but some other group members did not do the same. The case was selected for field audit in February 2001 when an IRD field audit officer suspected, after obtaining and reviewing the group's consolidated accounts, that a tax avoidance scheme was in place, as the tax paid by the group amounted to only a small percentage of its profits.

The field audit found that half of the group's global profits should be subject to profits tax in accordance with an established practice. As a result, the IRD raised additional assessments in July 2001 to charge Corporation B a back tax of \$28 million for the period 1994-95 to 1999-2000.

Audit observations

Audit noted that for 1994-95 to 1999-2000, Corporation B's tax returns were examined by different assessing officers who did not raise any queries. In Audit's view, the assessing officers could have detected the tax avoidance scheme for reducing the profits if they had obtained and reviewed the group's consolidated accounts.

Source: IRD's records

Case C

Assessing officers failed to detect understated sales and overstated purchases

Case particulars

Corporation C, incorporated in August 1984, was engaged in manufacturing business. For 1994-95, 1996-97, 1998-99 and 1999-2000, Corporation C's tax returns were examined by different assessing officers who did not raise any queries. For 1995-96 and 1997-98, Corporation C's tax returns were accepted by different assessing officers for assessment without further examination.

Corporation C was identified as a supplier of another corporation in the course of an IRD field audit of the latter corporation. The case was selected for field audit in February 2001 when an IRD field audit officer reviewed Corporation C's accounts and noted that the reported gross profit rate was unreasonably low compared with that of other businesses of similar nature and comparable scale.

The field audit found that Corporation C had understated sales and overstated purchases. As a result, the IRD raised additional assessments in August 2001 to charge Corporation C a back tax of \$6 million for the period 1994-95 to 1999-2000.

Audit observations

In Audit's view, the assessing officers could have detected that Corporation C's gross profit rate as reported in its accounts was unreasonably low and referred the case to IRD field audit officers for action.

Source: IRD's records

2.12 Audit appreciates that the scope of work performed in a field audit is broader than that in an examination of a tax return. However, out of the 11 examined cases referred to in paragraph 2.11 above, the assessing officers failed to detect the irregularities in 8 cases. It is worthy of note that in most cases the relevant information, used by the IRD field audit officers to detect the irregularities, should have been available to the assessing officers. It appears that the assessing officers in these cases should have been more vigilant when examining the tax returns. Failure of assessing officers to detect irregularities in a tax return can result in significant revenue loss because:

- (a) only a small number of taxpayers are selected by the Field Audit and Investigation Unit for conducting field audits. In 2001-02, 380,000 profits tax assessments were made by assessing officers, but only 515 field audit cases were completed; and
- (b) even if the irregularities are subsequently detected by IRD field audit officers, the IRD may not be able to raise additional assessments to charge a back tax on the understated profits. This is because additional assessments can only be made within six years after the expiration of the year of assessment (see para. 2.7 above). **For example, in Cases A, B and C mentioned in paragraph 2.11 above, back tax could not be charged for the years before 1994-95. Audit estimated that, in Case A, the revenue loss for the years 1990-91 (year of incorporation of Corporation A) to 1993-94 amounted to \$54.8 million.**

2.13 **Audit considers that:**

- (a) **there is a need for the IRD to review those cases in which assessing officers had examined the tax returns but failed to detect the irregularities later revealed by IRD field audit officers, in order to identify room for improvement in the procedures for examining tax returns;**
- (b) **there is a need for the IRD to provide adequate training and instructions to assessing officers to ensure that they examine tax returns thoroughly and effectively; and**
- (c) **there is a need for IRD field audit officers to share their experience and knowledge gained in conducting field audits with assessing officers on a regular basis.**

Need to review the guidelines on reopening back year assessments

2.14 Section 60 of the Inland Revenue Ordinance empowers assessors to raise additional assessments for back years (see para. 2.7 above). For IRD field audit officers, when understated profits of back years are found, they are required to demand back tax on the understated profits by raising additional assessments up to the past six years.

2.15 However, Audit has noted that, for assessing officers in Unit 1, they are required to follow a different set of guidelines as stated in the IRD’s staff handbook:

“Assessing officers should not reopen back year assessments unless very substantial amount of tax was involved, say, over half a million of tax for each year, or situation having a chain effect, e.g. where it is a question of whether the property was acquired for investment or dealing *ab initio*. Before an assessment is reopened, the assessing officer must prepare a submission to the Assistant Commissioner and seek his approval.”

Audit was informed by the IRD that the above guidelines were applicable only to cases in which there was a change of opinion of the assessing officer on the tax treatment of certain items in the tax returns. They were not applicable to other cases requiring reopening of back year assessments such as those in which understated profits of back years were found. However, Audit has reservations about the threshold of “over half a million dollars of tax for each year” for reopening back year assessments by assessing officers in Unit 1 (which handles Profits Tax Returns) because it could result in revenue loss (Note 4). Audit noted that there was no similar threshold for reopening of back year assessments by assessing officers in Unit 2 (which handles Individual Tax Returns). **In Audit’s view, similar to the requirements imposed on IRD field audit officers mentioned in paragraph 2.14 above, the IRD should require all assessing officers to reopen back year assessments provided that the additional potential tax revenue would exceed the administrative cost involved.**

Need to evaluate the effectiveness of different selection methods for identifying irregularities in tax returns

2.16 The AFAL System allows the selection of tax returns to be carried out by one (or a combination) of the following three methods:

- (a) **Fixed selection.** Returns are selected randomly from predetermined categories (e.g. businesses of various sizes);
- (b) **Priority selection.** Returns meeting pre-set selection criteria are selected (e.g. cases with profits from sale of capital assets exceeding a certain amount); and
- (c) **Normal selection.** Certain items, such as offshore profits, are pre-set as risk areas. Returns are then selected, based on risk assessment, either randomly or in accordance with pre-set criteria.

Note 4: *The amount of revenue losses in past years could not be ascertained due to the absence of readily available statistics.*

2.17 Since November 2001 the IRD had used different selection methods to select tax returns from the AFAL System for examination by assessing officers. In each case, the assessing officer was required to record the examination results, including the amount of any adjustment made, in the AFAL System for management review. As at 31 July 2002 (date of completion of Audit's field work), the examination of tax returns for 2000-01 was still in progress. In many cases, the taxpayers had not yet responded to the queries raised by the assessing officers or the assessing officers were considering the taxpayers' response.

2.18 Audit considers that, when the examination of tax returns for 2000-01 is substantially completed, the IRD should conduct a review of the examination results based on different selection methods. The findings of the review would help the IRD evaluate the effectiveness of different selection methods for identifying irregularities in tax returns and improve the selection process in future.

Need to evaluate whether checking procedures are effective for detecting transcription errors

2.19 When adjustments to the profits reported in a tax return are found necessary by an assessing officer, he is required to prepare a profits tax computation showing the profits per return, the adjustments and the adjusted profits. In the process, he is required to transcribe the relevant figures from the tax return onto the computation sheet. Assessing officers should perform self-checking of their own work to ensure that transcription errors do not occur because such errors may result in underassessment of tax. The IRD's selective quality check procedures performed by senior officers for operations review and monitoring purposes (see para. 3.3 below) also help detect transcription errors. However, in one of the profits tax cases examined in this audit (Case E9 in Table 5 in para. 3.12 below), Audit noted that, due to the incorrect transcription of a loss of \$103 million as per the tax return as a loss of \$104 million in the profits tax computation, the adjusted profits of \$247 million shown in the profits tax computation prepared by the assessing officer were understated by \$1 million. The consequential undercharge of profits tax amounted to about \$150,000.

2.20 Audit considers that there is a need for the IRD to investigate the circumstances leading to the transcription error and identify deficiencies in the checking procedures to prevent future mistakes. The IRD should also consider raising an additional assessment in this case to demand the profits tax undercharged.

Audit recommendations on examination of tax returns

2.21 **Audit has *recommended* that the Commissioner of Inland Revenue should:**

- (a) **conduct regular reviews to identify what lessons can be learned from the profits tax**

cases in which understatements of profits were detected by IRD field audit officers for improving the assessment procedures of the profits tax assessing units of the IRD. In particular, the Commissioner should:

- (i) critically review the 3 summary acceptance cases and the 7 accepted cases referred to in paragraph 2.9 above to ascertain why the taxation officers and assessing officers concerned had passed the relevant tax returns for assessment;**
- (ii) use the review's findings to set more effective selection criteria for inputting into the AFAL System for selecting cases for desk audit and improve the manual screening for the selection of tax returns for examination;**
- (iii) review the 8 cases referred to in paragraph 2.11(b) above in which the assessing officers had examined the tax returns but failed to detect the irregularities; and**
- (iv) take action to ensure that assessing officers examine tax returns thoroughly and effectively by:**
 - providing them with adequate training and instructions; and**
 - asking IRD field audit officers to share their experience and knowledge gained in conducting field audits with assessing officers on a regular basis;**
- (b) similar to the practice of IRD field audit officers referred to in paragraph 2.14 above, require all assessing officers of the profits tax assessing units of the IRD to reopen back year assessments provided that the additional potential tax revenue would exceed the administrative cost involved;**
- (c) when the examination of tax returns for 2000-01 is substantially completed, conduct a review of the examination results based on different selection methods (see para. 2.18 above). The findings of the review would help the IRD evaluate the effectiveness of different selection methods for identifying irregularities in tax returns and improve the selection process in future;**
- (d) investigate the circumstances leading to the transcription error mentioned in paragraph 2.19 above and identify deficiencies in the checking procedures to prevent future mistakes; and**

- (e) **consider raising an additional assessment for the transcription error case to demand the profits tax undercharged.**

Response from the Administration

2.22 The **Commissioner of Inland Revenue** agrees to conduct reviews with a view to identifying ways and means to improve the assessment procedures and to further strengthen the profits tax system. She has said that:

IRD's profits tax assessing system

- (a) in 1991, the IRD made a conscious decision to reorganise its structure by setting up field audit teams with a view to deploying its resources in a more efficient and rational manner. Although the assessing and field audit teams both work on profits tax cases, there is a distinct difference in their roles. While the assessing teams concentrate mainly on the technical adjustments in the accounts submitted, the field audit teams are responsible for identifying and tackling cases with understatement of profits and tax avoidance potential. The number of cases handled by an assessing officer far exceeds that of a field audit officer. An assessing officer cannot treat each case with the same depth and/or spend similar amounts of time and effort as a field audit officer does. Given their different roles, the field audit teams, which have developed their own criteria of case selection which are commensurate with the resources allocated to them, perform a complementary function to the assessing teams in the assessment system. This system enables the IRD to finalise all the assessments in an efficient and timely manner, and devote more resources to the high-risk tax evasion and avoidance cases;

Detection of understatements of profits by IRD field audit officers

- (b) in the majority of cases, the capability of field audit officers to unearth tax avoidance schemes and/or understatements of profits is built on the extensive research and in-depth enquiry work done in their case selection. In terms of costs, it takes about 200 times more effort to complete a field audit case than a sole proprietorship profits tax case or 76 times more than in a corporation profits tax case. Moreover, of the cases screened by the field audit teams in 2001-02, only about 7% were eventually selected for field audit. The subsequent detection of substantial understatements of profits in a few selected field audit cases does not suggest that the previous assessment work in respect of a much larger number of normal tax returns was inadequate, as the work focus and the information revealed as a result of the efforts of the two groups of officers vary to a great extent;

***Tax returns with irregularities not selected by
taxation officers/assessing officers for examination***

- (c) it is the IRD's practice to make use of audit findings through various internal and external audit activities to improve the case selection process under the AFAL System. The 3 summary acceptance cases and the 7 accepted cases mentioned in paragraph 2.9 above contained no apparent irregularities and hence were passed for assessment. They were subsequently selected by the field audit teams according to their criteria, based on the information available to them after conducting in-depth enquiries;

***Irregularities not detected by
assessing officers through examination of tax returns***

- (d) the results of the IRD's review of the 8 examined cases mentioned in paragraph 2.11(b) above are as follows:

- (i) **Case A.** In the early nineties, it was generally accepted that debentures listed on overseas stock exchanges were genuine commercial papers issued for the purpose of fund raising. In the absence of prima facie evidence indicating any irregularities with the debentures, the assessing officer did not raise any queries nor ask for the consolidated accounts of the group. Apparently, the assessing officer found the submitted accounts of Corporation A to be in order. In March 2000, in conducting an anti-tax avoidance project targeting debenture interest deductions, an IRD field audit officer identified the group of which Corporation A was a member and obtained the group's consolidated accounts for referral to his assessing counterpart for probing into the debentures issued. As the job nature, approach and focus of assessing officers and field audit officers are so different, it is hard to make a meaningful comparison of their performance. Indeed, it is difficult to detect tax avoidance schemes involving overseas debentures. An Inland Revenue (Amendment) Bill was introduced in 2000 to deal with the problem. The bill introduced specific anti-tax avoidance provisions for schemes involving debenture interest expenses. If enacted, the IRD will, subject to the approval of the Board of Inland Revenue (Note 5), amend the Profits Tax Returns to require taxpayers to provide specific information about debentures issued. Such information in the tax returns will enable assessing officers in Unit 1 to detect possible tax avoidance schemes of this nature at an early stage;

Note 5: *The Board of Inland Revenue is constituted under section 3 of the Inland Revenue Ordinance. It is chaired by the Financial Secretary and comprises four other appointed members, of whom only one can be a government official. This Board operates independently of the IRD. One of its functions is to prescribe the form of the returns for property tax, salaries tax, profits tax and personal assessment.*

- (ii) **Case B.** The holding company of Corporation B was a company listed outside Hong Kong. When examining the accounts of Corporation B, the assessing officer considered that there was no prima facie evidence suggesting any irregularities and hence he did not ask for the group's consolidated accounts. This is a correct approach as it is unrealistic and not cost-effective for an assessing officer to ask for consolidated accounts in each and every case he handles. The field audit team eventually selected the case for field audit according to its criteria. It was only after careful and in-depth scrutiny of the operations of each and every member of the group that the field audit team was able to form the view that there was a tax avoidance scheme and tackle it accordingly;
- (iii) **Case C.** This was an "offshoot" of another field audit case. The field audit officer discovered that Corporation C had some unusual bank transactions and hence started the field audit. The relatively low gross profit rate was not the main reason for selecting this case; and
- (iv) **Remaining 5 cases.** One case had been selected by the field audit team prior to examination by the assessing officer. Two cases were "offshoots" of other field audit cases which means there were no apparent irregularities and hence these cases were not picked up by the assessing officers. Two cases were selected after the field audit officers had obtained additional information from the taxpayers and third parties;

Training of assessing officers

- (e) all profits tax assessments are made personally by or under the supervision of professional officers. These officers are given a comprehensive induction course when first joining the IRD, followed by on the job training and regular educational programmes including continuing professional education programmes on taxation matters. Abundant written instructions, handbooks, manuals and tax precedent publications are distributed to them for reference and guidance with a large percentage of them uploaded to the IRD's web site and unit technical stores in the intranet for their easy access through desk top computers. Small group discussions among different units are also held on an ad hoc basis. While maintaining that its assessing officers have received adequate training and instructions and are competent in their work, the IRD accepts the audit recommendations mentioned in paragraph 2.21(a)(iv) above that more can be done in this area. To foster better experience sharing, earlier this year, an inter-unit working group has been formed among the field audit teams and assessing units to formulate cross-training plans;

Guidelines on reopening back year assessments

- (f) regarding reopening of a finalised assessment involving a change of opinion by different officers, a submission to the Assistant Commissioner is considered necessary as it is prudent to obtain a second opinion. Besides, as raising additional assessments under such circumstances often entails costly objection and appeals proceedings, the \$500,000 criterion was set in order to ensure that only substantial and justifiable cases are considered. The IRD has reviewed this arrangement and come to the view that as reopening of change of opinion cases is rare and each suggestion is considered by the Assistant Commissioner personally on the individual merits including strength of evidence and cost-effectiveness, it may not be necessary to set a limit in terms of tax involved. The IRD hence accepts the audit recommendation mentioned in paragraph 2.21(b) above and will amend the staff handbook by deleting the reference to the limit;

Effectiveness of different selection methods for identifying irregularities in tax returns

- (g) the IRD accepts the audit recommendation mentioned in paragraph 2.21(c) above. It is part of the AFAL Project plan to review on a regular basis the selection methods and evaluate their effectiveness for identifying irregularities in tax returns; and

Effectiveness of checking procedures for detecting transcription errors

- (h) the IRD's investigation of the case mentioned in paragraph 2.19 above shows that the transcription error was due to inadvertence of the assessing officer. The transcription error has been rectified with the adjusted profits corrected. Notwithstanding the rarity of incident of this nature and that it is hard to prevent human error, the IRD will remind all its assessing officers to be more vigilant when transcribing the profits or loss figures from the tax return to the computation sheets. Besides, the IRD will include transcription of data as one of the relevant items in its quality check procedures.

2.23 The **Secretary for Financial Services and the Treasury** welcomes the audit recommendations. He has said that he will review the follow-up actions together with the IRD with a view to improving the services to the public.

PART 3: EXERCISE OF DISCRETION BY IRD OFFICERS

3.1 This PART examines whether, in the performance of their duties, IRD officers have exercised their discretion fairly and consistently in accordance with the procedures in the IRD's staff handbook.

IRD's guidelines on exercise of discretion

3.2 Under the Inland Revenue Ordinance, IRD officers, including assessing officers, field audit officers and those involved in tax collection, are given or delegated by the Commissioner of Inland Revenue discretionary power in performing their duties. According to the IRD's staff handbook, all officers should observe the following requirements in exercising discretion:

- (a) officers should not exercise discretion arbitrarily to benefit "private interests";
- (b) when making a decision, the officer is required to state briefly, but cogently, in the file the reasons for the decision; and
- (c) supervisors and senior management are responsible for ensuring that the instruction regarding the exercise of discretionary power is adhered to. When reviewing files or in the process of quality checks, supervisors should make a note in their sections' management files of the cases reviewed/checked and indicate whether they are satisfied in this regard.

IRD's internal review of exercise of discretion

3.3 Since February 1998, the IRD has set up an in-house Operations Review and Monitoring Committee (ORAMCO), chaired by the Deputy Commissioner of Inland Revenue (Operations), to oversee the internal controls and the quality of judgement exercised by officers. Units 1 to 4 and the Computer Section of the IRD have each formed a subcommittee to review and monitor matters under their purview. These subcommittees are responsible for reviewing, through selected tax cases, the performance of duties by IRD officers, including their exercise of discretion. They are required to provide the ORAMCO with half-yearly reports detailing the cases reviewed and the findings.

Audit observations on exercise of discretion

3.4 According to the half-yearly reports submitted to the ORAMCO during the period November 1998 to May 2002, supervisors and senior management in each unit had regularly reviewed selected individual cases. They did not find any major weaknesses, irregularities or conflicts of interest in the cases reviewed.

3.5 In the exercise of discretion, IRD officers are required to state in the file the reasons for their decisions (see para. 3.2(b) above). To determine whether this requirement has been complied with, Audit randomly selected (Note 6) and examined cases in which IRD officers had decided to:

- (a) withhold penalty action for late submission of tax returns (see paras. 3.6 to 3.9 below);
- (b) hold over tax unconditionally (see paras. 3.10 to 3.12 below); and
- (c) allow payment of tax by instalments (see paras. 3.13 to 3.15 below).

**Audit's examination of exercise of discretion in 10 cases
of late submission of tax returns without penalties imposed**

3.6 ***Provisions of the Inland Revenue Ordinance.*** Section 80 of the Inland Revenue Ordinance provides that any person who without reasonable excuse fails to submit a tax return within the time stated by the IRD shall be guilty of an offence. The penalty is a fine of not exceeding \$10,000 and treble the amount of tax which has been undercharged in consequence of such failure or would have been undercharged had such failure not been detected. The Commissioner of Inland Revenue may compound this offence.

3.7 ***IRD's procedures.*** The IRD's procedures for dealing with outstanding tax return cases are as follows:

- (a) ***Unit 1.*** In Unit 1, the IRD's computer system regularly screens all outstanding return cases and generates compounding letters (Note 7) for issue to those taxpayers meeting pre-set criteria. Assessing officers will manually screen the remaining cases and use their judgement to decide whether to issue compounding letters to the taxpayers, to institute prosecution action against the taxpayers or to take no penalty action. Compounding cases will be closed after the taxpayers have submitted the completed tax returns and paid the compound penalties. In cases where the taxpayers have submitted the completed tax returns but do not agree to pay the compound penalties, assessing

Note 6: *None of the cases selected randomly by Audit had previously been reviewed by the subcommittees of the ORAMCO.*

Note 7: *By means of the compounding letter, the IRD offers not to prosecute a taxpayer for the failure to submit a tax return within the stated time provided that the taxpayer:*

- (a) *pays to the IRD a specified amount of compound penalty when required to do so; and*
- (b) *submits the completed tax return within a specified period (normally 14 days) from the date of the letter.*

officers will use their judgement to decide whether to institute prosecution action against the taxpayers; and

- (b) **Unit 2.** In Unit 2, basically all compounding letters are generated by the computer system. Assessing officers are mainly required to decide whether to institute prosecution action against the taxpayers in cases meeting pre-set criteria and where the taxpayers do not agree to pay compound penalties. Though some broad guidelines are given, they are required to exercise their judgement to select warranted cases for prosecution.

3.8 **Audit findings.** Audit noted that, depending on the discretion exercised by the assessing officers, some taxpayers who had submitted late tax returns were required to pay compound penalties or prosecuted, but some taxpayers were not. In 2001-02, compound penalties were imposed on 10,439 taxpayers and 5,475 taxpayers were prosecuted for late submission of tax returns. However, there are no readily available figures on the number of taxpayers who were not so penalised. Audit examined a random sample of 10 cases of late submission of tax returns with due dates in 2001-02 in which the assessing officers had exercised discretion not to impose compound penalties on, or institute prosecution action against, the taxpayers (Note 8). Details of these 10 cases are given in Table 4 below.

Note 8: *The audit sample of 10 cases is used only for illustration purposes and is not intended to be statistically representative of all such cases.*

Table 4

10 cases of late submission of tax returns with due dates in 2001-02

Case (Note 1)	Due date for submission of return	Receipt of tax return by IRD		Assessable profits (\$'000)	Number of times of late submission in the past five years	Number of times compound penalties imposed in the past (Note 2)
		Date	Number of days past due date			
D1	2 Aug. 2001	14 Nov. 2001	105	258	3	-
D2	2 Aug. 2001	16 Nov. 2001	107	215	2	-
D3	2 Aug. 2001	31 Dec. 2001	152	232	4	-
D4	2 Aug. 2001	9 Mar. 2002 (Note 3)	220	192	1	-
D5	2 Aug. 2001	9 Apr. 2002 (Note 3)	251	159	1	-
D6	31 Aug. 2001	4 Oct. 2001	34	72	1	-
D7	31 Aug. 2001	8 Oct. 2001	38	572 (Note 4)	2	-
D8	31 Aug. 2001	19 Oct. 2001	49	157	4	1
D9	15 Nov. 2001	27 Dec. 2001	42	134	3	2
D10	15 Nov. 2001	7 Jan. 2002	53	2,252 (Note 4)	1	-

Source: IRD's records

Note 1: Cases D1 to D5 involved individuals and were handled by assessing officers in Unit 2. Cases D6 to D10 involved corporations and were handled by assessing officers in Unit 1.

Note 2: In all the 10 cases, none of the taxpayers was prosecuted by the IRD in the past for late submission of tax returns.

Note 3: In Cases D4 and D5, compounding letters were generated by the IRD's computer system based on pre-set criteria and were issued to the taxpayers on 21 November 2001 and 9 January 2002 respectively. As the taxpayers did not submit the completed tax returns and did not agree to pay the compound penalties within the stated time, the compounding offers lapsed.

Note 4: In Cases D7 and D10, the assessable profits for the year were less than the losses brought forward from the previous year.

3.9 According to the IRD’s staff handbook, the assessing officers are required to state briefly but cogently in the file the reasons for exercising their discretion. Moreover, it calls for a harder line of action for taxpayers who habitually submit late returns. In Cases D1, D3, D8 and D9 in Table 4 above, Audit noted that the taxpayers had habitually submitted late returns (i.e. three or more times) within the past five years of assessment. Compound penalties had been imposed on the taxpayers in Cases D8 and D9 for late submission of returns in the past. However, in all the cases of late submission in Table 4 above, as far as Audit could ascertain, documented reasons were not given by the assessing officers in the relevant tax files for not imposing compound penalties on, or instituting prosecution action against, the taxpayers (Note 9).

**Audit’s examination of exercise of discretion
in 10 cases of unconditional hold over of tax**

3.10 **Provisions of the Inland Revenue Ordinance.** Section 64 of the Inland Revenue Ordinance states that a taxpayer may object to an assessment by giving notice in writing to the Commissioner of Inland Revenue within one month after the date of notice of assessment. The Commissioner shall consider the objection and within a reasonable time may confirm, reduce, increase or annul the assessment objected to. Section 71 of the Ordinance provides that tax shall be paid notwithstanding any notice of objection, unless the Commissioner orders that payment of tax or any part thereof be held over pending the result of such objection. The Commissioner may hold over the payment of tax or any part thereof conditionally upon the taxpayer providing security for the payment of the tax by either purchasing a tax reserve certificate or furnishing a banker’s undertaking.

3.11 **IRD’s procedures.** The IRD’s staff handbook states that:

- (a) where, upon receipt of a valid objection and request for hold over, an assessing officer considers that the objection has little chance of success or he has doubt on the taxpayer’s financial standing, no hold over of tax should be granted;
- (b) where it is immediately apparent to the assessing officer that the objection should be allowed, tax may be held over unconditionally;

Note 9: *In Cases D1 to D5, the taxpayers were listed on a computer-generated report entitled “Control List for Prosecution Cases” for the responsible IRD officers to decide whether to institute prosecution action. For the purpose of updating the computer program which generated the report, the IRD officers marked an action code “R” against the cases, indicating that the tax returns had been received, the cases were not selected for prosecution and there were no reasonable excuses for deletion of the offence records. However, no reasons were given for not instituting prosecution action against the taxpayers.*

- (c) where the objection has some merit but the balance of probability, based on the known facts, does not weigh definitely in favour of the taxpayer, a conditional hold over of tax may be granted; and
- (d) in each case, the assessing officer is required to document his decision in an internal instruction form. When an unconditional hold over of tax is granted, the assessing officer is specifically required to state the reasons for his decision in the space provided in the form.

3.12 **Audit findings.** Audit noted that, depending on the discretion exercised by the assessing officers, some taxpayers were not granted a hold over of tax. For those taxpayers who were granted a hold over of tax, some were required to provide security for the payment of the tax held over, while some were not required to do so. In 2001-02, 665 cases of conditional and 2,408 cases of unconditional hold over of tax were granted. However, there are no readily available figures on the number of cases in which the taxpayers' requests for hold over of tax were rejected. Audit examined a random sample of 10 cases in which the assessing officers had exercised discretion to hold over tax under objection unconditionally (Note 10). The results are shown in Table 5 below.

Note 10: *The audit sample of 10 cases is used only for illustration purposes and is not intended to be statistically representative of all such cases.*

Table 5

10 cases in which tax was held over unconditionally
(as at 31 March 2002)

Case	Date hold over granted	Amount of tax held over (\$ million)	Reasons stated in the internal instruction form for granting the unconditional hold over
Cases with stated reasons			
E1	7 November 2000	28.6	Taxpayer's claims were prima facie correct.
E2	21 February 2001	43.8	The same income was already assessed in an alternative year of assessment.
E3	5 October 2001	81.1	Taxpayer was not likely to have assessable profits.
E4	19 October 2001	34.9	Taxpayer's claim seemed to be valid.
Cases without stated reasons			
E5	21 March 2001	17.9	None
E6	3 May 2001	9.7	None
E7	15 October 2001	8.0	None
E8	5 November 2001	5.6	None
E9	9 January 2002	34.1	None
E10	27 March 2002	16.1	None

Source: IRD's records

Note: In Cases E3, E8 and E10, the taxpayers submitted late tax returns and raised objections to the estimated assessments made by the IRD. In particular, in Case E10 the taxpayer submitted a tax return which reported a loss for the year. In other cases, the taxpayers raised objections to the assessments made by the IRD based on the tax returns previously submitted by them. In all cases except Case E4, the IRD raised queries about the taxpayers' tax returns to obtain further information for determining whether the objections should be allowed.

In 6 cases (i.e. Cases E5 to E10 in Table 5 above), Audit noted that the assessing officers had not stated in the internal instruction form the reasons for granting an unconditional hold over of tax. In particular, in Cases E9 and E10, Audit noted that the taxpayers' representatives

had informed the IRD that the taxpayers were in financial difficulties. According to the IRD's staff handbook, no hold over of tax should be granted if an assessing officer has doubt on a taxpayer's financial standing (see para. 3.11(a) above).

**Audit's examination of exercise of discretion
in 10 cases of payment of tax by instalments**

3.13 **Provisions of the Inland Revenue Ordinance.** Section 71 of the Inland Revenue Ordinance provides that tax shall be paid on or before the due date specified in the IRD's tax demand note. Where any tax is unpaid by the due date, the Commissioner of Inland Revenue may order that a surcharge not exceeding 5% shall be added to the unpaid tax and recovered therewith. On the expiry of six months from the due date, the Commissioner may order that a surcharge not exceeding 10% shall be added to any amount remaining unpaid and recovered therewith. Notwithstanding any of these provisions, the Commissioner may agree to accept payment of tax by instalments.

3.14 **IRD's procedures.** The IRD's staff handbook states that:

- (a) requests for payment of tax by instalments should be discouraged and arrangement should be tightened for early settlement as far as possible. However, where circumstances warrant, such requests should be granted subject to the case officers being satisfied that the requests are justifiable. The decision should rest with the case officers; and
- (b) when negotiating an instalment plan with a taxpayer, case officers must collect sufficient information and documents to ascertain the taxpayer's current financial position. Instalment payments should include the amount of surcharges that the taxpayer is liable to pay.

3.15 **Audit findings.** Audit noted that, depending on the discretion exercised by the assessing officers, some taxpayers were allowed to pay tax by instalments, while some were not. In 2001-02, 1,524 cases of payment of tax by instalments were granted. However, there are no readily available figures on the number of cases in which the taxpayers' requests for payment of tax by instalments were rejected. Audit examined a random sample of 10 cases in which the assessing officers had exercised discretion to allow the taxpayers to pay tax by instalments and the tax had not been fully settled as at 31 March 2002 (Note 11). In all the 10 cases, Audit noted that:

Note 11: *The audit sample of 10 cases is used only for illustration purposes and is not intended to be statistically representative of all such cases.*

- (a) the case officers had stated the reasons for accepting payment of tax by instalments (i.e. taxpayers in financial difficulties) and filed the documents provided by the taxpayers to indicate their financial position; and
- (b) the instalment payments had included the amount of surcharges that the taxpayers were liable to pay.

Need to ensure that discretion is exercised properly

3.16 In exercising the discretionary powers under the Inland Revenue Ordinance, IRD officers have a duty to act with fairness and consistency. Taxpayers expect the same treatment from the IRD given the same facts. In this respect, the IRD requires its officers to follow the procedures set out in the IRD's staff handbook and to state in the file the reasons for exercising discretion to accord a particular treatment to a taxpayer (see para. 3.2(b) above). The discretion exercised by IRD officers in the performance of their duties often carries revenue implications (e.g. imposing penalties on taxpayers increases government revenue).

3.17 However, the results of Audit's examination revealed cases in which this requirement had not been complied with. Audit noted that:

- (a) in all the 10 cases of late submission of tax returns, the assessing officers did not state their reasons for not imposing compound penalties on, or instituting prosecution action against, the taxpayers (see para. 3.9 above);
- (b) in 6 of the 10 cases in which an unconditional hold over of tax was granted, the assessing officers did not state the reasons for exercising the discretion (see para. 3.12 above); and
- (c) in 2 cases, the assessing officers exercised the discretion to grant an unconditional hold over of tax although they knew that the taxpayers were in financial difficulties (see para. 3.12 above). This was contrary to the IRD's requirement that no hold over of tax should be granted if an assessing officer has doubt on a taxpayer's financial standing (see para. 3.11(a) above).

3.18 **Audit considers that there is a need for the IRD to ensure that its officers comply with all the requirements stated in the IRD's staff handbook (see para. 3.2 above) and act with fairness and consistency when exercising discretion. There is also a need for the IRD to ensure that the discretion exercised by IRD officers is proper through regular reviews of their work by their immediate supervisors and the senior management (see para. 3.3 above).**

Audit recommendations on exercise of discretion

3.19 **Audit has *recommended* that the Commissioner of Inland Revenue should:**

- (a) investigate the circumstances of the cases concerning the exercise of discretion by IRD officers and ascertain the reasons for:**
 - (i) not imposing compound penalties on, or instituting prosecution action against, the taxpayers in Cases D1 to D10 (see Table 4 in para. 3.8 above);**
 - (ii) not requiring the taxpayers in Cases E5 to E8 (see Table 5 in para. 3.12 above) to provide security for the payment of tax under objection; and**
 - (iii) granting an unconditional hold over of tax to the two taxpayers in Cases E9 and E10 (see Table 5 in para. 3.12 above), who were known to be in financial difficulties;**
- (b) based on the findings of the IRD's investigation, consider whether there is a need to revise the procedures in the IRD's staff handbook for the imposition of compound penalty and prosecution for late submission of tax returns, and the hold over of the payment of tax under objection;**
- (c) regularly remind IRD officers to:**
 - (i) exercise discretion fairly and consistently in accordance with the procedures stated in the IRD's staff handbook; and**
 - (ii) state in the file the reasons for exercising discretion to accord a particular treatment to a taxpayer, especially if the treatment does not comply with the procedures stated in the IRD's staff handbook; and**
- (d) strengthen the in-house quality assurance work of the ORAMCO (see para. 3.3 above) with a view to ensuring that IRD officers exercise discretion properly in the performance of their duties.**

Response from the Administration

3.20 The **Commissioner of Inland Revenue** accepts the audit recommendations mentioned in paragraph 3.19(c) and (d) above. In response to the audit recommendation mentioned in paragraph 3.19(a) above, the IRD has investigated the cases concerned and found that the officers' decisions were backed by valid reasoning. The IRD considers that there are already ample and adequate instructions in its staff handbook for the imposition of compound penalty and prosecution for late submission of tax returns and the hold over of the payment of tax under objection. Nevertheless, the IRD accepts the audit recommendation mentioned in paragraph 3.19(b) above and will review the procedures and instructions relating to these areas from time to time. The Commissioner of Inland Revenue has said that:

Cases D1 to D10 mentioned in paragraph 3.8 above

- (a) in considering whether any penalty or prosecution actions should be instituted, IRD officers must take into account the administrative cost and deterrent effect likely to be incurred and generated by such actions. In Cases D1 to D5, the taxpayers concerned did not accept the compounding offers. Having regard to the experience from prosecution cases, the IRD officers were of the view that it would be more appropriate to consider imposing a penalty under section 82A of the Inland Revenue Ordinance (Note 12), rather than instituting prosecution action, for late submission of tax returns. Prosecution action was therefore not instituted. However, a section 82A penalty was not imposed eventually because the quantum of net assessable profits in each case did not meet the amount pre-set by the Unit 2 management. In order to strengthen the tax return follow-up action, the Unit 2 management will review if the pre-set amount needs to be revised;
- (b) in Cases D7, D8 and D10, there were losses brought forward from previous years, which would completely offset the assessable profits for the year concerned. In Cases D6 and D9, the amount of profits reported in the tax returns was relatively small. It seems clear that the officers concerned had taken this factor into account when exercising their judgement. However, with the benefit of hindsight, in Cases D8 and D9, as the taxpayers had poor filing records, it is perhaps arguable that the case officers' approach had been too lenient. The IRD will remind its officers that due weight should be accorded to the past filing records when making similar decisions in future; and

Note 12: *According to section 82A of the Inland Revenue Ordinance, any person who without reasonable excuse fails to submit a tax return within the time stated by the IRD shall, if no prosecution has been instituted by the IRD, be liable to be assessed to additional tax of an amount not exceeding treble the amount of tax which has been undercharged in consequence of such failure or would have been undercharged had such failure not been detected. Such assessments of additional tax may be made only by the Commissioner of Inland Revenue personally or a Deputy Commissioner personally.*

Cases E5 to E10 mentioned in paragraph 3.12 above

- (c) the results of the IRD's investigation of Cases E5 to E10 are as follows:
- (i) **Case E5.** This was a joint-venture case. The taxpayer claimed that the profits had been assessed in the files of the individual joint-venture partners. The assessing officer allowed an unconditional hold over in order to avoid double taxation;
 - (ii) **Case E6.** The assessing officer considered that prima facie the taxpayer's claim had merit. The objection could be allowed after certain confirmatory information was obtained;
 - (iii) **Case E7.** The taxpayer had objected to the assessment of the previous year on exactly the same issue. The assessing officer stated the reason for allowing an unconditional hold over in a letter to the taxpayer, viz. pending outcome of objections for past years;
 - (iv) **Case E8.** The tax return showed a large loss and the assessing officer considered that there were unlikely to be any assessable profits for the year in question;
 - (v) **Case E9.** The tax return showed a loss and the taxpayer claimed a refund of provisional tax paid. The assessing officer considered that the taxpayer's grounds of objection were, on the face of them, valid and the objection was eventually allowed. A refund was eventually made; and
 - (vi) **Case E10.** The assessment was an estimated assessment made by the IRD in the absence of a completed tax return. The subsequently filed tax return showed a large loss and the taxpayer claimed a refund of provisional tax paid. The assessing officer considered that the taxpayer was unlikely to have any tax liability for the year. Further information has yet to be supplied by the taxpayer before the objection can be finalised.

3.21 The **Secretary for Financial Services and the Treasury** welcomes the audit recommendations. He has said that he will review the follow-up actions together with the IRD with a view to improving the services to the public.

PART 4: ASSESSMENT AND COLLECTION OF PROFITS TAX PAYABLE BY NON-RESIDENTS

4.1 This PART examines the assessment and collection of profits tax payable by non-residents carrying on a trade, profession or business in Hong Kong without a permanent business presence.

Provisions of the Inland Revenue Ordinance

4.2 A non-resident who carries on a trade, profession or business in Hong Kong without a permanent business presence is chargeable to profits tax in respect of profits arising in or derived from Hong Kong. For example, a non-resident entertainer or sportsman who performs in Hong Kong is chargeable to profits tax in respect of the performance fee he receives. The provisions of the Inland Revenue Ordinance relating to the assessment and collection of profits tax payable by such non-residents are as follows:

- (a) ***Non-residents who have an agent (Note 13) in Hong Kong.*** Under section 20A of the Ordinance, a non-resident who has an agent in Hong Kong shall be chargeable to tax either directly or in the name of his agent. The tax so charged shall be recoverable out of the assets of the non-resident or from the agent. The agent shall retain, out of any assets coming into his possession or control on behalf of the non-resident or in his capacity as agent, a sufficient amount of money for payment of the tax;
- (b) ***Non-resident entertainers and sportsmen.*** Under section 20B of the Ordinance, a non-resident entertainer or sportsman is chargeable to tax in the name of any person in Hong Kong who made payment of performance fee to him. The tax so charged shall be recoverable from that person in Hong Kong. The person in Hong Kong shall, at the time he makes payment, deduct a sufficient amount of money for payment of the tax; and
- (c) ***Non-residents other than entertainers and sportsmen who do not have an agent in Hong Kong.*** A non-resident who is not an entertainer or sportsman and who does not have an agent in Hong Kong is chargeable to tax directly in accordance with the same provisions as applicable to residents.

4.3 There is no definition of “resident” or “non-resident” in the Inland Revenue Ordinance. According to the IRD, the common law test for residence is that:

- (a) in the case of an individual, it can be the place where he maintains a place of abode; and

Note 13: *Section 2 of the Inland Revenue Ordinance states that an agent, in relation to a non-resident, includes:*

- (a) *the agent, attorney, factor, receiver or manager in Hong Kong of the non-resident; and*
- (b) *any person in Hong Kong through whom the non-resident is in receipt of any profits or income arising in or derived from Hong Kong.*

- (b) in the case of a corporation, it is generally the place where the central management and control is based. Therefore, a corporation is normally resident in the place where its board of directors holds meetings and carries out its duties.

In relation to sections 20A and 20B of the Ordinance referred to in paragraph 4.2 above, the IRD has accepted that a non-resident refers to a person who has no permanent business presence in Hong Kong.

IRD's procedures

4.4 According to the IRD's staff handbook, the procedures for assessing and collecting profits tax payable by non-residents are as follows:

- (a) ***Non-residents who have an agent in Hong Kong.*** The IRD requires taxpayers other than individuals to report in their annual tax returns whether they have, as agent, received on behalf of a non-resident any trade or business income arising in or derived from Hong Kong. The IRD will also issue a tax return to any taxpayer known to have received such income for reporting the assessable profits made by the non-resident. After making the profits tax assessment, the IRD will issue a tax demand note to the taxpayer requiring payment of the tax due by the non-resident out of the amount retained (see para. 4.2(a) above);
- (b) ***Non-resident entertainers and sportsmen.*** In the majority of situations, the "Hong Kong payer" who makes payment of performance fee to a non-resident entertainer or sportsman is the promoter or sponsor of the activity concerned. The IRD requires the Hong Kong payer to give notice, in a specified form, to the IRD immediately when the non-resident entertainer or sportsman arrives in Hong Kong. Upon receipt of the notification, the IRD will issue a tax return to the Hong Kong payer for completion on behalf of the non-resident entertainer or sportsman. After making the profits tax assessment, the IRD will issue a demand note to the Hong Kong payer requiring payment of the tax due by the non-resident entertainer or sportsman out of the amount retained (see para. 4.2(b) above); and
- (c) ***Non-residents other than entertainers and sportsmen who do not have an agent in Hong Kong.*** The IRD will issue a tax return to any non-resident known to have carried on a trade, profession or business in Hong Kong. Upon receipt of the completed return, the IRD will make the profits tax assessment and issue a tax demand note to the non-resident.

Audit observations on assessment and collection of profits tax payable by non-residents

Individuals not required to report income received on behalf of a non-resident

4.5 As stated in paragraph 4.4(a) above, the IRD requires taxpayers other than individuals to report in their annual tax returns whether they have, as agent, received on behalf of a non-resident any trade or business income arising in or derived from Hong Kong. However, Audit could not find, from the IRD's records, documented reasons for not requiring individuals to do the same. **Audit considers that, to facilitate the identification of non-residents chargeable to profits tax, the IRD should consider imposing a similar reporting requirement on individuals.**

No general requirements for reporting payments to non-residents for services rendered in Hong Kong

4.6 A non-resident receiving payments for services rendered in Hong Kong is chargeable to profits tax. However, the persons who have made such payments, other than payments of performance fee to non-resident entertainers or sportsmen (see para. 4.2(b) above), are not required by the Inland Revenue Ordinance to withhold a sufficient amount from the payments for settlement of the profits tax due by the non-residents. They are also not required to report such payments to the IRD. As such, the IRD has difficulties in identifying the non-residents for assessing and collecting their profits tax. In the absence of readily available data, Audit could not ascertain the effect of non-reporting of payments to non-residents (other than entertainers and sportsmen) by the private sector on the assessment of profits tax by the IRD. However, Audit noted that, as the IRD had realised, non-reporting of payments by some government departments to non-residents would have an adverse effect on the assessment and collection work of the IRD. Details are given in paragraphs 4.7 to 4.12 below.

IRD requested government departments to report payments to non-residents for services rendered in Hong Kong

4.7 Government departments, like taxpayers in the private sector, engage non-residents from time to time to provide services in Hong Kong. In April 2000, the IRD issued a memorandum to selected government departments (Note 14). These departments, according to the IRD's understanding, had occasionally made payments to non-residents for their services rendered in Hong Kong. The IRD requested such departments to withhold 15% of the payments to non-residents for settlement of the profits tax due by them, and advise the IRD as early as possible of such cases for assessing and collecting the profits tax.

Note 14: *IRD officers told Audit that this memorandum was not issued to all government departments at that time. Only those departments, which the IRD thought had engaged non-residents to work for them temporarily, received the memorandum. The IRD does not have a list of the departments to whom the memorandum was issued.*

Audit's examination of payments by government departments to non-residents for services rendered in Hong Kong

4.8 To test check whether the government departments referred to in paragraph 4.7 above have acted in accordance with the IRD's request, Audit randomly selected 3 of these departments and for each of them examined 5 cases of payments made in 2000-01 to non-residents for services rendered in Hong Kong (Note 15). The audit findings are given in paragraphs 4.9 to 4.12 below.

4.9 **Environmental Protection Department (EPD).** In all the 5 cases examined by Audit, the EPD did not withhold any money from the payments to non-residents and did not report the payments to the IRD. Details of the 5 cases are shown in Table 6 below.

Table 6
5 cases of payments made
by the EPD to non-residents in 2000-01

Case	Nature of payment	Amount paid (\$)
F1	Consultancy fee	312,000
F2	Consultancy fee	252,000
F3	Consultancy fee	216,000
F4	Consultancy fee	48,000
F5	Training fee	12,610

Source: EPD's records

According to the IRD's records, in all the 5 cases in Table 6 above, the non-residents did not report their profits to the IRD for assessment of profits tax. As a result, the IRD did not raise profits tax assessments on these non-residents. The profits tax assessments not raised are estimated to be \$84,000.

4.10 **Leisure and Cultural Services Department (LCSD).** The LCSD accorded different treatments in 5 cases of payments to non-residents as shown in Table 7 below.

Note 15: *The audit sample of 15 cases is used only for illustration purposes and is not intended to be statistically representative of all cases of payments made by government departments in 2000-01 to non-residents for services rendered in Hong Kong.*

Table 7

5 cases of payments made by the LCSD to non-residents in 2000-01

Case	Nature of payment	Amount withheld	Amount paid	Date of payment to the non-resident	Date payment reported to IRD
		(\$)	(\$)		
G1	Entertainer's performance fee	—	249,376	22 May 2000	Not reported
G2	Entertainer's performance fee	—	524,077	16 October 2000	Not reported
G3	Entertainer's performance fee	—	1,248,160	31 October 2000	Not reported
G4	Consultancy fee	16,800 (Note)	151,200	7 September 2000	2 May 2001
G5	Consultancy fee	—	271,500	11 January 2001	2 May 2001

Source: LCSD's records

Note: In Case G4, the agreed consultancy fee was \$168,000. The LCSD withheld 15% of this fee after allowing for the consultant's expenses estimated at one third of the fee. The amount withheld was \$16,800 [i.e. (\$168,000 - \$168,000 × 1/3) × 15%].

Audit noted that:

- (a) in Cases G1 to G3, the contracts with the non-residents specified that the performance fee was a fixed sum net of profits tax. However, as at 31 July 2002, the LCSD did not report the cases to the IRD. As a result, the IRD did not raise assessment of the profits tax payable by the LCSD for the non-residents. The profits tax not paid by the LCSD is estimated to be \$240,000;
- (b) in Case G4, the LCSD withheld \$16,800 from the payment to the non-resident and reported the case to the IRD on 2 May 2001 in the annual tax reporting exercise. As a result, the IRD raised profits tax assessment and collected the tax due by the non-resident; and
- (c) in Case G5, the LCSD did not withhold any money from the payment to the non-resident but reported the case to the IRD on 2 May 2001 in the annual tax reporting exercise. The IRD raised profits tax assessment and collected the tax due by the non-resident.

4.11 **Department of Justice (D of J).** In all the 5 cases examined by Audit, the D of J made payments to overseas counsel for services rendered in Hong Kong. The D of J withheld 15% of the payments and made timely reports of the payments to the IRD. As a result, the IRD raised profits tax assessments and collected the tax due by the non-residents. Audit noted that on 12 December 2001, the D of J issued to its staff a set of guidelines on engaging local and overseas counsel, solicitors, arbitrators, experts and other professionals. According to the guidelines, to facilitate the recovery of tax for work done by non-residents for the D of J in Hong Kong, the following terms should be included in the contracts entered into with such non-residents:

“We shall withhold 15% of the fee payable to you (exclusive of the reimbursement of expenses if any) in respect of work performed in Hong Kong for the settlement of Hong Kong tax chargeable on the fee. Any balance will be paid to you upon final determination of such tax liabilities.”

4.12 The results of Audit’s examination of the 15 cases of payments made in 2000-01 by the EPD, the LCSD and the D of J to non-residents for services rendered in Hong Kong revealed that:

- (a) the IRD relied on the reporting of cases of payments to non-residents by departments for identifying non-residents chargeable to profits tax. In Cases F1 to F5 (see Table 6 in para. 4.9 above) and Cases G1 to G3 (see Table 7 in para. 4.10 above), due to the non-reporting of these cases by the departments concerned, the IRD could not identify the non-residents for assessing and collecting the profits tax; and
- (b) if departments only reported to the IRD cases of payments to non-residents but did not withhold a sufficient amount of money from the payments for settlement of the profits tax due by the non-residents, the IRD might have difficulties in recovering the full tax due from the non-residents. In Case G5 (see Table 7 in para. 4.10 above), Audit noted that the non-resident had departed from Hong Kong upon completion of the contract. The IRD received the tax due by the non-resident on 31 July 2002.

Need to implement measures to facilitate assessment and collection of profits tax payable by non-residents

4.13 **Audit considers that there is a need for the IRD to provide all government departments with guidelines on withholding money from payments to non-residents for services rendered in Hong Kong, and regularly remind them to follow such guidelines. In this connection, Audit considers that, in the absence of statutory power for deducting money from payments other than those made to non-resident entertainers or sportsmen, government departments need to include special terms in the contracts entered into with non-residents, similar to those stated in the guidelines issued by the D of J (see para. 4.11 above). This would enable departments to withhold a sufficient amount of money for payment of the tax due by the non-residents.**

4.14 **Audit also considers that, for persons in the private sector who have made payments to non-residents (other than entertainers and sportsmen) for services rendered in Hong Kong, the IRD should consider whether such persons should also be required to:**

- (a) report to the IRD such payments; and
- (b) withhold a sufficient amount of money from such payments for settlement of the tax due by the non-residents.

4.15 For all government departments (including the EPD and the LCSD), Audit considers that they need to review their records and report to the IRD all payments made in 1996-97 or after to non-residents for services rendered in Hong Kong (including the payments identified by Audit), as the IRD is empowered to raise additional assessments for a back year within six years after the expiration of the year concerned.

Audit recommendations on assessment and collection of profits tax payable by non-residents

4.16 Audit has *recommended* that the Commissioner of Inland Revenue should:

- (a) consider requiring individuals to report in their tax returns whether they have, as agent, received on behalf of a non-resident any trade or business income arising in or derived from Hong Kong (see para. 4.5 above);
- (b) for persons who have made payments to non-residents (other than entertainers and sportsmen) for services rendered in Hong Kong, consider requiring them (as in cases in which they have made payments to non-resident entertainers or sportsmen — see para. 4.4(b) above) to:
 - (i) report to the IRD such payments; and
 - (ii) withhold a sufficient amount of money from such payments for settlement of the profits tax due by the non-residents;
- (c) provide all government departments with guidelines on withholding money from payments to non-residents for services rendered in Hong Kong, and regularly remind them to follow such guidelines so as to ensure that the profits tax due by such non-residents is properly assessed and collected (see para. 4.13 above); and
- (d) consider asking all government departments to review their records to identify payments made in 1996-97 or after to non-residents for services rendered in Hong Kong and to report to the IRD such payments for profits tax assessment (see para. 4.15 above).

4.17 Audit has *recommended* that the Director of Environmental Protection and the Director of Leisure and Cultural Services should report to the IRD the payments to non-residents as identified by Audit and all other similar payments made in 1996-97 or after for profits tax assessment (see para. 4.15 above).

Response from the Administration

4.18 The Commissioner of Inland Revenue has said that:

Reporting by individuals of income received on behalf of a non-resident

- (a) the IRD accepts the audit recommendation mentioned in paragraph 4.16(a) above. A proposal to amend the tax returns will be submitted to the Board of Inland Revenue for approval;

Reporting of payments to non-residents for services rendered in Hong Kong

- (b) the IRD accepts the audit recommendation mentioned in paragraph 4.16(b)(i) above. A proposal to amend the tax returns will be submitted to the Board of Inland Revenue for approval. On the audit recommendation mentioned in paragraph 4.16(d) above, the IRD will select the government departments which it considers most likely to have made such payments and request them to review their records and provide the relevant information for profits tax purposes; and

Withholding of tax on payments to non-residents for services rendered in Hong Kong

- (c) on the audit recommendations mentioned in paragraph 4.16(b)(ii) and (c) above, the Inland Revenue Ordinance contains no provision which requires the paying party, be it a government department or a private enterprise, to withhold tax on payments to non-residents, other than entertainers and sportsmen, for rendering services in Hong Kong. Legislative amendment would be required to make provision for this. The IRD will consult the Financial Services and the Treasury Bureau and the D of J to ascertain whether there is any justification to introduce such a provision. In the meantime, as a practical administrative alternative, the IRD will communicate with various government departments suggesting that they consider the D of J's example of inserting a fund-withholding clause in their service contracts.

4.19 The **Secretary for Financial Services and the Treasury** welcomes the audit recommendations. He has said that he will review the follow-up actions together with the IRD with a view to improving the services to the public. In particular, he will consider Audit's recommendation to require persons to withhold tax on payments to non-residents, other than entertainers and sportsmen, for rendering services in Hong Kong.

4.20 The **Director of Environmental Protection** accepts the audit recommendation mentioned in paragraph 4.17 above. He has said that:

- (a) the EPD would report to the IRD the payments to non-residents as identified by Audit and all other similar payments made in 1996-97 or after as far as possible for profits tax assessment;
- (b) government departments do not have the statutory power to deduct money from payments to non-residents and the EPD does not in practice do so. In the circumstances, the EPD had not made returns to the IRD in the context of the memo issued by the IRD in April 2000 (see para. 4.7 above); and
- (c) to enable the EPD to withhold a sufficient amount of money for payment of the tax due by the non-residents, the EPD would include a special clause in tenders and contracts entered into with non-residents, similar to the requirements laid down in the guidelines issued by the D of J (see para. 4.11 above).

4.21 The **Director of Leisure and Cultural Services** accepts the audit recommendation mentioned in paragraph 4.17 above. He has said that:

- (a) the LCSD will endeavour to report to the IRD the payments to non-residents as identified by Audit and all other similar payments made in 1996-97 or after for profits tax assessment. However, since the LCSD was established only on 1 January 2000, it expects to have practical difficulties in retrieving records dating back to the ex-Councils era as some offices had already been restructured; and
- (b) with the benefit of the Audit Report, the LCSD will review internally to see how best it can comply with the relevant provisions in future. The LCSD expects to have a few areas that will require advice from the IRD and the D of J. The LCSD will consult them in due course.

4.22 The **Director of Administration and Development, Department of Justice** agrees with the audit findings mentioned in paragraph 4.11 above.

PART 5: WRITE-OFF OF PROFITS TAX

5.1 This PART examines write-offs of profits tax to identify whether there is room for improvement in the assessment and collection procedures.

Recovery of tax in default

5.2 The Inland Revenue Ordinance provides that tax shall be paid on or before the due date specified in the IRD's tax demand note. Any tax not so paid shall be deemed to be in default. The IRD may take the following actions to recover the tax in default:

- (a) **Imposition of surcharge.** Under the Inland Revenue Ordinance, the IRD may impose a surcharge not exceeding 5% on the tax in default. On the expiry of six months from the due date, the IRD may impose a surcharge not exceeding 10% on all unpaid amount including the 5% surcharge;
- (b) **Issue of recovery notices.** Under the Inland Revenue Ordinance, the IRD may issue a recovery notice to any third party who owes or holds moneys for the defaulting taxpayer requiring the third party to pay such moneys not exceeding the amount of tax in default to the IRD within a stipulated time;
- (c) **Institution of recovery proceedings in the District Court.** In accordance with the provisions of the District Court Ordinance (Cap. 336) and the Inland Revenue Ordinance, the IRD may take action in the District Court to recover the tax in default as a civil debt due to the Government. Upon entry of judgement, the defaulting taxpayer becomes liable to legal costs and interest on the judgement debt from the date of commencement of proceedings to the date of full settlement in addition to the outstanding tax. If the judgement debt is not settled, the IRD may apply to the District Court to levy execution against the movable property and apply charging order on the immovable property belonging to the taxpayer;
- (d) **Application to the District Court for a departure prevention direction.** Under the Inland Revenue Ordinance, if the IRD applies to a District Judge and satisfies him that there are reasonable grounds for believing that an individual intends to depart, or has departed, from Hong Kong to reside elsewhere without paying all the tax due from him, the District Judge shall issue a departure prevention direction to stop the individual from leaving Hong Kong; and
- (e) **Institution of bankruptcy or winding-up proceedings in the High Court.** If the defaulting taxpayer is an individual, the IRD may institute bankruptcy proceedings under

the Bankruptcy Ordinance (Cap. 6) by presenting a bankruptcy petition to the High Court against the taxpayer. If the defaulting taxpayer is a corporation, the IRD may institute winding-up proceedings under the Companies Ordinance (Cap. 32) by presenting a winding-up petition to the High Court against the taxpayer.

Procedures for write-off of tax

5.3 The IRD's staff handbook states that where all possible recovery actions have proved fruitless and the outstanding tax (including any surcharge) is irrecoverable, the amount should be put up for write-off. The procedures for write-off of tax are as follows:

- (a) **Cases requiring the approval of the Secretary for Financial Services and the Treasury.** The Commissioner of Inland Revenue is required to make application for write-off to the Secretary for Financial Services and the Treasury:
 - (i) for cases involving fraud or negligence on the part of a public officer, irrespective of the amount of loss;
 - (ii) for cases involving theft or suspected theft of an amount greater than \$50,000; and
 - (iii) for cases involving other losses of an amount greater than \$500,000; and
- (b) **Cases approved by IRD officers.** Cases not requiring the approval of the Secretary for Financial Services and the Treasury are written off by the Commissioner or authorised IRD directorate officers. The Commissioner is required to submit a half-yearly return to the Secretary for Financial Services and the Treasury showing the amounts written off departmentally and stating briefly the action taken to effect recovery. The Commissioner must certify that proper investigations and record have been made of the circumstances and that she is satisfied that the amounts are irrecoverable.

Audit observations on write-off of profits tax

Substantial and increasing amounts of profits tax written off

5.4 The write-offs of profits tax during the period 1997-98 to 2001-02 are shown in Table 8 below.

Table 8

Write-offs of profits tax during the period 1997-98 to 2001-02

Year	Corporations		Unincorporated businesses		Total	
	Number of cases	Amount	Number of cases	Amount	Number of cases	Amount
	(a)	(b)	(c)	(d)	(e) = (a) + (c)	(f) = (b) + (d)
		(\$ million)		(\$ million)		(\$ million)
1997-98	1,004	108	1,592	52	2,596	160
1998-99	996	135	1,270	54	2,266	189
1999-2000	1,031	169	1,222	48	2,253	217
2000-01	1,280	255	1,011	46	2,291	301
2001-02	1,121	334	1,091	62	2,212	396
Total	<u>5,432</u>	<u>1,001</u>	<u>6,186</u>	<u>262</u>	<u>11,618</u>	<u>1,263</u>

Source: IRD's records

Note: The IRD maintains the collection files and records of all write-off cases. If recovery of any items already written off appears possible at a later date, the IRD will commence recovery action. For write-off cases reopened during the period 1997-98 to 2001-02, the tax recovered averaged \$17 million a year.

As shown in Table 8 above, the total write-offs of profits tax increased from \$160 million in 1997-98 to \$396 million in 2001-02. According to the IRD's records, in the majority of the profits tax write-off cases, the taxpayers were untraceable or had no assets for tax recovery.

Audit's examination of 20 profits tax write-off cases

5.5 To ascertain if there is room for improvement in the profits tax assessment and collection procedures, Audit examined a random sample of 20 profits tax write-off cases in 2001-02, selected from cases with write-offs exceeding \$0.5 million. The amounts of profits tax written off in these 20 cases ranged from \$0.6 million to \$23.8 million (average \$3.7 million for each case). In 15 of the 20 cases examined by Audit (Cases H1 to H15), the taxpayers were corporations. In the remaining 5 cases (Cases H16 to H20), the taxpayers were individuals. The audit findings are given in paragraphs 5.6 to 5.24 below.

Corporations chargeable to profits tax not timely identified

5.6 The IRD identifies persons chargeable to profits tax from records maintained by its Business Registration Office (Note 16) and information obtained from other sources. In particular, the Property Dealing/Share Dealing/Consignment Section (PSC Section) of Unit 1 of the IRD is responsible for ascertaining whether a person's activities in property transactions constitute a trade with profits derived therefrom subject to profits tax. The procedures for identifying potential property dealing cases are summarised as follows:

- (a) **Manual screening of Form IRSD26.** Information about property transactions is contained in the questionnaires (Form IRSD26) completed by solicitors to facilitate the collection of stamp duty by the Stamp Office of the IRD. Each IRSD26 consists of a number of copies. One copy is sent to the PSC Section and another copy is sent to the Property Section of Unit 2 of the IRD. The PSC Section screens the IRSD26s received from the Stamp Office to pick out confirmor (Note 17) cases for urgent action. According to the IRD, it normally takes 2 weeks, counting from the date of its completion by the solicitor, for an IRSD26 to reach the PSC Section for screening; and
- (b) **Advisory notices generated by IRD computer program.** The Property Section is responsible for inputting all IRSD26s into a computerised Property Tax Database. A computer program is run quarterly to scan the database for potential property dealing cases using pre-set criteria. Details of such cases are printed on advisory notices for action by the PSC Section.

According to the IRD's procedures, the PSC Section, after completing the necessary procedures (such as obtaining further information from the persons concerned or records maintained by the Land Registry), is required to refer all potential property dealing cases speedily to the IRD's assessing sections for profits tax assessment.

5.7 Audit noted that, in Cases H1 to H7, the taxpayers had derived assessable profits from the sale of properties in Hong Kong but had not reported the profits to the IRD for profits tax assessment. Details are given in Table 9 below.

Note 16: *Under the provisions of the Business Registration Ordinance (Cap. 310), every person carrying on any business must register his business with the IRD's Business Registration Office within one month of the commencement of the business. A corporation incorporated in Hong Kong, or an overseas corporation which has established a place of business in Hong Kong, is deemed to be a person carrying on business and is liable to be registered under the Business Registration Ordinance.*

Note 17: *A confirmor is an intermediate buyer of a property who has subsequently resold the property prior to assignment. The profits so derived are likely to be subject to profits tax.*

Table 9

**7 profits tax write-off cases in 2001-02 in which
the taxpayers' property dealing activities were not timely identified**

Case	Date of IRSD26	Date case identified by PSC Section (Note)	Number of days taken to identify the case	Amount of profits tax written off (\$ million)
<i>Overseas corporations</i>				
H1	27 October 1994	4 August 1998	1,377	1.9
H2	22 November 1994	29 August 1997	1,011	5.3
H3	28 November 1996	3 June 1997	187	1.6
H4	26 March 1997	25 January 1998	305	1.1
H5	22 August 1997	10 March 1998	200	23.8
<i>Corporations incorporated in Hong Kong</i>				
H6	3 July 1992	17 September 1995	1,171	1.0
H7	1 March 1995	15 January 1997	686	4.6

Source: IRD's records

Note: This is the date on which the first action was taken by the PSC Section as revealed by documents in the case file.

5.8 In the 7 property dealing cases shown in Table 9 above, the time taken by the PSC Section to identify the cases ranged from 187 days to 1,377 days (average 705 days or almost two years). The taxpayers were untraceable when they were identified and all the subsequent recovery actions taken by the IRD were in vain. Audit noted that:

- (a) Cases H1 to H5 were confirmor cases and should have been picked out in 2 weeks' time by the PSC Section when it screened the IRSD26s received from the Stamp Office (see para. 5.6(a) above); and
- (b) Cases H6 and H7 should also have been quickly picked out by the IRD computer program which was run quarterly to scan the IRSD26s input into the computerised Property Tax Database (see para. 5.6(b) above).

Audit considers that there is a need for the IRD to investigate the circumstances leading to the late detection of the taxpayers in Cases H1 to H7 with a view to improving the procedures for identifying potential property dealing cases.

5.9 Cases H1 to H5 involved overseas corporations. Audit noted that:

- (a) these overseas corporations had not been registered with the Companies Registry or the IRD's Business Registration Office. They had no registered offices in Hong Kong and did not seem to have a permanent business presence locally; and
- (b) in the sale and purchase agreements, these overseas corporations declared their solicitors as their agents for the purposes of receiving all moneys payable to them pursuant to the agreements (Note 18).

5.10 Under section 20A of the Inland Revenue Ordinance (see paras. 4.2(a) and 4.3 above), a non-resident who has an agent in Hong Kong shall be chargeable to tax either directly or in the name of his agent, and the tax so charged shall be recoverable out of the assets of the non-resident or from the agent. The agent shall withhold a sufficient amount of money from any payments to the non-resident for payment of the tax. **Audit considers that there is a need for the IRD to consider the feasibility of treating, for profits tax cases similar to Cases H1 to H5, the overseas corporations as non-residents. This would enable the IRD to invoke section 20A of the Inland Revenue Ordinance to require the agent of an overseas corporation in Hong Kong to withhold a sufficient amount of money out of the corporation's assets for payment of the tax.**

Profits tax assessments and tax demand notes not timely issued

5.11 Audit noted that, in Cases H8 and H9, there was delay in issuing profits tax assessments and tax demand notes, after receiving the tax returns from the taxpayers. Details are given in Table 10 below. The sequence of events which led to the write-off of profits tax in Cases H8 and H9 is shown in Appendix A.

Note 18: *The declaration by the vendor of his solicitor as his agent in a sale and purchase agreement is one of the covenants and conditions specified in the second schedule of the Conveyancing and Property Ordinance (Cap. 219).*

Table 10

Tax demand notes not timely issued in 2 profits tax write-off cases in 2001-02

Case	Date IRD received tax return	Date IRD issued tax demand note	Number of days taken to issue tax demand note	Amount of profits tax written off (\$ million)
H8	21 July 1995 (Note)	28 April 1999	1,377	2.1
H9	3 September 1996	22 March 1999	930	8.6

Source: IRD's records

Note: In Case H8, the profits tax for 1994-95 to 1996-97 was written off in 2001-02. For simplicity, only the date of receipt of the tax return for 1994-95 is shown in this table.

5.12 The prompt issue of tax demand note for a year of assessment enables taxpayers to plan and make provision for the payment of the tax. In doing so, they should be able to pay the tax even if losses are incurred in subsequent years. It also enables the IRD to take timely recovery actions which cannot be taken until the IRD has issued the tax demand note and the tax has remained unpaid after the due date. **In corporation winding-up cases like Case H9, the IRD's staff handbook specifically requires that assessing officers should issue tax demand notes as early as possible. However, it took nearly four years in Case H8 and nearly three years in Case H9 for the IRD to issue the tax demand notes after receiving the tax returns from the taxpayers. In Audit's view, due to the delay, the IRD was unable to take timely recovery actions.**

5.13 Audit considers that there is a need for the senior management of the IRD to investigate Cases H8 and H9 to ascertain why the profits tax assessments and tax demand notes were not issued as early as possible by the assessing officers. To prevent a similar recurrence, the IRD should take additional control measures to detect any undue delay on the part of assessing officers in issuing profits tax assessments and tax demand notes, especially in cases where the revenue is at risk (e.g. the taxpayer has ceased business).

Instalment payments not honoured by taxpayers

5.14 Audit noted that, in Cases H10 to H12, the taxpayers were in financial difficulties and requested the IRD's approval to pay the profits tax by instalments. In these cases, after ascertaining the taxpayers' financial position, the assessing officers approved the taxpayers to pay tax by instalments. However, the taxpayers did not honour all the instalment payments. Details are given in Table 11 below.

Table 11

**3 profits tax write-off cases
in 2001-02 with payment of tax by instalments**

Case	Amount of profits tax paid by instalments	Amount of profits tax written off
	(\$ million)	(\$ million)
H10	1.7	5.8
H11	0.4	1.6
H12	0.4	0.6

Source: IRD's records

In all the cases in Table 11 above, the IRD initiated recovery actions when the taxpayers failed to make the instalment payments. However, the IRD only recovered \$602 in Case H12, and could not recover any profits tax unpaid in Cases H10 and H11.

Delay in issuing assessments and taking recovery actions in objection cases

5.15 Audit noted that, in Cases H13 to H15, the taxpayers had objected to the IRD's profits tax assessments. **In each case the assessing officer granted a hold over of the profits tax on the condition that the taxpayer bought an equal amount of tax reserve certificates by the specified date to provide security for the payment of the tax.** Details are given in Table 12 below.

Table 12

3 profits tax write-off cases in 2001-02 in which taxpayers raised objections

Case	Date of notice of objection	Date by which tax reserve certificates should be purchased	Amount of profits tax written off
			(\$ million)
H13	27 February 1995	21 March 1995	3.8
H14	21 September 1995	11 October 1995	1.6
H15	16 December 1996	7 January 1997	3.6

Source: IRD's records

5.16 The sequence of events which led to the write-off of profits tax in Cases H13 to H15 is shown in Appendix B. Audit noted that:

- (a) ***Delay in issuing assessments.*** The IRD had not given specific instructions to assessing officers for the issue of assessment for a current year when the taxpayer's objection to the assessment for a prior year had not yet been finalised. In Case H13, the assessing officer did not take action to issue the tax demand notes for 1994-95 to 1996-97 until the assessment for 1993-94, objected to by the taxpayer, had been finalised; and
- (b) ***Delay in taking recovery actions.*** In Case H14, other than the imposition of a 5% surcharge on the tax in default in late November 1995, the IRD did not initiate recovery actions until mid-June 1996, 8 months after the taxpayer failed to purchase tax reserve certificates. In Case H15, the IRD issued recovery notices to the taxpayer's bankers in mid-December 1997, 11 months after the taxpayer failed to purchase tax reserve certificates.

5.17 Audit considers that:

- (a) in Case H13, the assessing officer, instead of waiting for the determination of the assessment for 1993-94 by the Commissioner of Inland Revenue, should have promptly issued the tax demand notes for 1994-95 to 1996-97 to enable early recovery actions to be taken; and
- (b) in Cases H14 and H15, as the taxpayers had failed to purchase tax reserve certificates and therefore did not comply with the condition of granting hold over of tax, recovery actions should have been taken immediately to recover the unpaid tax.

In Audit's view, there is a need for the IRD to promulgate clear procedures to be followed by assessing officers in case of objection by taxpayer to ensure that assessments and tax demand notes are issued promptly.

Charging order on property not timely obtained

5.18 Case H16 involved write-off of profits tax of \$1.2 million unpaid by an individual who had successfully transferred one of his properties to his wife before the IRD obtained a charging order on that property. Details are given in Table 13 below.

Table 13

Chronology of key events which led to the write-off of profits tax in Case H16

	Date	Event
(a)	14 October 1994	The IRD obtained judgement in the District Court to recover the tax debt.
(b)	16 November 1994	The IRD initiated actions, including conducting land searches at the Land Registry and exchanging correspondence with the bank providing mortgage loans to the taxpayer, to gather further information on Property A and Property B for applying to the District Court for a charging order (Note) on both properties.
(c)	20 March 1995	The taxpayer assigned his interest in Property A to his wife at a consideration of \$1.2 million.
(d)	9 September 1996	The IRD requested the D of J to assist in applying to the District Court for a charging order on Property B.
(e)	18 December 1996	The District Court issued a charging order on Property B.
(f)	9 November 2000	The taxpayer's wife and son jointly paid \$500,000 to the IRD as partial settlement of the profits tax due by the taxpayer in exchange for the release of the charging order on Property B.
(g)	4 January 2002	Unpaid profits tax of \$1.2 million was written off as the taxpayer had no other sources of income or assets for tax recovery.

Source: IRD's records

Note: Under section 52A of the District Court Ordinance, the District Court may by order impose a charge on a judgement debtor's property for securing the payment of any money due, or to become due, under a judgement of the Court.

5.19 As at 14 October 1994, according to the IRD's Property Tax Database, Property A was co-owned by the taxpayer and his son, and Property B was co-owned by the taxpayer and his wife. As shown in Table 13 above, the taxpayer was able to assign his interest in Property A to his wife on 20 March 1995 because the IRD had not obtained a charging order on Property A prior to that date. **Had the IRD made application to the District Court immediately after judgement was entered on 14 October 1994, the IRD could have timely obtained a charging order on Property A to recover the unpaid tax. Audit considers that there is a need for the IRD to improve the procedure for making timely application to the District Court to place charging orders on taxpayers' properties.**

Departure prevention directions not timely obtained

5.20 Cases H17 and H18 involved individuals who had left Hong Kong without first paying their profits tax. Case H19 involved an individual who was untraceable. Details of these 3 cases are given in Table 14 below.

Table 14

**3 profits tax write-off cases in 2001-02 where
the taxpayers had left Hong Kong or were untraceable**

Case	Due date for payment of tax	Date taxpayer left Hong Kong	Date IRD obtained departure prevention direction	Amount of profits tax written off (\$ million)
H17	21 March 1994	9 January 1995	14 December 1995	1.6
H18	11 May 1998	12 July 1999	30 June 2000	1.2
H19	23 December 1999	Not applicable (Note)	Not obtained	0.7

Source: IRD's records

Note: In Case H19, the taxpayer had departed from Hong Kong and returned again many times. There was no evidence to indicate that he had taken up residence outside Hong Kong (see para. 5.22 below).

5.21 In Cases H17 and H18, Audit noted that there was delay in obtaining departure prevention directions. The sequence of events which led to the write-off of profits tax in these 2 cases is shown in Appendix C. In Audit's view, if the IRD had obtained timely departure prevention directions, the taxpayers would have been prevented from leaving Hong Kong. **Audit considers that there is a need for the IRD to review Cases H17 and H18 to ascertain if there is**

room for improvement in its procedure to ensure that departure prevention directions are obtained timely in warranted cases (Note 19).

5.22 In Case H19, Audit noted that:

- (a) according to the information obtained by the IRD from the Immigration Department, the taxpayer departed from Hong Kong and returned again 15 times during the period September 1999 to February 2002. The duration of each trip ranged from a few hours to 5 days;
- (b) in early March 2002, the IRD requested the Immigration Department to include the taxpayer in the watch list and inform the IRD when the taxpayer arrived at or departed from Hong Kong; and
- (c) in early May 2002, the Immigration Department informed the IRD that the taxpayer had departed from Hong Kong and returned again on the same day.

According to the IRD, as there was no evidence to indicate that the taxpayer had intention to depart, or had departed from Hong Kong to reside elsewhere, a departure prevention direction could not be obtained (see para. 5.2(d) above). The IRD will commence recovery action if the taxpayer becomes traceable.

Delay in issuing assessments in a bankruptcy case

5.23 The taxpayer in Case H20 was an individual. He was one of the two partners in a partnership. In November 1999, following the institution of bankruptcy proceedings in the High Court by his creditor, the taxpayer was adjudicated bankrupt. The chronology of key events which eventually led to the write-off of the profits tax due by the taxpayer is shown in Table 15 below.

Note 19: *In Chapter 7 of the Director of Audit's Report No. 35 of October 2000, Audit reported that the IRD took a long time to obtain a departure prevention direction in salaries tax write-off cases involving employees recruited from outside of Hong Kong. Audit recommended that the IRD should review the relevant procedure with a view to shortening substantially the time taken to obtain a departure prevention direction from a District Judge. In their Report No. 35 of February 2001, the Public Accounts Committee noted that the IRD had set up an ad hoc committee to examine how best to implement the audit recommendations, including the shortening of the time taken to obtain departure prevention directions.*

Table 15

Chronology of key events which led to the write-off of profits tax in Case H20

	Date	Event
(a)	Late October 1999	The IRD, after reaching agreement with the partnership on the tax treatment of certain items, revised the assessable profits for 1993-94 to 1997-98 of the partnership. Both the taxpayer and his partner elected Personal Assessment (Note).
(b)	17 November 1999	The taxpayer was adjudicated bankrupt.
(c)	7 December 1999	The IRD issued the tax demand note for 1998-99 to the taxpayer.
(d)	10 January 2000	The IRD issued the tax demand notes for 1994-95 and 1995-96 to the taxpayer.
(e)	24 March 2000	The IRD issued the tax demand notes for 1993-94, 1996-97 and 1997-98 to the taxpayer.
(f)	22 May 2000	The IRD submitted to the Official Receiver the proof of the tax debts due from the taxpayer.
(g)	30 August 2001	The Official Receiver advised the IRD that no dividend would be paid as insufficient assets had been realised.
(h)	4 January 2002	Profits tax of \$1.1 million unpaid by the taxpayer was written off.

Source: IRD's records

Note: After the election of Personal Assessment, the partners, instead of the partnership, were chargeable to tax for their share of the assessable profits of the partnership.

The IRD's staff handbook specifically requires that, in bankruptcy cases like Case H20, similar to corporation winding-up cases like Case H9 (see para. 5.12 above), assessing officers should issue all outstanding assessments at once. However, in Case H20 as shown in Table 15 above, the assessing officer did not issue all the tax demand notes until March 2000, 5 months after the election of Personal Assessment by the taxpayer in late October 1999. As mentioned in paragraph 5.13 above, Audit considers that there is a need for the IRD to take additional control measures to detect any undue delay on the part of assessing officers in issuing tax demand notes.

Overall audit observations on the profits tax write-off cases

5.24 As indicated by Audit's sample review of 20 profits tax write-off cases, there were many instances where timely actions had not been taken by the IRD to assess and collect the outstanding tax from the taxpayers. In some cases (i.e. Cases H1 to H9, H13 and H20 — see paras. 5.6 to 5.13, 5.15 to 5.17, and 5.23 above), there was delay in action on the part of the assessing sections. In other cases (i.e. Cases H14 to H18 — see paras. 5.15 to 5.21 above), there was delay in action on the part of the collection sections. **In Audit's view, there is a need for the IRD to review regularly the significant write-off cases with a view to improving the coordination between its assessing and collection sections and rectifying the deficiencies in the existing assessment and collection procedures.**

Audit recommendations on write-off of profits tax

5.25 **Audit has *recommended* that the Commissioner of Inland Revenue should:**

- (a) **review regularly significant profits tax write-off cases with a view to improving the profits tax assessment and collection procedures, and the coordination between the IRD's assessing and collection sections;**
- (b) **review and improve the procedures for identifying promptly potential property dealing cases for profits tax assessment, in the light of the circumstances leading to the late detection of property dealing cases (see para. 5.8 above);**
- (c) **review the profits tax cases involving overseas corporations which have derived assessable profits from property dealing activities in Hong Kong (see para. 5.9 above) to determine the feasibility of invoking section 20A of the Inland Revenue Ordinance to require the overseas corporations' agents in Hong Kong, such as their solicitors, to withhold a sufficient amount of money out of the assets held on their behalf, for payment of profits tax;**
- (d) **take additional control measures to ensure that there is no undue delay on the part of assessing officers in issuing profits tax assessments and tax demand notes, especially in cases where the revenue is at risk (e.g. the taxpayer has ceased business);**
- (e) **provide specific instructions to assessing officers for dealing with profits tax cases where the taxpayers have objected to the IRD's assessments to ensure that:**

- (i) **recovery actions are immediately taken if taxpayers do not comply with the condition for granting hold over of the profits tax under objection; and**
- (ii) **current year's assessments are timely issued even though the taxpayer's objections to assessments issued in prior years may not have been finalised;**
- (f) **improve the procedure for making application to the District Court for charging orders on properties belonging to taxpayers to ensure that such orders are promptly issued after the entry of judgement for unpaid profits tax; and**
- (g) **review the profits tax write-off cases in which there were delays in obtaining the departure prevention directions as identified by Audit (see para. 5.21 above) and improve the relevant IRD procedures to ensure that departure prevention directions are timely obtained in warranted cases.**

Response from the Administration

5.26 The **Commissioner of Inland Revenue** accepts the audit recommendation to review regularly significant profits tax write-off cases with a view to improving the profits tax assessment and collection procedures, and the coordination between the IRD's assessing and collection sections. She has said that:

Review of write-off cases

- (a) the IRD's Collection Enforcement Section has regular contacts with assessing units on large tax arrears cases with a view to seeking information which would assist in collecting the tax outstanding. This arrangement has been strengthened and an inter-unit committee has been formed to enhance coordination among the assessing units and collection office and to facilitate the tax assessment and collection work. The committee will regularly review the write-off cases to identify areas for improvement;

Corporations chargeable to profits tax not timely identified

- (b) the IRD has investigated Cases H1 to H7 in accordance with the audit recommendation mentioned in paragraph 5.25(b) above. The results are as follows:

- (i) **General.** Prior to September 1995, the PSC Section did not screen the relevant IRSD26s related to corporations as it was an established belief that corporations carrying on a property dealing business in Hong Kong would report their profits from such business in the accounts accompanying their tax returns. In September 1995, as part of a global plan to combat property speculation, the IRD designed a computer program whereby parameters were input to identify speculative property transactions. Also, it was found that some property dealing corporations did not maintain an active file reference with the IRD. Hence, since September 1995, the PSC Section began to screen all current IRSD26s for non-residential property transactions conducted by corporations as confirmors with a view to speeding up the assessment process. In 1997 and 1998, the PSC Section also screened transactions completed before the change of practice, especially transactions between July 1993 and August 1995;
- (ii) **Cases H1 and H2.** They were pre-September 1995 cases of which the IRSD26s were not then screened by the PSC Section. They were eventually identified in 1998 and 1997 respectively;
- (iii) **Cases H3 to H5.** The delay in identifying them was caused by the large volume of transactions during 1996 and 1997;
- (iv) **Case H6.** It was picked up only after the computer program was implemented in September 1995; and
- (v) **Case H7.** This case involved a series of transactions. As the addresses shown in the IRSD26s were different from that shown in the records of the Rating and Valuation Department, the officer had to verify the correct one, leading to delay in updating the data in the computer system;

Feasibility of requiring overseas corporations' agents in Hong Kong to withhold money for payment of profits tax

- (c) on the audit recommendation mentioned in paragraph 5.25(c) above, the IRD is prepared to explore the feasibility of invoking section 20A of the Inland Revenue Ordinance where appropriate. Legal advice is being sought from the D of J;

Profits tax assessments and tax demand notes not timely issued

- (d) the IRD's staff handbook has made explicit requirement for assessments to be issued in a

timely manner especially in cases where the revenue is at risk. In accordance with the audit recommendation mentioned in paragraph 5.25(d) above, the IRD will review the relevant procedures with a view to speeding up follow-up actions. The results of the IRD's investigation of Cases H8 and H9 mentioned in paragraph 5.11 above and Case H20 mentioned in paragraph 5.23 above are as follows:

- (i) **Case H8.** The taxpayer claimed from the start that its profits were of an offshore nature and therefore not taxable. The assessing officer needed to obtain further information to ascertain the taxpayer's tax liability. The cessation of the business was reported to the IRD on 12 August 1998. The assessing officer issued the assessments on 28 April 1999 after obtaining the necessary information. There seems to be no undue delay in this case as time was taken by the assessing officer to obtain sufficient information to ascertain the amount of assessable profits of the taxpayer. Furthermore, the taxpayer has a legal responsibility to settle its tax liability despite its business having ceased;
- (ii) **Case H9.** This was a voluntary liquidation case. As the taxpayer was solvent, the risk of tax in default was generally very small. The assessing officer did not raise the assessment early because there was a dispute over the application of section 15C(b) of the Inland Revenue Ordinance. There seems to be no undue delay in the case; and
- (iii) **Case H20.** The delay in the issue of Personal Assessment demand notes was due to the input of incorrect data to the computer which prevented the automatic generation of the demand notes concerned. Manual follow-up action was subsequently taken and hence the delay. This was an isolated case;

Delay in issuing assessments in objection cases

- (e) there cannot be any hard and fast rule concerning the issue of assessment for a current year when the taxpayer's objections to the assessments issued in prior years have not yet been finalised. This is because the circumstances in each case are different. The assessing officers are required to make the best decision according to their professional judgement. Nonetheless, in accordance with the audit recommendation mentioned in paragraph 5.25(e)(ii) above, a new procedure is now in place whereby the assessing officer is required to state clearly the assessment position for all outstanding assessments in a file and the reasons for not assessing up to date when submitting an objection report to the Assistant Commissioner for his approval to refer it to the Appeals Section of the IRD;

Delay in taking recovery actions in objection cases

(f) on the audit recommendation mentioned in paragraph 5.25(e)(i) above, the IRD will continue to review its procedures and instructions for recovering unpaid tax under objection with a view to identifying areas for improvement. Currently, objection cases with outstanding taxes are treated no differently from other default cases. The same recovery actions are taken regardless of whether the assessing officer has previously agreed to allow hold over of tax upon complying with a specified condition. There are instances where it may not be appropriate or possible to commence recovery actions immediately after the tax becomes in default. Among them are cases where the taxpayers are in financial difficulties and have before the due date applied for payment of tax by instalments. The IRD also considers it desirable to forewarn the defaulting taxpayers before initiating some of the more vigorous recovery actions. Furthermore, the IRD often has to gather information about the taxpayers' assets from third parties before it can issue recovery notices. All these actions take time but are essential and effective in securing payment. The results of the IRD's investigation of Cases H14 and H15 mentioned in paragraph 5.16(b) above are as follows:

- (i) **Case H14.** Apart from imposing a 5% surcharge in late 1995, the IRD had also issued a warning letter and had written to third parties for information on the taxpayer's assets. Upon receipt of the reply, the IRD issued a recovery notice to a bank in mid-June 1996; and
- (ii) **Case H15.** The IRD wrote to a third party for information on the taxpayer's bankers in March 1997. By the time the reply from the third party was received, the writ of summons had already been issued. The taxpayer filed a defence on ground of violating the provisions of the Hong Kong Bill of Rights Ordinance (Cap. 383) and lodged a counterclaim against the IRD. Because of the controversial nature of the claims, it was then considered appropriate to withhold the issue of recovery notice pending the settlement of the litigation;

Charging order on property not timely obtained

(g) on the audit recommendation mentioned in paragraph 5.25(f) above, the IRD will review the existing procedures for making application to the District Court for charging orders on properties belonging to taxpayers with a view to speeding up the process. Before making such an application, the IRD has to assess whether it is cost-effective to do so especially when the property is mortgaged. The IRD will normally seek a valuation of the properties involved and raise enquiries to ascertain the amount of outstanding mortgage. Since the process could take some time, other recovery action is taken simultaneously. In Case H16 mentioned in paragraph 5.18 above, while the IRD was in

the process of obtaining information from various parties to assess the cost-effectiveness of applying for charging orders on the taxpayer's properties, the taxpayer transferred his interest in one of his properties to a member of his family. Other recovery action was however taken concurrently, resulting in the recovery of \$12,953 from a bank; and

Departure prevention directions not timely obtained

(h) the IRD accepts the audit recommendation mentioned in paragraph 5.25(g) above. It will continue to improve its procedures to ensure that departure prevention directions are timely obtained in warranted cases. Depending on the circumstances of each case, preventing a taxpayer from departing from Hong Kong may not be appropriate, nor is it necessarily an effective or efficient way to recover the outstanding tax. Where the taxpayer is in extreme financial difficulties, applying for a departure prevention direction against him may not facilitate tax recovery. The results of the IRD's investigation of Cases H17 and H18 mentioned in paragraph 5.21 above are as follows:

- (i) **Case H17.** The IRD's Collection Enforcement Section was informed in early 1994 that the taxpayer had left Hong Kong in late 1992. The taxpayer had since been actively negotiating for the settlement of his objection and had applied for payment of the outstanding tax by instalments. He paid 4 instalments during the period June 1994 to October 1994. At that time, it was not considered appropriate or necessary to apply for a departure prevention direction. After the taxpayer stopped making payments, the IRD commenced recovery actions. They included sending reminders and warning letters to the taxpayer and initiating proceedings in the District Court. The IRD obtained a departure prevention direction against the taxpayer in December 1995; and
- (ii) **Case H18.** The taxpayer was in great financial difficulties and had applied for payment of the outstanding tax by instalments. He failed however to forward any concrete proposal afterwards. The IRD issued recovery notices to his bankers. A departure prevention direction was subsequently obtained against the taxpayer.

5.27 The **Secretary for Financial Services and the Treasury** welcomes the audit recommendations. He has said that he will review the follow-up actions together with the IRD with a view to improving the services to the public.

Sequence of events which led to write-offs of profits tax in Cases H8 and H9

Case H8

- (a) On 21 July 1995, the IRD received the taxpayer's (a local corporation) tax return for 1994-95. In the return the taxpayer treated all profits as offshore income not subject to profits tax;
- (b) On 26 March 1996, the assessing officer raised queries about the taxpayer's business. Follow-up queries were issued on various dates thereafter;
- (c) **On 31 December 1997, the taxpayer ceased business;**
- (d) On 28 April 1999, the assessing officer issued profits tax assessments and tax demand notes to the taxpayer in which all profits were treated as onshore income subject to profits tax; and
- (e) The taxpayer did not pay the tax and was untraceable. All the recovery actions taken by the IRD were in vain.

Case H9

- (a) On 18 July 1996, the taxpayer went into voluntary liquidation. Its balance sheet as at 17 July 1996 showed that it had total assets of \$88 million and net assets of \$21 million before provision for profits tax. Its assets mainly comprised listed investments with a market value of \$144 million but shown at a cost of \$86 million in the balance sheet;
- (b) On 3 September 1996, the IRD received the taxpayer's tax return for 1996-97;
- (c) On 26 September 1996, the assessing officer raised queries about the disposition of the listed investments. Follow-up queries were issued on various dates thereafter;

- (d) On 22 March 1999, the assessing officer, in accordance with section 15C(b) of the Inland Revenue Ordinance (Note), deemed the taxpayer to have disposed of its listed investments on 17 July 1996 in the open market with a profit of \$58 million and issued a tax demand note to charge the taxpayer a profits tax of \$8.8 million; and

- (e) **The taxpayer was unable to pay the tax as the value of its listed investments had then dropped substantially.** The IRD instituted winding-up proceedings in the High Court against the taxpayer. Eventually, the IRD recovered an amount of \$0.2 million and wrote off the irrecoverable amount of \$8.6 million.

Source: IRD's records

Note: Section 15C(b) of the Inland Revenue Ordinance states that, where a person ceases to carry on a trade or business, the trading stock at the date of cessation, if it is not sold to a person carrying on a trade or business in Hong Kong, shall be valued for profits tax assessment purposes at the amount it would have realised if it had been sold in the open market at the date of cessation.

Sequence of events which led to write-offs of profits tax in Cases H13 to H15

Case H13

- (a) The IRD did not take any recovery actions as the taxpayer, even though it failed to purchase tax reserve certificates by 21 March 1995, fully paid the tax for 1993-94 (the assessment under objection) in 3 instalments by 26 May 1995;
- (b) On 30 January 1996, the IRD received the taxpayer's tax return for 1994-95. **The assessing officer remarked on the return that the assessment for 1994-95 was not to be issued until the taxpayer's objection to the assessment for 1993-94 had been determined;**
- (c) The IRD received the taxpayer's tax returns for 1995-96 and 1996-97 on 12 November 1996 and 14 October 1997 respectively;
- (d) On 30 June 1998, the Commissioner of Inland Revenue confirmed the assessment for 1993-94;
- (e) In late August 1998, the assessing officer issued tax demand notes to charge the profits tax for 1994-95 to 1996-97, totalling \$2.4 million. The taxpayer did not pay the tax and was untraceable; and
- (f) The IRD then initiated various recovery actions but recovered only \$1,098 from the taxpayer's bankers. The IRD did not initiate winding-up proceedings as the taxpayer had left no assets for tax recovery.

Case H14

- (a) In late November 1995, the IRD imposed a 5% surcharge on the tax in default. **The IRD did not initiate other recovery actions until mid-June 1996, 8 months after the taxpayer failed to purchase tax reserve certificates.** Only \$4,484 was recovered from the taxpayer's bankers;

- (b) On 7 October 1997, the Commissioner of Inland Revenue confirmed the assessment objected to by the taxpayer;
- (c) In December 1997, in response to the request made in November 1997 by the taxpayer, the IRD approved an instalment plan for the payment of the tax. However, the taxpayer failed to honour the plan after paying the first instalment of \$142,000; and
- (d) The IRD then initiated winding-up proceedings but eventually could not recover any of the unpaid tax.

Case H15

- (a) In April 1997, the IRD initiated recovery proceedings in the District Court, 3 months after the taxpayer failed to purchase tax reserve certificates;
- (b) On 19 August 1997, the Commissioner of Inland Revenue confirmed the assessment objected to by the taxpayer;
- (c) **On 10 December 1997, 11 months after the taxpayer failed to purchase tax reserve certificates, the IRD issued recovery notices to the taxpayer's bankers and recovered \$24,504; and**
- (d) In March 2000, the IRD instituted winding-up proceedings but eventually could not recover any of the unpaid tax.

Source: IRD's records

Sequence of events which led to write-offs of profits tax in Cases H17 and H18

Case H17

- (a) The taxpayer emigrated to another country in 1992;
- (b) After conducting an investigation, in January 1994 the IRD raised additional assessments to charge the taxpayer a back tax for the period 1987-88 to 1991-92;
- (c) **On 27 January 1994, at the instruction of an Assistant Commissioner of Inland Revenue, the assessing officer requested the Collection Enforcement Section of the IRD to consider obtaining a departure prevention direction;**
- (d) The taxpayer called at the IRD's office three times in May 1994, July 1994 and November 1994 to discuss the tax affairs with the assessing officer;
- (e) In late June 1994, the IRD approved an instalment plan for the payment of the tax. The taxpayer made 4 instalment payments during the period June 1994 to October 1994;
- (f) According to the information obtained by the IRD from the Immigration Department, the taxpayer left Hong Kong on 9 January 1995 and did not return to Hong Kong again;
- (g) On 14 December 1995, the IRD obtained a departure prevention direction against the taxpayer; and
- (h) In March 2002, profits tax of \$1.6 million unpaid by the taxpayer was written off.

Case H18

- (a) The taxpayer ceased his business in 1995;

- (b) In March 1998, the IRD completed a field audit and raised additional assessments to charge the taxpayer a back tax for the period 1991-92 to 1994-95;
- (c) **On 23 December 1998, an IRD field audit officer advised the Collection Enforcement Section that the taxpayer had left Hong Kong on 15 August 1998 and requested the Section to consider taking necessary action;**
- (d) According to the information obtained by the IRD from the Immigration Department, the taxpayer returned to Hong Kong and left again 31 times during the period 23 January 1999 to 12 July 1999;
- (e) On 30 June 2000, the IRD obtained a departure prevention direction against the taxpayer;
and
- (f) In January 2002, profits tax of \$1.2 million unpaid by the taxpayer was written off.

Source: IRD's records

Appendix D

Acronyms and abbreviations

AFAL	Assess First Audit Later
D of J	Department of Justice
EPD	Environmental Protection Department
IRD	Inland Revenue Department
LCSD	Leisure and Cultural Services Department
ORAMCO	Operations Review and Monitoring Committee
PSC	Property Dealing/Share Dealing/Consignment