

ANNUAL MEETING BETWEEN THE INLAND REVENUE DEPARTMENT AND THE HONG KONG SOCIETY OF ACCOUNTANTS – 2003

Preamble

As part of the Society's regular dialogue with the Government to facilitate tax compliance, improve procedural arrangements and to clarify areas of interpretation, representatives of the Society met the Commissioner of Inland Revenue ("CIR"), and members of her staff in January 2003.

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

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Full Minutes

The 2002-2003 annual meeting between the Hong Kong Society of Accountants' Taxation Committee and the Commissioner of Inland Revenue was held on Friday 17 January 2003 at the Inland Revenue Department.

IN ATTENDANCE

Hong Kong Society of Accountants (the Society)

Mr Tim Lui	Chairman, Taxation Committee
Mr Paul Chan	Deputy Chairman, Taxation Committee
Ms Yvonne Law	Deputy Chairman, Taxation Committee
Ms Deborah Annells	Member, Taxation Committee
Ms Florence Chan	Member, Taxation Committee
Mr David Southwood	Member, Taxation Committee
Mr Peter Tisman	Deputy Director (Business & Practice)
Mr John Tang	Assistant Director (Business & Practice)

Inland Revenue Department (IRD)

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

Mrs Alice Lau (CIR) welcomed the Society's representatives, in particular its two new members, and introduced the IRD officers in attendance. She reiterated her support for the annual meeting as a useful forum of communication on practical issues affecting both the Society's members and IRD. The meeting then proceeded to discussion of the agenda items put forward by both sides.

PART A - MATTERS RAISED BY THE SOCIETY

Agenda Item A1 – Issue of guidance

A1(a) Issue of guidance on transfer pricing

The Society referred to the question of guidance on transfer pricing it raised in the 2002 annual meeting (“2002 Meeting”). In the meeting, IRD referred the Society to sections 20, 21A, 61 and 61A of the Inland Revenue Ordinance (IRO) and to the brief reference to transfer pricing in the Departmental Interpretation & Practice Notes (DIPN) No.11A “Elements of Field Audit”. CIR suggested that the matter would be given serious thought in due course.

The Society would like to find out if there had been any new developments over the year and in particular whether there were more cases in dispute in relation to issues of transfer pricing.

CIR replied that there had not been any significant increase in the number of transfer pricing cases over the past year. As such, the IRD stance remained that there was no imminent need to provide more information on transfer pricing, in addition to those already available in DIPN 11A, DIPN 15 and DIPN 22.

A1(b) Publication of Advance Rulings

The Society noted that after the publication of the first set of four advance ruling cases on the IRD website on 28 February 2002, there had been no further advance ruling cases published. The Society suggested that as in the case of the Board of Review decisions, which were made known on an ongoing basis, more advance ruling cases should in principle be published so as to help taxpayers to understand the likely tax treatment of different business and personal transactions.

The Society should like to know whether there was a particular reason for the absence of recent cases on the website and to seek confirmation of IRD’s policy as regards publication.

CIR confirmed that IRD aimed to publish advance ruling cases on a periodic basis. The problem was with the number of suitable cases. She said the present practice was that advance rulings of general interest would be selected for publication on IRD website. Over the year, the situation remained that not many cases were worth publication. Most cases were either related to special categories of businesses or unique in nature. It was expected that another four cases would be uploaded to IRD website in February 2003.

CIR added that 2001 was the first year IRD published advance ruling cases. 4 cases were published. The English version was uploaded to the IRD website on 27.11.2001 and the Chinese version was uploaded on 17.1.2002. IRD was to review cases for publication on a more regular basis and would try to increase transparency.

A1(c) Change of Practice by IRD

The Society suggested that IRD should make taxpayers aware of any significant changes in IRD practices, prior to their implementation, including the way in which Departmental Interpretation and Practice Notes (DIPNs) were interpreted or applied by IRD. In this connection, the Society had in the past (most recently in the 2001 annual meeting) raised the issue of publication of the Assessors' Manual, which was the practice in some other jurisdictions. CIR had previously indicated that there was no objection to doing this in principle.

The Society believed that publication of the Assessors' Manual would help to improve transparency and consistency in approach and should like to ask whether there was any time-frame for implementing this project and, if not, whether CIR was prepared to commit to the project and to providing a timetable.

CIR noted the same issue had been discussed in the 2001 and 2002 annual meetings. However, there had not been any development since the last annual meeting. She explained that the Assessor Manual and DIPNs were written for different purposes. The former contained internal training materials and instructions, which might be of section 4 nature. Its contents were geared to suit internal needs, which were different from the needs of practitioners and taxpayers. As such, the Assessor's Manual in its present format was not suitable for publication. Having said that, CIR assured the Society that IRD was also moving towards the direction of improving transparency and consistency in approach. To serve both purposes, practices affecting tax practitioners and taxpayers had already been incorporated in DIPNs and publications such as advance ruling cases, frequently asked Q&A, penalty policy statement and press releases. All such publications were readily accessible via the IRD website.

Agenda Item A2 - Tax filing deadlines

A2(a) Compound Offer issued after Block Extension has been granted

The Society pointed out that concern had been raised by a member firm that IRD had issued compound offer letters in a number of cases to its clients on 28 November 2002 although the tax representative had applied for an extension for filing the "M" Code loss cases on 31 October 2002. The file number references were disclosed to IRD and were mostly category 22 cases (i.e. profits tax cases of the review section).

The Society requested clarification on the approach that was normally adopted by IRD with respect to applications for an extension in such cases.

Mr So referred the Meeting to the Block Extension Letter in which it was stated that "M" code loss cases filing date could be extended to 31 January, upon application received on or before 31 October. Such a policy had been followed strictly without variation. The cases mentioned by the Society were purely due to clerical errors. This probably could be attributed to the large number of loss extension cases received - around 8,000 and mostly lodged in the last few days of October. Mr So confirmed that there was no change in policy and suggested that this kind of human error could be avoided if the extension request was lodged by electronic application since the

application would be processed automatically. Mr So explained to the Meeting that electronic application was a simple process and urged the Society to encourage its members to make use of this channel. Details of such a service were provided in the Block Extension Letter. There were currently about 500 registered users.

A2(b) Submission of profits tax return for newly incorporated companies

In the 2002 Meeting, the Society raised the point that profits tax returns were sometimes being issued to some newly incorporated companies for the year of commencement of business. The Society suggested that consideration be given to allowing sufficient time for submission of tax returns in such cases, especially where two years of assessment were covered by the accounting basis period. IRD referred to the Companies Ordinance requirement that a company's first annual general meeting (AGM) should be held within 18 months after its corporation (s.111(1) of Companies Ordinance) and its profit and loss account and balance sheet made up to a date not earlier than 9 months before the date of the AGM should be laid at that AGM (s.122). Nevertheless, the Society was informed that applications for extension would be considered on the merits of the case.

The Society would like to have some further information regarding the circumstances in which extensions might be granted. There were situations for example in which companies were bought "off the shelf" close to the 18-month deadline for holding the first AGM or where, although the company might have been incorporated some time before, it had remained dormant for most of the first 18 months. In these situations the Society asked whether it would be normal for an extension of the filing deadline for the profits tax return to be granted.

Mr So replied that the rationale for IRD sending a tax return 18 months after the date of incorporation of a company had been fully explained in the 2002 Meeting [Agenda Item A2(c) of 2002 minutes]. The directors of a company had the duty to comply with the requirements of the Companies Ordinance. The legal obligation to hold the first AGM and prepare the first set of accounts could not be ignored simply because the company had not commenced business or there was a change in shareholders.

As regards the two situations mentioned by the Society, Mr So commented that they were not valid reasons for granting extension. He advised tax representatives not to use such reasons to apply for extension, as they would be turned down. Having said that, IRD did recognize there were other exceptional circumstances which warranted an extension. As an example, an extension had been granted in a case where the directors passed away in an accident. Another example was a case where a newly acquired computer accounting system had been damaged by virus. In any event, each case would be decided on its own merits.

A2(c) Inactive clients with IRD file reference bearing a prefix number of '22'

The Society pointed out that currently, taxpayers were sometimes advised by an IRD notice that profits tax returns would not be issued for the time being unless the company re-commenced trading or started to make profits chargeable to tax. However,

there was no fixed timetable for the subsequent issue of a BIR51 to these taxpayers after issue of the first notice. In addition, there was no certain and consistent time interval between these two IRD correspondences upon which taxpayers could rely as there had been situations where a BIR51 was issued to inactive companies just a few months after the 'No Return' notice had been issued, while, on the other hand, some inactive companies had not received any profits tax return for more than 3 years. Most of these inactive businesses were small family companies and they relied very much on the advice of their tax representatives. They might be disadvantaged in the kind of situations mentioned above where profits tax returns were issued to them at odd times (i.e. any date other than April 1) particularly if the returns were mislaid or lost on delivery. Their tax representatives were not in a position to advise these clients promptly in order to clear up any misunderstandings if they were not aware that a BIR51 had been issued to their clients.

The Society suggested that tax representatives should also be informed by IRD at the time of issue of any tax return where this was at a non-standard time for the issuing returns, or that a copy of such tax returns should be sent to the tax representative at the same time as they were issued to the taxpayer. As a minimum, the Society asked that the circumstances under which BIR51s might be issued at an "non-standard times" to inactive companies and the specific times at which they might be issued, should be clearly stated and made known to taxpayers and tax representatives (e.g. after the lapse of 3 years following the issue of a "No return" notice).

Mr Tam clarified that files bearing a prefix number of "22" were "review files" for inactive cases. Normally these were companies which were dormant or had no assessable profits for several years. When the files were changed to be "review files", a standard notice (Form No. 1812) was issued stating, among other things, that the company should not wait for the issue a tax return to prepare annual audited accounts and a return might be issued to the company from time to time. In the majority of cases, tax returns were issued 3 to 4 years after the standard notice was issued. There were however "odd-issue" of returns when, for example, there was information showing that the company was about to liquidate or it had potential tax liability.

In reply to the Society's first request, Mr Tam said that IRD would not consider issuing a duplicate tax return to the tax representative due to the costs involved. More importantly, there was a risk of breaching section 4 of the IRO because the company might have changed its tax representative without notifying IRD.

Mr Tam said IRD considered that the practical problem might be alleviated to a certain extent if the company remembered to notify IRD of its change of business and/or correspondence address. As such, IRD proposed that the standard notice (Form No. 1812) be amended by adding a note to remind the company that a change of address should be notified immediately. CIR added that this would be a right move towards solving the problem raised by the Society.

A2(d) Clients with 'N' code returns having no officers/directors in Hong Kong

The Society pointed out that companies with 'N' code returns normally had their accounts audited before receipt of the related tax form. No extension was granted by IRD to the April 30 deadline for these companies to submit their tax returns. The time

allowed to submit the 'N' code return could become very tight when the company involved had no officers or directors in Hong Kong. Such companies would be penalised if the tax form could not be signed and returned to Hong Kong within 2 weeks (i.e. after allowing for the time required for delivery of tax form to the tax representative, the preparation work, as well as the mailing time to and from the overseas officers or directors). In addition, there might also be situations where directors could not be located within these two weeks or where they were out of town or on business trips. However, applications for extensions had been declined by the IRD even under the above circumstances.

The Society suggested that consideration be given to

(i) issuing profits tax returns in advance to these clients, i.e. before April 1, so that they could be sent to overseas directors for their signature at the same time as the audited accounts. (The Society noted that tax forms were normally issued by IRD in advance to companies which had ceased business during the fiscal year); or

(ii) granting an extension to the deadline for submission of returns to such companies if their audited accounts and tax computations had been submitted to IRD anytime before April, 1; or

(iii) allowing a two-month submission period for companies having overseas directors only (similar to the arrangement and time allowed for completion of Form BIR54 for non-resident persons).

Mr So noted that the audited reports and accounts of "N" code companies were normally completed before 1 April. Tax representatives could also arrange to complete the tax computations and schedules before that date.

According to section 57(1) of the IRO, the secretary, manager or any director of a corporation shall be answerable for doing all such acts, matters, or things as are required to be done under the IRO. Section 57(2) further provides that if no secretary, manager or director is ordinarily resident in Hong Kong, the corporation shall keep CIR informed at all times, of the name and address of an individual ordinarily resident in Hong Kong who shall be so answerable. In other words, the IRO requires that at all times there should be an individual in Hong Kong for complying with the requirements of the IRO.

For these reasons, the absence of directors from Hong Kong was not considered a valid reason for not submitting the tax return within time. Mr So further pointed out that the declaration section of the tax return clearly showed that the return could be signed by the secretary or manager of the company i.e. not necessarily by a director.

For information, Mr So told the Meeting that the lodgement performance in "N" code cases for 1999/2000 to 2001/02 actually showed a pattern of steady improvement. IRD therefore considered that there are no solid grounds for changing the present arrangement for "N" code cases.

Agenda Item A3 - Improving the level of certainty – profit cases

A3(a) “Assess First Audit Later” programme

The Society noted that the “Assess First Audit Later (AFAL)” programme represented a significant change of practice within IRD in relation to the raising of assessments. However, this change of practice had not been accompanied by any legislative changes. At present Section 59(1) IRO states:

“Every person who is in the opinion of an assessor chargeable with tax under this Ordinance shall be assessed by him as soon as it may be after the expiration of the time limited by the notice requiring him to furnish a return under Section 51(1).”

Section 59(1) requires the assessor to exercise his opinion as to whether a taxpayer is chargeable to tax and then to assess that taxpayer accordingly. The Society could not find any reference in the IRO which would facilitate the implementation of the AFAL, where the assessor simply raised an assessment based on the tax return issued and returned without undertaking any review and exercising his or her opinion as the chargeability to tax of the taxpayer.

The Society considered that section 59 required an assessment to be made after the assessor had exercised his judgement and opinion in this matter not before such judgement had been exercised.

- (1) The Society therefore requested clarification as to the legislative authority for the implementation of the AFAL programme.*
- (2) It was also interested to hear the IRD’s evaluation of how successful the implementation of the AFAL programme had been so far.*

In respect of the first question, CIR said legal opinion had been sought by IRD and it was confirmed that the authority could be found in section 59(2)(a) of the IRO which provided that where a person had furnished a return under section 51, the assessor may “accept the return and make an assessment accordingly”. The crucial question was therefore whether the assessor accepted the return.

CIR further explained that under the AFAL programme, not all returns were accepted. IRD had gone through the process in deciding which returns were to be accepted. This was done by setting certain selection criteria into the programme. These criteria might be changed from time to time. Returns accepted by the programme were assessed accordingly. In short, IRD considered that section 59(2)(a) already provided the legislative authority for the AFAL programme.

As to the second question, CIR said that so far the AFAL programme had been working well. As expected, assessments had been issued earlier than in previous years. This was more prominent for salaries tax cases than for profits tax cases. More than half of the salaries tax assessments had been made in the first few months of the assessment season. The “Audit Later” aspect also functioned as planned. Currently there were two approaches used in the audit programme, i.e. random sampling and a risk assessment approach. IRD would continue to monitor the programme carefully.

A3(b) Re-opening of prior years' assessments by IRD as a result of a change in opinion

The Society said that a member firm had come across a case in which its client's offshore claims on its trading profits for the years of assessment from 1993/94 to 1995/96 had been agreed by IRD. The said original assessments were issued without any note indicating that they were subject to review or queries. However, as a result of a change in the assessor dealing with the case, the offshore status was subsequently withdrawn.

The Society noted that the CIR had previously indicated that only in exceptional circumstances would additional assessments be made as a result of a change in opinion.

In the case referred to, although the tax representative repeatedly requested the IRD to disclose the exceptional circumstances, no explanation was forthcoming. Nevertheless, the assessor, having cleared the matter with the Assistant Commissioner of the Profits Tax Unit, insisted on issuing additional assessments on the ground that exceptional circumstances existed in this case.

Ultimately, the case was settled by taxpayer withdrawing the offshore claims for subsequent years, in return for IRD annulling the additional assessments for 1993/94 to 1995/96.

The Society asked IRD to re-clarify its stance on the re-opening of prior years' tax assessments as a result of a change in opinion, and whether it was IRD's policy and practice to provide some details of the exceptional circumstances giving rise to such a decision.

Mr Tam confirmed that IRD's policy on re-opening back-year assessments remained the same. This had already been explained in the 2001 Meeting [Item A8 of the 2001 minutes]. Whether exceptional circumstances existed had to be decided on a case-by-case basis. IRD had the duty to protect public revenue. Past assessments were therefore subject to review. To reduce the chances for such readjustments, Mr Tam said that it was obviously necessary for both the assessing officers to raise correct assessments and the taxpayers to make proper disclosures of controversial items in the first instance. In most cases, back-year assessments were re-opened on the basis of additional information coming into light, subsequent to the Assessor's enquiry. This was the reason for the existence of section 60. The taxpayer equally had the right to re-open back-year assessments under section 70A, subject to the same time limit of six years.

As regards the particular case mentioned by the Society, Mr So said it had a long history of offshore claims starting from the 1980s. It was the practice of IRD to review offshore claims periodically. In the most recent review, the Assessor considered that the previous acceptance of the offshore claims clearly could not stand as a matter of law. Having followed the internal procedural for approval, the Assessor raised back-year additional assessments up to the time-barred year. In an interview with the tax representatives, the Assistant Commissioner has explained the reason for re-opening the assessments. The objection was subsequently settled after further information and explanation were provided by the taxpayer.

Mr So stressed that re-opening of an assessment due to change of opinion by an Assessor would need his endorsement. CIR added that such cases were rare as in most cases they were re-opened due to new information or facts. Mr Tisman asked in cases of a change of opinion, whether it was IRD's position that the opinion had to have been wrong at the time it was made or wrong in the light of current practice. Mr So replied that a change of opinion situation could arise due to an important fact not having been taken into account, a mis-interpretation of law or based on the then available information, no reasonable person would have arrived at the opinion. Mr Southwood followed up and asked whether the introduction of AFAL would lead to more of such re-opened cases. CIR replied that for desk audit cases the Assessor would normally be asked for further information first. Further, CIR told the Meeting that where based on the same information, the original opinion was an equally acceptable opinion, IRD would not disturb the original assessment i.e. the *Edwards v. Bairstow* principle applied.

A3(c) Form BIR 51 Profits Tax Return - Corporations

The Society referred to a question it raised at the 2002 Meeting concerning box 5.3 on Form BIR 51, and IRD's response that a BVI-company whose directors were resident in Hong Kong and whose central management and control were in Hong Kong should not be regarded as a non-resident company. The Society noted that this answer was now provided on the FAQ (frequently asked questions) on the IRD website. However, in practice, it might be that the taxpayer would know that the company concerned was overseas incorporated but might not know where the central management and control were located and the company might not wish to disclose this information. Under the circumstances, it seemed that the taxpayer would sometimes have no option but to treat such a company as non-resident for the purposes of the question on BIR 51.

The Society asked for confirmation from CIR that this was the correct approach to adopt or for IRD to indicate what alternative action the taxpayer could take.

CIR pointed out that the taxpayer had a duty but was not required to spend a lot of effort in ascertaining the place where the central management and control of the company was located. If, to the best of his knowledge, the taxpayer considered that the company was not centrally managed and controlled in Hong Kong, he should treat the company as non-resident in Hong Kong.

Agenda Item A4 - Improving the level of certainty - loss cases

A4 Tax loss for companies exempted from annual filing

In the 2002 Meeting, the Society suggested that, to assist companies in ascertaining their financial position for accounting purposes, IRD should consider confirming the amount of any loss carried forward when exempting a company from filing its annual profits tax return. CIR replied that the standard practice was to agree the loss before exempting a company from filing returns, i.e. before transferring the files to the review section. In some exceptional cases, however, where the assessor and the tax

representative could not agree on the loss after lengthy discussion and where it appeared that the business was unlikely to have profits in the near future, the cases would also be transferred to the review section.

The Society asked, in a situation where e.g. a company suffered eight consecutive years of losses, followed by a profit in the ninth year, whether the first three years of losses would still be able to be offset against the profits or whether they would be treated as being time barred.

CIR replied that the first three years of losses were not time-barred. These losses, if agreed, could be used to set off against the profits of the ninth year. Section 60 governed assessments and loss statements were not assessments, as decided in the Board of Review case *D5/88 3 IRBRD 144*.

Agenda Item A5 - Improving the level of certainty - other areas

A5 Companies in members' voluntary liquidation

The Society said a member had suggested that a different approach seemed to be adopted by different case officers in relation to the submission of audited accounts in certain situations when the profits tax return was filed. It appeared for example that some case officers did not insist on companies in insolvent liquidation submitting audited accounts in support of their profits tax returns. However, this approach might not necessarily be applied to members' voluntary liquidation cases.

- (1) Against the background of the statement made by the then CIR in the 1998 Meeting (Item A14 of the 1998 minutes – AG v Chino Industries), that it was not necessary for audited accounts to be submitted in liquidation cases, the Society requested clarification as to whether or not this was IRD's current policy and whether it was applicable to all companies in liquidation, including companies in members' voluntary liquidation, creditors' voluntary liquidation and court-ordered liquidation.*
- (2) Furthermore the Society also requested clarification as to the IRD's policy with respect to the following:
 - (i) the granting of extensions for submitting profits tax returns during the course of liquidation, or*
 - (ii) when fixing the deadline for payment of tax assessments (there are cases in which the deadline may be just few days after issuance of the tax assessment).**
- (3) The Society's member also expressed concern about cases where, during the course of negotiations with the case officer in the profits tax section, the taxpayer concerned received an estimated assessment from another section of the IRD. The Society therefore would also like to know the IRD's practice in this regard.*

CIR clarified that, in liquidation cases of all types, IRD's policy was not to insist on the submission of audited accounts provided that the accounts were signed by a responsible person (e.g. the liquidator). However, if the accounts were actually audited, the audited accounts should be submitted. The block extension scheme was not applicable to corporations in liquidation. This was clearly stated in paragraph 24 of the Block Extension Letter issued by IRD.

As for the granting of extension to submit profits tax returns, CIR said that such request would be considered on its merits. Normally the request would be rejected because, in order to protect public revenue, IRD had to ascertain the potential tax liability as early as possible.

On the due date for tax payment, CIR stressed that it would be set as early as possible in liquidation cases in order to protect public revenue. Where the last day for filing a proof of debt was only a few days ahead, the tax due date could be set at that date. However, such cases were rare.

As regards the issue of estimated assessments, CIR said that the file of a corporation (whether in liquidation or not) was normally handled by one case officer only at any point in time. Without details of the cases mentioned, IRD was unable to comment further.

Agenda Item A6 - Penalty Notifications

A6(a) Late payment of tax

The Society noted that it had been the IRD's practice to forward a copy of a notice of assessment to the tax representatives. It suggested that, similarly, where a 5% penalty had been imposed on a taxpayer in cases of late payment, a notice be issued to the tax representative. Such a notice would help tax representatives to give more timely advice to their clients.

CIR responded by saying that unlike tax assessments, which the taxpayers might wish tax representatives to assist in resolving technical issues, penalty notices purely related to the payment position of the tax bills and financial position of the taxpayers. The taxpayers would go to their representatives for advice if considered necessary. Considering the additional administrative costs involved to implement the suggestion and given the fiscal stringency these days, IRD could not accede to the request.

A6(b) Late payment of business registration fee

Similarly, the Society suggested that it would be useful if the Business Registration Office (BRO) could issue to tax representatives a similar notice of the penalty for late payment of business registration fee (currently HK\$300). Under the current system, if the taxpayers had omitted to attend to the penalty notice, or did not receive it at all, the BRO would refer the case to the prosecution unit at some stage and a summons would be issued to clients. This could be the cause of some distress. For example, in the case of a sole proprietorship, the sole proprietor would have to attend the proceedings in person unless he was legally represented. Where the sole proprietor

could not attend the proceedings due to sickness or for other reasons, he would need to arrange legal representation. However, engaging legal representation could impose an undue financial burden on a small-sized proprietorship and was probably not justified in view of the fact that such cases tend to be relatively simple. A CPA was not considered by the BRO as a valid representative.

CIR replied that BR fee was a regular annual charge for ongoing businesses and it involved no technicality. Payment or non-payment of BR fee was purely a financial matter of the business owners and as mentioned earlier, it was more appropriate for the business owners to inform their representatives if they so wished.

However, the tax representatives could help their clients meeting their BR obligations by reminding them of the need to promptly report changes in business address and to renew their BR certificates at regular intervals. CIR said that the issue of demand notes for business registration fees followed a more or less fixed pattern on a yearly basis. For instance, where a business' current business registration certificate expired in, say, March, a notice of renewal and demand note for the following year would be issued in the preceding month, i.e. February, and the due date for payment would be issued in the following month, i.e. April. If the fee was not settled by the due date, BRO would issue a penalty notice.

Agenda Item A7 - Penalty policy

A7(a) Policy for imposing penalties in cases of late filing of returns

The Society said it wished to seek clarification of the IRD's current policy in respect of the imposing of penalties under s82A in cases of late filing of tax returns. It appeared to the Society that, in the past, where a taxpayer had a good track record of timely filing of tax returns, IRD had not sought to impose penalties under s82A on the first occasion that the taxpayer failed to file a tax return within the required filing period, unless there were particular or aggravated circumstances in the case. Instead the taxpayer received a notification and/or a compound penalty.

However it appeared to the Society that in recent years there had been an increasing trend for the CIR to seek to impose penalties under s82A on the first occasion that the taxpayer had failed to file within the extended filing deadlines. Whilst acknowledging that late filing of tax returns caused additional administrative work to the IRD, the Society believed that, where a taxpayer had failed to file its tax return for the first time in a significant number of years, unnecessary additional work for both the IRD and the taxpayer would result if the process of imposing penalties under s82A was initiated by the IRD. The Society therefore wished to clarify the current position regarding the imposition of penalties under s82A with IRO in respect of such late filing and, in particular, the position where a taxpayer had filed late for the first time in say six years.

CIR referred the Society to the revised penalty policy statement of IRD uploaded to the IRD website in December 2002. So far as "first offence" cases were concerned, there was in fact no change of policy. In other words, when a taxpayer filed a late return on the first occasion, section 82A penalty might be imposed. Tax

representatives should not assume that in such cases only compound penalty would be imposed.

A7(b) Penalty on anti-avoidance (section 61A) cases

The Society observed that the IRD's practice appeared to be to impose additional tax penalty under s82A of the IRO for s61A cases even though the taxpayer could provide evidence that the transactions were not artificial or fictitious. Section 61A cases were real transactions, and usually did not involve any fraud or understatement of income. It was very often a matter of opinion as to whether the sole or dominant purpose of the transactions involved was to obtain a tax benefit. Moreover, under the common law, a taxpayer was free to arrange his or her affairs with a view to minimising his or her tax liability. Accordingly, the Society did not see why, in a case where a transaction was disallowed for tax purposes under s61A, an additional penalty should be imposed on the taxpayer as well.

The Society asked CIR to comment on this issue.

Mr. Chan of IRD replied that the Society was right in saying that a taxpayer was free to arrange his affairs with a view to minimizing his tax liability. However, the dividing line between tax avoidance and tax evasion was a very thin one. Legal advice obtained by IRD from the Department of Justice indicated that section 61/61A and section 80/82/82A were not mutually exclusive. As such, the penalty provisions under the IRO could apply even if a taxpayer was caught by section 61/61A. It was necessary to determine whether a tax avoidance scheme was a sham set up for the purposes of tax evasion.

Mr. Chan went on to say that there was no single factor which could lead to such a conclusion. In general, transactions that were artificial or fictitious were likely liable to penalty. With respect to section 61A cases, the IRD's view was that schemes which were not properly structured, not adequately supported by evidence and not genuinely effected or implemented would, in substance, amount to tax evasion. The fact that individual transactions executed as part of an arrangement were real did not mean that the overall arrangement was either real or legal.

Mr. Chan said in any event, CIR or the Deputy Commissioner would consider a taxpayer's written representations before raising additional tax assessments under section 82A. The taxpayer had a right to appeal to the Board of Review. As such, a taxpayer right was protected.

CIR added that the choice of penal action would be carefully made upon consideration of a number of factors such as whether the taxpayer was a first or habitual offender, nature of the offence etc.. Sometimes if a taxpayer could show a reasonable excuse, there would be no penalty. The penalty demand notes would indicate in what categories, with reference to the IRD's penalty policy statement, penalties were imposed and taxpayers could always dispute their classification. Besides, she appealed to the Society for reminding its members of the importance of sending in timely and thorough representations. The Court and Board of Review placed considerable emphasis on a taxpayer's representations.

Mr. Southwood followed up by saying that IRD's reply seemed to focus on tax evasion cases rather than tax avoidance ones which were being addressed. Mr Tam replied that the penal action being addressed was section 82A, not section 82.

Therefore the question should be whether the taxpayer could show a reasonable excuse.

Agenda Item A8 - Field Audit and Investigation

A8(a) Combined 50:50 apportionment claims

The Society noted that taxpayers were facing increasing difficulties/confusion with respect to the combined 50:50 apportionment claims. “Combined 50:50 apportionment” referred to having the profits/losses of a PRC company being added to the profits/losses of a Hong Kong company, and 50% of the combined profits, after certain tax adjustments, being assessed as the Hong Kong sourced profits of the Hong Kong company. Specifically, this had been IRD’s practice for settling a number of field audit cases.

Typically, the PRC company was a wholly- owned subsidiary or a joint venture company owned by the Hong Kong company. Effectively, the PRC company was treated as a contract manufacturer of the Hong Kong company. As such, the Society found it difficult to discern IRD’s assessing practice in view of the different cases experienced, e.g:

- (i) For a case without prior history of field audit settlement under the combined 50:50 apportionment.*

Additional assessments initially disapproving the combined 50:50 apportionment for 1997/98 to 1999/2000 had subsequently been cancelled after enquiries. This indicated that the IRD had accepted the combined 50:50 apportionment up to 1999/2000. However, enquiries on the basis of the combined 50:50 apportionment claims were continuing to be made for years of assessment 2000/01 and 2001/02.

- (ii) For cases with prior history of field audit settlement under the combined 50:50 apportionment.*

Another type of situation was where the combined 50:50 apportionment claim had been adopted by the IRD in the settlement of a field audit/tax investigation exercise. But IRD now disapproved such combined apportionment claim in the subsequent years of assessment.

During subsequent meetings with senior IRD officers, it was indicated that the tax filing position based on the combined accounts of the Hong Kong company and its PRC company would no longer be accepted by IRD. In addition, the IRD would even consider imposing a penalty on these cases.

The Society requested IRD to clarify its stance on the combined 50:50 apportionment claims.

Mr. So said the starting point was that the Hong Kong company and the PRC company were two separate companies. Their accounts should not be combined for tax purposes. It had been the IRD policy to follow the practice outlined in DIPN 21. According to paragraph 17 of DIPN 21, apportionment did not arise if the manufacturing in the Mainland had been contracted to a sub-contractor, whether a

related party or not, and paid for on an arm's length basis with minimal involvement of the Hong Kong business.

However, Mr So said taxpayers under field audit were often unable to provide records or evidence to demonstrate the pricing arrangements between the Hong Kong business and the Mainland processing unit. On the other hand, IRD audit often revealed that sums purportedly to have been paid over to the Mainland enterprise as processing fees or purchases had never been paid. In the circumstance, settlement on a "global" basis, i.e. combined 50:50 apportionment, was adopted to quantify the omitted profits by compromise. Such settlement basis was made on the grounds of practicability and expediency, in order to save the time and costs of both taxpayers and IRD in field audit enquiries. The settlement was however not binding on the taxpayer or IRD for subsequent years. Taxpayers were expected to follow DIPN 21 in preparing the tax returns for the post-audit years.

Mr. So supplemented that IRD discovered some taxpayers used the "global" basis for preparing returns which were not the subject of field audit. In an interview with the relevant tax representative in November 2002, the IRD's position was clearly explained. The Hong Kong companies were requested to prepare tax computations again using the normal basis. Objections to the assessments in these cases were expected and the matter would be resolved through the normal and appeal channel. To sum up, Mr So said the 50:50 apportionment only applied to field audit years.

A8(b) Penalty policy in field audit and investigation cases

The Society referred to the existing penalty policy where field audit / anti-avoidance cases closed within 3 months and investigation cases closed within 6 months from the initial interview could be classified as falling under the category of "Disclosure with Full information promptly on challenge" for the determination of penalty loading. However, in May 1996 the CIR decided that there should not be any disparity between the Field Audit Group and the Investigation Unit [now merged as Field Audit and Investigation Unit], both in the method of quantification of understatement of earning and profits and penalty policy [Reference: Para. 10.28 in Audit Commission Report dated 3 October 1997].

The Society believed that a greater degree of flexibility would need to be allowed given that delays might caused by factors beyond the taxpayer's control, which could include the assessor's response time which may not always be quick due to IRD's workload; the need to respond to complex queries raised by IRD that may be more hypothetical than based on in actual circumstances; or changes of the taxpayer's personnel or the need to obtain information from third parties.

Under the circumstances, the Society suggested that the three-month time condition in relation closing field audit cases / anti-avoidance cases within should be adjusted in line with the six months period allowed for investigation for the following reasons, amongst others:

- (i) The time for settlement could not always be taken as an accurate yardstick to measure the responsiveness, co-operativeness and sincerity etc., of a taxpayer, particularly when no reference to the complexity of individual cases was made. A period of three months might be too short and insufficient for taxpayers where e.g. information was required to be obtained from banks, in relation to which it was difficult for the taxpayer to set any effective deadline and the time*

taken was therefore to a large extent out of the taxpayer's control.

- (ii) *In the event of a long leave of absence or transfers of handling officers, the extra time that was allowed on a discretionary basis was often a matter of individual judgment and could cause hardship to taxpayers.*

Mr. Chan of IRD replied that in normal circumstance, field audit involved detailed examination of one year's records whereas back duty investigation involved the review of six years' affairs. Flexibility is allowed in field audit cases. Paragraph 22 of DIPN 11A (Elements of Field Audit) suggested that it might not be necessary for the tax representative to prepare revised accounts in every case. Mr Chan suggested that the representative should discuss the approach with the field auditor. He opined that an effective and efficient approach would be for the taxpayer to provide **all** necessary information and records to enable the field auditor to quantify the understatement, using either direct or indirect methods, and to settle the findings with the taxpayer and the tax representative. Penalty under "Disclosure with Full Information Promptly on Challenge" would still be applicable if this was achieved in three months.

As regards the 3-month period, Mr Chan said it was counted from the start of the audit, usually the date of the initial interview, to the date of submission of the disclosure. If a taxpayer submitted a settlement proposal in three months and the Assessor accepted the proposal eventually, say in the 5th month because he was on leave in the 4th month, the taxpayer would still be regarded as having made a disclosure within three months and be categorised as "Disclosure with Full Information Promptly on Challenge" for penalty purpose. In other words, long leave of absence or transfer of handling officers in general would not have impact on the counting of the 3-month period.

On the disparity between field audit and investigation cases, Mr Chan pointed out that given the extent of work involved, IRD considered it reasonable to set different time schedules for making disclosure in field audit and investigation cases.

Mr. Lui commented it was always debatable when was the cut-off time, despite IRD's clarification of how the 3-month period was counted. For instance, a taxpayer might submit a settlement proposal subsequent to the initial interview with IRD officers. The officer went on leave and upon return requested for further information from the taxpayer after the expiration of 3 months. Mr Lui said in the circumstance, the IRD officer taking leave would have an impact on the 3-month period.

CIR replied that urgent mails would be handled by other IRD officers rather than being left on the desk of the officer on leave. She said that if a dispute arose about the deadline, the absence of particular case officer could always be included as a further point in any representations. Mr Chan added that if the further enquiry did not end up in material adjustments, the 3-month period would still be counted till the date of taxpayer's first settlement proposal.

A8(c) Settlement of field audit and investigation cases by the adoption of gross profit rate method

The Society said concern had been raised that field auditors often used a single gross profit rate for making reassessments without having due regard to the commercial reality, business cycle and the stage of business development of individual taxpayers. The severe impact of the economic downturn in recent years did not seem to have been taken adequately into account in the context of the general audit targets as a whole. There might also be reasons why it would be inappropriate to apply an industry-based gross profit margin rate to particular taxpayers in that industry. In addition, it might not be equitable to apply a single uniform rate to all years of assessment and it was not clear that taxpayers were aware that this was what would be done if they expressed no objection to a particular rate.

The Society would therefore like to seek clarification as to the principles and the justification behind the approach of imposing a uniform, industry-based, gross profit margin rate on all years in dispute in the context of field audit and investigation cases.

Mr. Chan of IRD explained that a projection using gross profit rate was an indirect method to quantify the omitted profits. Indirect methods were only meant to estimate a taxpayer's profits. On the question of legal authority, Mr Chan referred to a court case in 1962 [*Mok Tsze Fung v. CIR, HKTC 166*]. It was held in that case that an assessor was entitled to raise an additional assessment if there was evidence indicating that a taxpayer had not disclosed all his profits and that the law allowed the assessor to "estimate" the profits for tax purposes. Gross profit rate method was widely used in the UK and was known as the "Business Economics" method. As an indirect method, gross profits rate did not provide a precise or exact result, but there was no question about its validity. As a matter of fact, there was no indirect method which would produce a 100% correct result.

Mr. Chan further informed the Society that IRD had computed industry-based gross profit margin rates for individual industries from previous audit results. These rates were used for reference only and would not be indiscriminately applied to any case under audit. If IRD adopted the gross profits rate method, the rate was usually worked out from the taxpayer's records. IRD accepted that there were ups and downs as a result of the general economic situation and therefore seldom applied a single uniform rate to all years of assessment. Mr Lui asked if the IRD would consider submissions from taxpayers. Mr Chan replied that it was always open to the taxpayer to make representations in the course of negotiation. CIR indicated that adjustments were sometimes made on the basis of a taxpayer's representations. A business might for example have lost a major customer one year. Adjustments could however go in either direction.

Furthermore, Mr Chan said it had been IRD's practice to explain the basis of all calculations to the taxpayer, including the basis of projection if gross profit rate method was adopted. IRD could not stress more that taxpayers were protected by the objection right under the IRO. Mr Lui expressed that it was usually difficult for tax practitioner to explain to taxpayer in the event that a single gross profit margin rate was applied by IRD. Mr Chan replied that it was rare that a single rate was unilaterally used by IRD.

Agenda Item A9 – Place of residence provided by employer

The Society referred to the decision in [CIR v Peter Leslie Page HCIA 2/2002], and sought clarification as to whether CIR envisaged any changes in practice by IRD in relation to the provision of housing benefits by employers to their employees.

Mr Chu replied that insofar as is relevant, the Recorder in the Page case has pointed out that-

- (a) The clear wordings in section 9(1A) should not be qualified by the additional requirement that the employer must have a particular kind of system to control over the relevant payment in deciding that it was a rent refund.
- (b) However, it would generally be of great assistance to the taxpayer intending to claim certain payment as a rent refund to be able to show that his/her employer did have some sort of system of control over the payment.
- (c) The real test was the nature of the payment itself. The intention of the employer and the employee at the time of the payment had to be ascertained.

In short Mr Chu confirmed that there was no change in practice. CIR said that these three points were consistent with IRD's present practice.

In line with the Page judgment, Mr Chu said it had been the IRD's view that in ascertaining the real nature of a payment, IRD considered that the employer's control over the relevant payment was an important, but not necessarily conclusive factor. Hence, there was no need to change any IRD practice in consequence of the Page judgment.

Agenda Item A10 – Time-apportionment claims

The Society said it had often been unclear as to whether a taxpayer's employment could be considered offshore in nature such that only the portion of income attributable to his services rendered in Hong Kong was taxable for Hong Kong salaries tax purposes ("time-apportionment claim"). DIPN No.10 attempted to clarify the uncertainty of the scope of charge under section 8(1) and section 8(1A)(a) of the IRO. According to DIPN No.10, a taxpayer would normally be considered to have an offshore employment and be eligible for time-apportionment claim where the following three factors are present:

- (a) *the contract of employment was negotiated and entered into, and was enforceable outside Hong Kong;*
- (b) *the employer was resident outside Hong Kong; and*
- (c) *the employee's remuneration was paid to him outside Hong Kong.*

The Society commented it would appear from the above that the CIR was of the view that the three tests identified in DIPN No.10 should be used in the majority of cases and it was only in problematic cases that additional factors would be considered.

The Society was of the view that DIPN No.10 recognised this as it also quoted from the decision in the Geopfert case as follows:

'There could be no doubt therefore that in deciding the crucial issue the Commissioner may need to look further than the external or superficial features of the employment. Opinions may be deceptive. He may need to examine other factors that point the real locus or the source of income of the employment.'

Although the Society took the IRD's approach in DIPN No.10 to mean that the three tests would generally be used to determine offshore employment, in practice the Society believed that the position had become far from certain for taxpayers. In this respect there were two separate areas of concern.

Firstly, in the Board of Review case D87/00 Board members were of the opinion that DIPN No.10 "was inaccurate and misleading to taxpayers and assessors alike. It did not properly reflect the law". It further stated that DIPN No.10 "has only served to add to the difficulty" in determining the locality of employment of a taxpayer (paragraph 53 of the above case).

On this point the Society said it did not necessarily agree with the Board in D87/00 as it considered that the existence of DIPN No.10 actually provided clear guidance and a straightforward and practical approach to resolving the question of Hong Kong source employment in the majority of cases, as had been demonstrated by the dramatic reduction in Board of Review cases on this topic since the issue of DIPN No.10.

- (1) The Society therefore sought CIR's confirmation that DIPN No.10 would remain in force as a means of settling the majority of cases in this area.*
- (2) The second problem, however, was one of application of DIPN No.10 by assessors. As set out above, the Society's view was that DIPN No.10 suggested the three tests listed above would be regarded as the key indicators and it would only be in exceptional cases, or cases where the position was not clear, that the IRD would look at the so-called "totality of facts". However there was an increasing trend by assessors to resort to a totality of facts test rather than the three tests and to rely upon a bundle of information which the assessor called the "totality of facts" but which included items that were unrelated to or bore very little relevance to the source of employment. The Society quoted the following actual examples to illustrate the some of the reasons for uncertainty:*

"(i) Mr. A was an employee of X Group and was previously employed by X-Singapore during his Singapore assignment. He was subsequently seconded to Hong Kong and later transferred to another offshore entity of X Group, due to his regional roles. He fulfilled the three criteria of DIPN No.10. However, the IRD disallowed his time-apportionment claim on the grounds that he had been participating in X-Hong Kong's retirement scheme and X-Hong Kong's personnel had indicated that he was "employed" by X-Hong Kong (which was in fact merely the sponsoring entity of Mr A) in the work visa extension application. Thus the IRD argued that in substance Mr A was under a Hong Kong employment."

"(ii) Mr. B was an employee of Y Group and was seconded from the U.S. to Hong Kong. His case also satisfied the three criteria under DIPN No.10. However, his time-apportionment claim was denied on the ground that the IRD considered that his employer, a Cayman Island entity acting as a global employment vehicle, was a Hong Kong company because most of its

employees were based in Hong Kong (although its Board of Directors resided outside Hong Kong and the company's administrative function was conducted outside Hong Kong). Most of the employees of this company were based in Hong Kong merely because Hong Kong was the regional headquarters of Y Group, but all the employees concerned had regional responsibilities and offshore employment. They had been transferred to the global employment vehicle merely for administrative reasons."

"(iii) In various other cases the assessors had variously sought to show that an employee had a Hong Kong source employment because,

- (a) the employee observed public holidays in Hong Kong rather than the public holidays in his home jurisdiction whilst on secondment to Hong Kong;*
- (b) that the employee did not take a holiday moving from one company in an international group to another (notwithstanding that there was also a change of duties and terms);*
- (c) that the employee remained within the same international group of companies and retained his seniority in the group notwithstanding that the employee was relocated to a new company in the group.*

Items (b) and (c), for example, were claimed to be evidence of continuity of employment."

In view of the grounds for uncertainty in the application of DIPN No.10, outlined above, the Society requested clarification on the extent to which the IRD was relying on the three factors specified in the DIPN vis-à-vis other factors, in determining the time-apportionment claims. Given the clarity that had in principle been provided by DIPN No.10 since the Geopfert case, the Society did not advocate any significant amendment to DIPN No.10 but requested some clarification regarding circumstances in which other factors would be considered.

- (3) More generally, the Society asked how CIR intended to respond to the Board of Review's comments regarding DIPN No.10 in Case No.87/00.*

CIR responded by saying that this issue could be clarified as follows:

Legal Position

Section 8(1) of the Inland Revenue Ordinance imposes salaries tax on employment income "arising in or derived from Hong Kong". For employment income not "arising in or derived from Hong Kong", section 8(1A)(a) extends the charge of salaries tax to income "derived from services rendered in Hong Kong". In practical terms, time-apportionment claims could only be accepted in the extended-charge cases under section 8(1A)(a).

Employment commonly refers to a master-servant relationship. In [*CIR v. George Andrew Geopfert 2 HKTC 210*], Macdougall, J. enunciated that the legal test in ascertaining whether certain employment income arises in or is derived from Hong Kong is "to look for the place where the income really comes to the employee, that is to say, where the source of income, the employment, is located." In other words, it is necessary to ascertain the location of the master-servant relationship in question. This is a finding of fact; and it is trite to say that the "totality of facts" test as approved by

Macdougall, J. in the Geopfert case is binding authority in deciding whether certain employment income should be charged to salaries tax under section 8(1) or alternatively under section 8(1A)(a) [by accepting time-apportionment claims].

Departmental Interpretation and Practice Notes No. 10

In fact-finding processes, it is incorrect, or even impossible, to rely on an exhaustive list of factors in arriving at the proper conclusion. In paragraph 3 of DIPN No. 10, IRD has clearly stated that the application of the 3-factor test is “subject to the qualification at paragraph 6”, which reads-

“It is expected that in the greater majority of cases the question of Hong Kong or non-Hong Kong employment would be resolved by considering only the three factors mentioned above. However, IRD must reserve the right, in appropriate cases, to look beyond those factors. The situations in which further factors would have to be examined cannot be laid down with precision.”

Hence, assessors in appropriate cases are bound by their duties to request for information beyond the 3 factors in order to decide whether time-apportionment claims could be accepted.

Confirmation that DIPN No. 10 remains in force

IRD had no intention to alter the present status of DIPN No. 10 on applying the 3-factor test with a view to resolving the greater majority of cases on the question of Hong Kong or non-Hong Kong employment. Assessors would continue the practice of requesting for relevant information beyond the 3 factors only in cases in which the application of the 3 factors alone was considered inappropriate.

Comments on the Society’s three quoted examples

IRD did not see fit to comment on specific cases in the annual meetings.

Circumstances in which factors other than the three factors specified in DIPN 10 would be considered

IRD expected that in the greater majority of cases the question of Hong Kong or non-Hong Kong employment would be resolved by considering only the three factors mentioned above. However, IRD must reserve the right, in appropriate cases, to look beyond those factors.

Board of Review’s comments regarding DIPN 10 in Case No.87/00

CIR said that DIPN No. 10 did not offer any legal views that contradicted those established in the Geopfert case. It clearly stated that the IRD was ready to look beyond the 3 factors in appropriate cases. Notwithstanding the comments made in Case No. 87/00, the IRD considered that it was proper to retain DIPN No. 10 as a guidance note on the administration of salaries tax.

Mr Lui asked if it was possible for IRD to provide data on the respective numbers of cases applying the three factors and the “totality of facts” test. He said that practitioners had the impression that the number of the latter cases was growing. Mr Southwood concurred and said that this seemed to be the case for the last 15 months. CIR replied that IRD did not collect such statistics but the general feeling she and Mr Tam got from approving determinations was there had not been a significant growth in the number of cases applying “totality of facts”.

To sum up, Mr Lui said the main concern of the Society was the growing number of cases which satisfied the three tests but was turned down due to consideration of other factors by IRD. CIR reiterated that the experience of IRD was such cases were not many and could be due to settlement of old cases. In any event, CIR promised that IRD would look into this issue and, where possible, remind assessors to follow DIPN10.

Agenda Item A11 – Lodgement of tax returns

The Society indicated that, as in previous Annual Meetings, it would be happy to discuss with the CIR the latest lodgment figures.

Mr So provided the following lodgement statistics for 2001/02 corporation and partnership returns. Mr So commented that there was a slight improvement in “N” and “M” code cases. IRD appreciated the effort made by taxpayers and tax representatives, and hoped it would be a continuous trend. To be more specific, the lodgement performance of both ‘N’ and ‘M’ code accounts showed improvement of 6% and 7% respectively. For the performance of ‘D’ code accounts, the comparison might not be too meaningful as the lodgement date had been advanced from 30 August to 15 August in 2002.

A. Lodgement Comparison from 1999/2000 to 2001/02

	<u>Y/A</u> <u>1999/2000</u>	<u>Y/A</u> <u>2000/01</u>	<u>Y/A</u> <u>2001/02</u>	Comparison 2000/01 and <u>2001/02</u>
1. Bulk issue (on 1 April)	144,000	145,000	149,000	+3%
2. Cases with a failure to file by due date: -				
'N' Code	2,000	1,800	1,700	-6%
'D' Code	4,500	4,000	4,400	+10%
'M' Code	<u>8,600</u>	<u>8,700</u>	<u>8,100</u>	-7%
	15,100	14,500	14,200	-2%
3. Compound offers issued	7,200	7,000	7,200	+3%
4. Estimated assessments issued	3,900	3,700	3,500	-5%

B. 2001/02 Details Profits Tax Returns Statistics

	<u>'N'</u>	<u>'D'</u>	<u>'M'</u>	<u>Total</u>
Total returns issued	18,000	45,000	104,000	167,000
Failure to file on time	1,700	4,400	8,100	14,200
Compound offers issued	800	2,500	3,900	7,200
Estimated assessments issued	500	1,100	1,900	3,500

C. Represented Profits Tax Returns – Lodgement Patterns

<u>Code</u>	<u>Lodgement Standard</u>	<u>Actual Performance</u>	
		<u>2001/02 PTRs</u>	<u>2000/01 PTRs</u>
D - 15 August	100%	81% ⁽¹⁾	-
D - 31 August	100%	-	85%
M - 31 August	25%	14%	14%
M - 30 September	55%	21%	20%
M - 31 October	80%	41%	40%
M - 15 November	100%	84% ⁽²⁾	83%

⁽¹⁾ 35% lodged within a few days around 15 August 2002 (23% lodged within a few days around 31 August 2001 for 2000/01 PTRs)

⁽²⁾ 33% lodged within the period 1-15 November 2002 (35% for 2000/01 PTRs)

D. Tax Representatives with Lodgement Rate of less than 84% of 'M' code Returns as at 15.11.2002

1,541 T/Rs have 'M' Code clients. Of these, 681 firms were below the average performance rate of 84%. An analysis of the firms, based on size, is: -

	No. of clients per firm	<u>Last Year Performance</u>				<u>Current Year Performance</u>			
		Total No. of firms	No. of firms below the average of 84%	No. of non-compliance Cases	% of total non-compliance Cases	Total No. of firms	No. of firms below the average of 83%	No. of non-compliance Cases	% of total non-compliance Cases
Small size firms	100 or less	1,391	637	4,087	73%	1,290	607	4,285	73%
Medium size firms	101 - 300	135	42	1,380	25%	140	41	1,395	24%
Large size firms	Over 300	15	2	102	2%	16	3	156	3%
		<u>1,541</u>	<u>681</u>	<u>5,569</u>	<u>100%</u>	<u>1,446</u>	<u>651</u>	<u>5,836</u>	<u>100%</u>

Agenda Item A12 - Legislative changes

A12(a) Inland Revenue (Amendment) Bill 2000

The Society asked about the current position of the above Bill.

Mr Tam replied that following the drawing up of a preliminary draft of CSAs to the Bill, a second round of consultation was started in July 2002 to invite comments from the interested parties on the provisions under the draft CSAs.

At the end of October 2002, a total of 10 deputations were received, including one from the Society. An analysis of the comments made by the deputations had been submitted by IRD to the Financial Services and Treasury Bureau on 12 November 2002 for consideration. It was understood that the law draftsman was working on the refinement of the amendment bill. The CIR indicated that the IRD would give an official response to each of the deputations.

A12(b) Inland Revenue (Amendment) (No.2) Bill 2001

The Society enquired as to the timetable for the implementation of the above Bill.

CIR said the purpose of the Inland Revenue (Amendment) (No. 2) Bill 2001 was to provide a legal basis for the use of password/PIN for authentication and fulfillment of signature requirement for filing of Tax Return for Individuals and Property Tax Returns through the Government's ESD Scheme and the telephone (Telefiling).

The Bill was introduced into the Legislative Council (LegCo) on 21 November 2001 and discussed at the LegCo Panel for Financial Affairs on 7 January 2002. A Bills Committee was formed on 18 January 2002 and held its first meeting on 22 July 2002.

The Bills Committee had proceeded with the clause-by-clause examination of the Bill in its 5th meeting held on 3 January 2003. IRD representatives had also recently attended a meeting with the IT representatives who were seeking greater security in the system. However IRD's position was that PINs were widely used in tax filing and banking outside of Hong Kong, although the department was not claiming that the use of PINs was as secure as the use of digital signatures. It was a question of finding a balance between providing a reasonable level of security and facilitating electronic tax filing. In the meeting, the Administration tried its best to address their concerns and answer all their queries with a view to winning their support. Subject to enactment of the Bill by the LegCo, IRD aims to implement these new electronic filing services in April 2003.

Agenda Item A13 – Double tax agreements and exchange of information articles

In the 2002 Annual Meeting, the CIR had said that the Government was actively pursuing the policy of exploring opportunities of concluding double taxation agreements. The IRD had also consulted tax professional bodies, including the Society, and chambers of commerce, on the “Exchange of Information” article in a Comprehensive Double Taxation Agreement. The Society had expressed some reservations on the liberalisation of the information exchange provisions.

The Society wished to know the current position with respect to this subject.

CIR replied that apart from consulting professional bodies, the Administration had also embarked on consultation with chambers of commerce. The Administration consulted 23 bodies in total and 15 of them responded in writing.

There was a general view that since Hong Kong adopts a territorial source of profits concept, had limited withholding mechanism for direct tax and was in a relatively low-tax environment, the primary incentive for other tax jurisdiction to negotiate a DTA with Hong Kong would be to have access to tax information from Hong Kong. Many chambers/associations were of the view that Hong Kong should resist requests from other jurisdictions to enter into a stand-alone agreement on exchange of information, as Hong Kong would not derive any benefit therefrom. This was also the IRD’s stance.

As regards the questions on whether Hong Kong should relax the exchange of information so as to facilitate conclusion of DTAs, CIR said that there were diverse views. IRD had summarized all the opinions and invited views from the International Business Committee [which is chaired by the Chief Secretary with representatives from chambers of commerce as members] on the way forward in October 2002. The Committee recognized the international trend of negotiation and concluding DTAs and opined that Hong Kong should step up its efforts in entering into DTAs. To achieve the goal of successful conclusion of DTAs, Hong Kong could be more flexible with exchange of information with other tax jurisdictions. Many members of the Committee were prepared to accept exchange of information article in the 1995 OECD Model Convention. The Administration proposed as a first step in liberalizing the exchange of information provisions adopting the version suggested by the negotiating partner during the first round of negotiation in March 2001 which was close to the 1995 OECD model convention. This proposal was endorsed by the Committee.

Mr Tam supplemented that there was a separate issue concerning juridical assistance under Basic Law 96 and it would need the approval of the Central Government before negotiation could proceed.

Agenda Item A14 – Position on self-assessment

In the Annual Meeting 2002, CIR had said that the Government had no concrete plan to implement a “self-assessment” system to replace the “official assessment” system. The Society enquired whether there had been any further developments on the issue of self-assessment and the IRD’s current thinking on this.

CIR replied that IRD had no plan to implement a self-assessment system in the medium-term. The existing official assessment system would not be changed for the next few years.

Agenda Item A15 – Submission of communication by e-mail

Currently, taxpayers could be required to submit to the IRD certain material in writing from time to time. Transmission by fax was generally acceptable for the submission of some written materials where an original signature was not required.

The Society was interested to know firstly whether there had been any further extension of the communications that IRD would accept by fax and, secondly, in view of the initiatives on the part of the IRD with respect to the delivery of services by electronic means, what was the view of the IRD in relation to accepting a range of other communications with taxpayers and tax representatives by email.

Mr Luk replied that IRD's current policy was that incoming mails through fax transmission was generally acceptable except for certain specified documents such as tax returns. The list of exception cases had been reviewed and no change was deemed necessary. Details of these exceptions could be obtained from the IRD homepage. IRD was prepared to consider any suggested changes.

Regarding electronic communication, Mr Luk said IRD in fact was providing two services: (a) Electronic Submission of Information and (b) E-forms. Both services were explained in detail in the IRD website. IRD welcomes communications via e-mail on the basis that those involving the personal information of taxpayers were signed by means of a digital certificate, which fulfilled the signature requirement as provided under the Electronic Transactions Ordinance.

Agenda Item A16 – Inspection of incoming mail by IRD mail attendants

Currently all incoming mail and packages delivered to the reception counter at Revenue Tower were open by IRD mail attendants and their contents carefully checked against the presenters' copies of the correspondences for the purpose of acknowledgment of receipt. However, there could be long queues of people waiting at the reception counter and the processing time for the hand delivery of mail to IRD could become unduly long. Moreover, once the envelopes were opened prior to reaching the assessors, there was a greater risk of documents going missing or being mislaid (especially the loose-leaf supporting papers).

If part of the intention of inspecting the contents of incoming mail at the reception counter was to ensure that all the documents stated in the covering letter had been submitted, the purpose would not be achieved unless the inspection carried out included reading the letter at the same time and understanding what had been enclosed with the letter. The Society wished to confirm what the position would be if a taxpayer claimed to have submitted all the relevant documents to the reception counter but subsequently an assessor found that the documents received were incomplete?

Further, the Society asked whether the stamping of an acknowledgement of receipt at the reception counter served as conclusive evidence that the documents submitted were in order. If not, clarification was sought as to the significance of a receipt issued at the reception counter and, given the long delays that sometimes occurred, referred to above, the Society questioned if there were grounds for reviewing the procedures for hand delivery of mail to IRD, including the most appropriate level of staff to man the counter.

Mr Luk commented that there were different ways of sending mail to the IRD. It could be by post, by dropping in the mail box on the G/F of the Revenue Tower, or by fax to the officer if this was acceptable. Unless specifically required by the officer, there was no need for the taxpayers or their representatives to deliver the mail physically to IRD.

The “Receipt and Dispatch Centre” was established in response to public demand. It was intended that the IRD chop only served as evidence of receipt of an item of mail without confirming the content of the documents received. It was definitely not conclusive evidence that the documents submitted were in order. As such, taxpayer or their representatives should not expect the IRD staff manning the “Receipt and Dispatch Centre” to inspect the incoming mail and check the nature of each item enclosed.

As to the hypothetical situation described in paragraph 2, Mr Luk said it could not be ruled out that sometimes loss of document in transit might occur, having regard to the volume of incoming mail received by IRD. However they should be very isolated cases, given the stringent measures adopted by IRD for internal transfer of mail. In the unfortunate event that it did happen, Mr Luk suggested that it was best for the taxpayer to send in the documents or copies of documents not received by the assessor.

Mr Luk said IRD had reviewed the mail-receipting pattern and was satisfied that its “Receipt and Dispatch Centre” was sufficiently staffed for most of the time of the year. Long queues might be seen at the deadlines for filing M code profits tax cases, D code cases, Employer’s returns, CTR returns and property tax returns. They could simply be avoided if taxpayers and their representatives helped by sending in their mail through other means or handing them in before the deadlines. In this connection, IRD would appreciate it if the Society could appeal to their practicing members to send in their clients’ returns early and make good use of the drop-in box on the G/F. The CIR indicated that the IRD would try to enlarge the drop-in box and to issue acknowledgements by the next day.

Finally, Mr Luk would like to advise the Society that owing to re-allocation of office and re-arrangement of priority, the space presently occupied by the “Receipt and Dispatch Centre” on G/F would be returned to the Government Property Agency. The office would be closed with effect from 1 April 2003. However the same service would continue to be provided at specified counters on the 1/F if an IRD chop was really needed.

Agenda Item A17 – Announcement to members of urgent and relevant matters prior to finalisation of the minutes

The Society indicated that members of the Society generally, and particularly members in business (rather than public practice) might not be aware of the matters discussed at the Annual Meeting and changes being effected until the time the minutes had been finalised and published. Given the exchanges that tend to take place between the Society and IRD, this process could take some time. As a general rule, the Society had not issued information separately to members after the meeting, prior to finalisation of the minutes.

However, given the importance of making members aware of any significant changes in a timely manner, and given that some issues might be more time-sensitive than others, the Society sought CIR's agreement to its announcing to members of the Society, in advance of publication of the minutes, certain of the more urgent and relevant matters discussed at the Annual Meetings.

CIR said that IRD had no objection to the suggestion by the Society, subject to IRD's prior agreement on those "urgent and relevant matters" to be announced.

PART B – MATTERS RAISED BY IRD

Agenda Item B1 – Discrepancies detected by field audit

Same as in the past years, CIR presented a table at the Appendix to demonstrate the specific problem areas detected in the tax audit of corporations between 1 January 2002 to 31 December 2002. The format of the table has been modified to show comparative figures for 3 years. CIR said this year IRD had not prepared a Table 2 as in previous years, because it had not found any specific cases with apparent discrepancies detectable through statutory audits.

Mr Chan of IRD commented that out of the 155 completed cases, 129 carried clean audit reports. The total discrepancies uncovered in clean audit report cases accounted for 88% of the total discrepancies detected in corporation cases completed during the year. This represented an increase of 24% over the percentage for the previous year (71%). Mr Tisman replied that the Society had issued a circular to its members on the issue raised in 2002 meeting as well as publishing the minutes of the Annual Meeting. Reference had also been made to it in the Society's "TechWatch" publication. CIR commented that continuous effort would be needed. Mr. So explained that around one third of the discrepancies involved expenses over-claimed. Mr. Lui noted that the total tax involved, i.e. around \$40 million, was not that high. He also noted that the figure of 129 discrepancies did not necessarily represent 129 separate cases, as one field audit could involve various individual discrepancies. CIR indicated that IRD would in future try to provide more information about the discrepancies.

Agenda Item B2 – Enquiries by tax representatives

Mr So said for many years the Profits Tax Unit had offered a general telephone enquiry service. Senior officers were assigned to answer telephone enquiries on a rotation basis. Recently it was found that the system was probably abused by some junior staff of certain tax representatives' firms. Instead of asking for direction from their supervisors, the junior staff just picked up the phone and rang the IRD asking for advice on how to deal with the client's tax matters (e.g. whether certain items are taxable, whether certain items are deductible expenses etc.). In many cases, the answers could be easily provided by the more experienced staff in their firms. Occasionally even questions on tax planning and hypothetical situations were raised.

Mr So explained that the general telephone enquiry service was to answer the public's enquiry on general tax matters (e.g. whether the business should be registered, when tax returns should be filed and whether they were legally required to appoint a tax representative etc.). The service was not to provide answers to tax representatives/taxpayers on the following matters: -

- (a) hypothetical cases,
- (b) tax planning schemes,
- (c) tax ruling cases,
- (d) detailed interpretation of the IRO, and

(e) tax advice on individual cases.

Mr So commented that obviously specific tax advisory services to the clients should be provided by the tax representatives. IRD was not in a position to provide such service. CIR pointed out that the website of IRD already contained a lot of tax information. On more specific and difficult matters, there were DIPNs. Tax representatives and in particular their junior staff should consult these materials instead of using the telephone enquiry service. The Society agreed to consider if it was appropriate to draw members' attention to this issue.

Agenda Item B3 – Interpretation of section 19C(4)

CIR said this matter was discussed in the 1995 meeting. [Agenda Item A13 of the 1995 minutes] IRD was of the view that the losses of a corporation could not be set off against the share of profits of a partnership that was established after the year in which the loss was incurred. In other words, before a corporation could set off a corporation loss against a share of partnership profits, the partnership had to be in existence when the loss was incurred.

CIR went on to say that in a recent Board of Review Decision [*D65/02 dated 30.9.2002, yet unpublished at this moment*], it was held that a corporation's loss in one year was available for set off under section 19C(4) against its share of profits from a partnership in subsequent years of assessment. After seeking legal advice, IRD decided to accept the Board's decision and withdrew its appeal to the court (in December 2002). Assessors had been instructed to follow the new interpretation. Nonetheless, CIR cautioned that tax avoidance schemes using section 19C(4) were susceptible to the operation of section 61/61A.

Ms Law asked if there was a particular order in which set-off should be effected, e.g. should corporate losses be set off against another group company first? Mr. So said that the same order still applied as when the issue was discussed in 1995. Ms. Law asked whether the new practice would be retrospective. Mr Tam replied that finalized assessments were subject to the prevailing practice rule and could not be re-opened, but the new practice would apply to unsettled cases.

Agenda Item B4 – Withdrawal of prosecution after a writ of summons is served

CIR said that IRD found some tax representatives advised their clients to ask the Assessors to withdraw the prosecution (for late filing of returns) on the grounds that the return had been subsequently filed (though late) and the compound offer would be accepted by the client if the prosecution was withdrawn. It should be noted that only in exceptional circumstances would a prosecution be withdrawn. Examples of such circumstances would be where IRD was at fault by reason of failing to take note of a change of address earlier advised or overlooking an extension already granted. Tax representatives were asked to advise their clients that filing the return late and offering to accept the lapsed compound offer would not be accepted by IRD for withdrawing the prosecution.

Agenda Item B5 – Completion of returns (BIR51)

Mr So pointed out that IRD found some BIR51s were not completed properly e.g. not all sections/boxes were completed, the declaration section was only partially completed, auditors reports were not attached, auditors reports were not signed, directors reports were not signed etc. From April to December 2002, some 5,000 such invalid returns were received. IRD needed to issue duplicate returns to the companies for completion again. This would be inconvenient to all parties concerned (the clients, tax representatives and IRD). IRD suggested that tax representatives checked the BIR 51s carefully before sending them to IRD. Tax representatives should note that “rejected returns” means that no return was filed. When the duplicate returns were filed, they might be late and penalty action might be taken by IRD.

Agenda Item B6 – Electronic lodgement of applications for Block Extension

CIR drew the attention of the Society to this service introduced in 1997. In the Block Extension Letters, tax representatives were invited to register for this service. It might assist both the tax representatives and the IRD. If the tax representative firm mentioned in item 2(a) used it, the error could have been avoided. Mr. So said that tax representatives would receive a response very quickly indicating whether or not the extension had been granted. In the previous year, around 13,000 files had been dealt with by electronic applications and 67,000 by letters. The telephone number for registering for the electronic service was on IRD’s website.

Mr Lui undertook to bring the matter to their members’ attention. Mr Paul Chan suggested IRD sending representatives to brief the SME meeting of the Society on the service. This was agreed by IRD.

Agenda Item B7 – Tax representatives seminar

CIR said that for the past few years, IRD held annual “tax representatives seminars” in April each year. The main purpose was to explain the block extension scheme, new design of tax returns and changes in the IRO. IRD expected there would not be any significant changes in the design of the tax returns for 2002/03. IRD did not see the need for holding a conventional “tax representatives seminar” which could only be attended by a limited number of persons. Instead, IRD would communicate with the tax representatives through E-seminar and update the Common Q&A for completion of tax returns in the IRD website. Further details of the E-seminar would be announced in the Block Extension Letter to be issued to the tax representatives in March this year.

Mr Tisman asked if the E-seminar was going to be bilingual. CIR replied it would be bilingual. In fact, IRD website was also bilingual.

CIR indicated that consideration would also be given to conducting the employers’ seminars, aimed at new employers, as E-seminars.

Agenda Item B8 – Date of next annual meeting

CIR suggested fixing the date of the 2004 annual meeting in either January or February 2004 and requested the Society to provide its proposed agenda at least six weeks before the date of the meeting. After discussion, it was decided that the 2004 Annual Meeting would be held on Friday 9 January 2004.

Analysis of Completed FA Corporation Cases for the years ended 31 December 2000, 2001 and 2002

Auditor's Report = Unqualified	No. of Cases			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2000	2001	2002	2000	2001	2002	2000	2001	2002
Sales omitted	30	11	17	\$33,373,609	\$27,406,649	\$18,813,616	\$4,730,949	\$4,244,385	\$2,423,898
Purchases overstated	13	7	5	\$14,085,843	\$10,710,316	\$5,993,825	\$2,368,631	\$1,530,702	\$1,018,809
Closing stock understated	4	4	3	\$5,201,522	\$1,186,821	\$7,927,960	\$822,487	\$175,183	\$1,289,435
Gross profit understated	32	32	33	\$54,789,996	\$71,679,646	\$106,396,797	\$7,521,584	\$11,682,074	\$17,024,166
Expenses over-claimed	49	42	42	\$36,561,665	\$15,683,318	\$39,091,650	\$4,892,986	\$1,687,279	\$6,040,345
Technical adjustments	30	30	26	\$36,196,302	\$3,560,472	\$11,211,149	\$5,228,338	\$447,817	\$1,820,124
Other	79	65	56	\$47,256,576	\$12,656,113	\$35,284,856	\$8,081,024	\$2,227,129	\$5,823,082
TOTAL	148*	132*	129*	\$227,465,513	\$142,883,335	\$224,719,853	\$33,645,999	\$21,994,569	\$35,439,859
AVERAGE AMOUNT PER CASE				\$1,536,929	\$1,082,450	\$1,742,014	\$227,338	\$166,626	\$274,728
* there may be more than one type of discrepancy in one case									
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2000	2001	2002	2000	2001	2002
Other statistics for the above cases: TOTAL				\$783,430,212	\$604,517,394	\$995,828,266	\$114,929,799	\$91,730,208	\$159,513,970
AVERAGE AMOUNT PER CASE				\$5,293,447	\$4,579,677	\$7,719,599	\$776,553	\$694,926	\$1,236,542

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Auditor's Report = Qualified	No. of Cases			Discrepancy Amount by Nature			Tax Undercharged by Nature		
	2000	2001	2002	2000	2000	2002	2000	2001	2002
Sales omitted	21	8	5	\$24,232,872	\$9,246,059	\$1,857,111	\$3,718,591	\$557,182	\$300,966
Purchases overstated	11	4	5	\$31,873,266	\$6,224,164	\$3,452,760	\$4,777,056	\$956,076	\$564,737
Closing stock understated	7	1	2	\$7,368,220	\$3,199,310	\$5,574,913	\$1,118,398	\$437,587	\$887,060
Gross profit understated	19	11	5	\$41,119,703	\$22,407,626	\$13,228,053	\$5,586,544	\$3,152,089	\$2,137,019
Expenses over-claimed	25	10	8	\$17,919,295	\$5,488,148	\$4,999,188	\$2,403,076	\$735,731	\$763,867
Technical adjustments	6	5	5	\$1,163,399	\$3,818,223	\$1,729,746	\$122,183	\$554,117	\$430,994
Other	21	15	17	\$27,382,176	\$8,416,850	\$3,419,966	\$4,547,975	\$1,566,124	\$554,621
TOTAL	54*	32*	26*	\$151,058,931	\$58,800,380	\$34,261,737	\$22,273,823	\$7,958,906	\$5,639,265
AVERAGE AMOUNT PER CASE				\$2,797,388	\$1,837,512	\$1,317,759	\$412,478	\$248,716	\$216,895
* there may be more than one type of discrepancy in one case									
				Total Discrepancy for All Years			Total Tax Undercharged for All Years		
				2000	2001	2002	2000	2001	2002
Other statistics for the above cases: TOTAL				\$497,714,938	\$250,632,791	\$135,392,518	\$75,643,667	\$35,017,925	\$22,242,599
AVERAGE AMOUNT PER CASE				\$9,216,943	\$7,832,275	\$5,207,405	\$1,400,809	\$1,094,310	\$855,485

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