

Hong Kong Tax Controversy Insight

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What is the path I am going to walk along in a tax audit case?

In our first Hong Kong Tax Controversy Insight, we have discussed the case selection process of the Inland Revenue Department (IRD) and factors that are likely to trigger a tax audit. If a person is selected by the IRD for a tax audit, it is important to know the whole process. In this issue, we will provide you with some insights on the normal procedures undertaken by the IRD during a tax audit.

Additional assessment

When a case is selected by the IRD for tax audit, it is a common practice for the IRD to issue back-year assessments pursuant to section 60 of the Inland Revenue Ordinance to keep the assessment year open within the 6 year statutory limitation.

Hence, the receipt of a notice of estimated / additional assessment soon before the statutory time-bar deadline (usually in January to March) would be an indication of being selected for tax audit.

Upon receipt of such assessment, taxpayers should consider whether an objection is to be lodged against the assessment to prevent the assessment from becoming final and conclusive.

An objection should be lodged within 1 month from the date of issue of the assessment. If an objection is lodged, tax in dispute could be held over with or without condition, which is at the discretion of the Commissioner of Inland Revenue.

Taxpayers are highly recommended to consider carefully the implications of the estimated / additional assessment, objection as well as the holdover condition. Due to the complication and the potential consequences, professional advice shall be sought before any action is taken.

Tax audits performed by the IRD

There are three types of tax audits performed by the IRD, i.e. Desk Audit, Field Audit and Investigation, to ascertain the correctness of the tax returns submitted by taxpayers.

► Desk Audit

Desk audits of profits tax and salaries tax cases are usually performed by the respective assessing sections of the IRD, i.e. Unit 1 (Profits Tax) and Unit 2 (Salaries Tax). The assessing officers would raise written enquiries to the taxpayers to examine the risk areas identified.

► Field Audit

The assessing officers of IRD Unit 4 (Field Audit and Investigation (FAI) Unit) are responsible for field audit cases. They normally focus on a particular year of assessment within the statutory limitation for which a tax return has been submitted when the case is selected for review. Any discrepancies identified for the tax audit year may be projected for other years under review. In addition to written enquiries, field audit works normally include examination of books and records, interviews with the taxpayers and visits to office premises of the taxpayers.

► Investigation

Investigation is a more in-depth examination performed by the assessing officers of FAI Unit. Investigation cases normally cover all 6 years of assessment prior to the year of assessment in which the investigation commences.

Process of field audit and investigation

The following graph highlights the key elements of the field audit and investigation cases handled by the FAI Unit of the IRD:



After a case is selected by the IRD for field audit or investigation, the IRD will gather background information, e.g. by reviewing the documents previously submitted to the IRD, including tax returns, computations and financial statements as well as any relevant information publicly available. The IRD may also conduct searches on various registers and request information from financial institutions. The taxpayer will then be notified by the IRD in writing and be requested to contact the IRD for arranging a mutual convenient time and place for the initial interview.

Some taxpayers may feel anxious about the written notice from the IRD and may try to call the officers immediately. In view that the process of tax audit is complicated and comprehensive, it is highly recommended that taxpayer consults professional advice before taking any action.

Prior to the initial interview, it would be critical for the taxpayer to understand clearly the tax issues that may arise and the flow of the interview.

Initial interview

Initial interview is normally conducted at the taxpayer's premise. At least two officers of the IRD would attend the interview. Taxpayers can be accompanied by their tax representative.

In this process, the IRD is trying to obtain a thorough understanding of the taxpayer's business operation and personal affairs with specific focuses determined on a case-by-case basis, including details of:

- ▶ The size and nature of the taxpayer's business;
- ▶ The mode of operation of the business;
- ▶ The accounting and book-keeping procedures used within the business;
- ▶ The personal financial affairs of the taxpayer and associated persons; and
- ▶ The taxpayer's personal and family living expenses.

After the interview, a written record will be prepared by the IRD and issued to the taxpayers for comment and confirmation.

Detailed information gathering and review by the IRD

During the initial interview, the IRD may indicate the review focuses and raise certain tax issues which have to be dealt with after the interview. In addition, the IRD will normally request the taxpayer to produce extensive information / documents for examination, including but not limited to the following:

- ▶ business books and records;
- ▶ documents supporting the tax position of the taxpayer;
- ▶ bank statements and slips;
- ▶ commercial contracts and agreements;
- ▶ tax and transfer pricing policies;
- ▶ transfer pricing documentation; and
- ▶ explanation on source of funds.

Negotiation of settlement

During the course of the tax audit, the taxpayer and his representative shall keep a close dialogue with the IRD. Through the back and forth process of exchanging opinions and information, a number of replies would have to be prepared for the IRD's review, and negotiations will take place for reaching a compromised settlement basis. Alternatively, the taxpayer could submit a compromised settlement proposal on a voluntary basis for the IRD's consideration. The whole negotiation process could possibly take months or even years to complete. Thus, to expedite the review process and the settlement of the case, taxpayers may consider getting professional advice in this respect.

If a settlement basis is mutually agreed by the taxpayer and the IRD, additional / revised assessments will be raised on the taxpayer. However, if a compromised settlement cannot be reached between the taxpayer and the IRD, the case will be referred to the Appeals section for the Commissioner's Determination. The taxpayer may consider appealing to the Board of Review or even the Courts if he does not agree with the Determination.

Penalty considerations

Subsequent to reaching a settlement basis, the IRD may impose penalty, which is calculated at certain percentage of the tax undercharged, on the taxpayers.

In assessing the penalties, the IRD would take a number of factors into consideration, e.g. the gravity of the case, the revenue loss suffered by the government, the degree of the cooperation given by the taxpayer, the evidence of deliberate tax evasion, and etc.

Therefore, to mitigate the penalty loading imposed by the IRD, taxpayers are encouraged to submit a reasonable settlement proposal for the IRD's consideration soon after the initial interview. If the case is closed according to the proposal subsequently, it would be one of the mitigating factors when the IRD considers the penalty loading.

The quantum of penalty is decided by the Commissioner / Deputy Commissioner in person.

Tips for tax audit

The approach in handling tax audits may vary depending on the complexity of the case and the issues involved. The way how the taxpayers negotiate with the IRD may have a great impact on the results of the tax audits. Proper handling of a tax audit case can significantly focus the scope of the audit on key issues and expedite the settlement. With an aim to handle the tax audit efficiently and effectively, taxpayers are recommended to seek professional advice in this respect.

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