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Raymond Yeung Tax Consultant

Hong Kong Tax Tips

Contents – Volume 1

Volume 2 is bound separately

1	Basic Tax Tips	7
2	Salaries Tax Tips	86
3	Profits Tax Tips	156
4	Property Tax Tips	330

Hong Kong Tax Tips

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From bottom of my heart, my I express the following gratitude:

Gratitude to God

May I express my gratitude to God:
You grant me my life,

For today and its blessings,
I owe You my greatest gratitude.

Gratitude expresses itself
Not for the gifts of this day only,
But for the day itself;
Not for what I believe will be mine in future,
But for the bounty what I've got in the past.

If I can't be content with what I have received,
I am thankful for what I have escaped.

Because so much has been given to me,
I have no time to ponder over what has been denied.

It isn't what I have in my pocket that makes me thankful;
But what I have in my heart.

I believe gratitude will transform my days into satisfaction;
Will turn routine jobs into joy;
And will change ordinary opportunities into Blessings.

Gratitude to my dearest wife

May I also express my gratitude to my wife, Meihua:
Indeed you are so wonderful
that make my business a reality.

If not for your encouragement and forbearance,
I would not have made my dream come true;

A dream that has been on my mind for so many years;
A dream that someday I would be my own master,

Running my own business, doing what I like to do.
Meihua: I love you from the bottom of heart.

Thank you very much.

Preface

How to reduce tax legally? Different tax advisors give different answers. Almost all tax advisors boast their answers to be the most effective and the least costly. Regrettably seldom do they publish their answers in a book. Of course, being a tax advisor, I have my own answers to the question. What's more, I publish them in a book.

I worked at the Inland Revenue Department for 18 years. I handled thousands cases of profits tax, salaries tax, property tax and estate duty. I understand how IRD works and how IRD interprets and practices the tax law. I know their powers as well as their limitations. And above all, I make all my understanding and knowledge the base of my tax tips.

I don't like boasting. I will tell you the truth, the whole truth. I will offer you advice from my knowledge, my work, my experience, my belief and my heart.

I must make it clear that my tax advice cannot make you free of all the tax burden and tax troubles. But you are rest assured that my advice can help you reduce your tax burden and tax troubles legally. Indeed I think it is impossible and unrealistic one can totally remove his tax burden and his tax troubles.

I must emphasize that reduction of tax must be achieved legally. Or else, it will lead to investigation, penalty or even prosecution.

In my experience, there are a lot of simple and easy ways to reduce tax legally. I will tell you about them in this book. So, please take a cup of tea, relax and enjoy reading it. I am sure you will soon discover: Yahoo! Tax reduction is not just a dream!

Raymond Yeung
April 2012

Chapter 1 Basic Tax Tips

- 1.0 Overview of Hong Kong Taxation
- 1.1 What to do if you disagree with an assessment
- 1.2 Correction of errors and omissions
- 1.3 Beware of your legal obligations
- 1.4 Tax penalty
- 1.5 Privacy and Access to IRD's record
- 1.6 Election for Personal Assessment
- 1.7 The legal aspects of tax administration
- 1.8 Advance tax ruling
- 1.9 Tax recovery
- 1.10 Double taxation relief
- 1.11 Avoidance and evasion of tax
- 1.12 The IRD's performance pledge
- 1.13 Complaints to IRD

Chapter 1 Basic Tax Tips

1.0 Overview of Hong Kong Taxation

The chief income taxes in Hong Kong are under three heads: Salaries Tax, Profits Tax and Property Tax.

For a Hong Kong resident, he may elect for Personal Assessment so that his total income under the three heads are combined and taxed like Salaries Tax. In fact, Personal Assessment is a tax relief, not a charging head. The election is up to the individual taxpayer. Where the taxpayer has salaries income only, such election is obviously pointless. Where the taxpayer has property income, business profit or business loss, then such election may reduce his total tax payable. For more on personal assessment, please read paragraph 1.6 below.

The law governing the aforesaid taxes is stipulated in the Inland Revenue Ordinance (IRO), Chapter 112, and its subsidiary legislations including Inland Revenue Rules and various orders made by Chief Executive under the Ordinance. All the tax law quoted in my book refers to the IRO except otherwise stated.

The Inland Revenue Department is responsible to administer the IRO. In this book, it is sometimes referred to as the IRD or the Revenue.

From time to time, there are many tax cases going to courts and these cases form part of the Hong Kong tax law. As Hong Kong adopts common law as in many English-speaking countries and the IRO originates from the UK, the tax cases of the UK and other common-law countries may be followed when interpreting the Hong Kong tax legislations with similar wordings.

Apart from the income taxes mentioned, there are also a number of government charges, fees, rates, duties ... etc. For simplicity

sake, such other topics are not included in this book.

Many people say that Hong Kong's tax system is simple. But do they know how simple? Next time, when you also say that, you can say more by adding the following points. In fact, these points are the salient features of the Hong Kong tax system. Saying them will make people believe you a tax expert.

1. Corporation's profits tax rate is 16.5%.
2. Individuals' overall tax rate does not exceed 15%. Low to medium income earners are taxed at lower rates under a progressive-rate system. They will be exempt from tax if their total income is below their total personal allowances.
3. Because of the low tax rates, the Revenue combats tax avoidance vigorously. Indeed, anti-tax avoidance law is difficult and complicated.
4. Only those incomes and profits derived from Hong Kong are taxable.
5. Capital expenditure is not deductible. But generous allowances are granted for expenditure on plant and machinery, acquisition of patents, information technology, scientific research, technical education, construction of industrial building and commercial building, refurbishment of buildings ... etc.
6. No tax on capital gains, dividends or interest.

1.1 What to do if you disagree with an assessment

If you disagree with an assessment, the first thing you should do is to write an objection to the Revenue. This is your statutory right. The legal requirements for a valid objection are:

- (a) have a written notice of objection signed by you,
- (b) send it to the Revenue within one month from the date of assessment,
- (c) state your grounds of objection precisely, and
- (d) file a tax return if you have not done so.

What if you miss the deadline of objection? Ask the IRD to accept your late objection --- Section 64 states that the Commissioner can accept late objection on the following grounds: (a) absence from Hong Kong (b) sickness, or (c) any other causes that have prevented you from lodging an objection within the time limit. If you have not received the assessment before, ask for a copy of the assessment as well as an acceptance of your late objection. Nowadays, the IRD sends almost all assessments to taxpayers by ordinary post. In fact, some may have been lost during transit of posting. Therefore, to grant the taxpayers benefit of doubt, the IRD accepts by concession almost all late objections in case the taxpayers claim non-receipt of assessments.

Besides, you are entitled to married allowance, child allowance and dependent parent allowance even if you have missed the deadline of the objection. In other words, there is practically no time limit for the statutory allowances --- and you can still get these allowances providing you fulfil the conditions for such allowances. What you should do is to write a letter to the IRD stating your claim for the allowances clearly and file a tax return in support of your claim if you have not done so.

If the assessment was not estimated in the absence of a tax return, then you are entitled to invoke Section 70A to ask for a revised assessment on the grounds that it contains an error or omission. The words “error or omission” are not defined in the IRO. From case law, “error” includes one made by a taxpayer or by the Revenue, whereas “omission” includes an omission of fact and even an omission of claim by the taxpayer. If the Revenue rejects your claim of error or omission, ask for a formal notice of rejection of Section 70A so that you can send a formal objection against their rejection. Then, your objection will be processed as a valid objection under Section 64. In other words, you can still proceed with your claim even if you fail to meet the objection deadline.

The objection and appeal procedures

To put it simply, the conditions of a valid objection under Section 64(1) of the IRO are:-

1. It must be in writing.
2. It must state precisely the grounds of objection.
3. It must be received by the IRD within one month from the date of the assessment.

In law, the one-month objection period can be extended if the taxpayer is prevented from lodging the objection due to absence from Hong Kong, sickness or other reasonable causes. In practice, the objection period can be extended if the taxpayer has reasonable causes for the delay. Virtually the Revenue will accept a late objection if the taxpayer does not receive the assessment. What constitutes "preventing a taxpayer from making the objection" was considered in the case *Lam Ying Bor Investment Co. Ltd. v. CIR*.

Lam Ying Bor Investment Co. Ltd. v. CIR

This case concerns whether the illness of the sole active director of a company constitute a reasonable cause for late objection. The Company had three directors. It did not object to a profits tax assessment within the objection period. It claimed that the delay had been caused by the illness of the Company's sole active director while the other two directors were either too old or too busy to attend to the Company's affairs. CIR did not accept the late objection. Then, the Company sought a judicial review of the CIR's decision from the court. The court upheld the CIR's decision. In his judgment, the judge drew a distinction between the circumstances preventing a taxpayer from making an objection within the time limit and the circumstances excusing him from not making an objection within the time limit. It was held that the circumstances had not 'prevented' the taxpayer from lodging an objection within the time limit. Rather, the delay was due to the Company's negligence.

An assessment under objection will be subject to revision in all aspects. The revision does not only apply to the grounds of objection, but also cover other aspects. So, as long as an objection is unsettled, a taxpayer can claim for other items which have not been mentioned in his objection letter. But if the assessment is estimated in the absence of a tax return, the taxpayer must file a properly completed tax return in support of his objection. In practice, the Revenue will issue a standard letter to the taxpayer requiring him to submit a tax return to validate the objection within 10 days. If the taxpayer needs more time to complete the tax return, he should first telephone the case officer according to that standard letter and then fax the IRD a written request. Below is a tax case on this topic.

CIR v. Mayland Woven Labels Factory Ltd.

This case concerns what is a properly completed return. The appellant company purported to make a return of profits under section 51(1) of the Inland Revenue Ordinance. It filed a profits tax return but it was not accompanied by the company's balance sheet, profit and loss account and auditor's report, as required in the notice printed in the tax return. The IRD did not accept the tax return as valid and therefore it issued an estimated assessment to the company. Then, the company objected to the assessment. In order to validate the objection, the assessor extended the time limit for the company to submit the required documents. But the company failed to do that. Then, the assessor informed the taxpayer that the objection was invalid. As such, the company lost the right of objection and the assessment had become final and conclusive --- the company must pay all the tax according to the assessment even if the tax estimated exceeded that computed in accordance with the tax return submitted.

If the objection is made against an 'additional' assessment, no revision will be made to the 'original' assessment. Nevertheless, the taxpayer can ask the Commissioner to extend the objection period of the original assessment on the grounds of absence from Hong Kong, sickness or other reasonable causes. In that case, his

objection can cover the original assessment as well.

If the objection is made against a Personal Assessment, no revision will be made to its composite assessments. Nevertheless, the taxpayer can ask the Commissioner to extend the objection period of the relevant composite assessments on the grounds of absence from Hong Kong, sickness or other reasonable causes. In that case, his objection can cover all the composite assessments.

To process an objection, the IRD may ask the taxpayer as well as other parties to supply information relevant to the objection. The information required from the taxpayer may include books or documents in his custody. After gathering all the relevant information, the IRD may allow the taxpayer's objection, or propose a revised assessment, or ask for a withdrawal of objection. Should there be no agreement from the taxpayer, the case will be submitted to Commissioner who will determine the objection --- he may confirm, reduce, increase or annul the assessment. If the taxpayer disagrees with the determination, he can appeal to the Board of Review. In that case, the burden of proof that the assessment is excessive will be on the taxpayer. Having heard the evidence and arguments submitted by the taxpayer and the IRD, the Board will decide on the case. If the taxpayer or the Revenue disagrees with the Board's decision, either party can ask the Board to refer the case to the court.

Board of Review's procedures

The following procedures assume that the appellant is represented by a professional (who may be an accountant or a lawyer). The appellant may attend the hearing by himself without a representative.

1. Board chairman and members come in.
2. The chairman checks with the representatives of the appellant and the Revenue about the documents.
3. The appellant's representative gives the opening submission.
4. The chairman asks the appellant's representative if he is

- calling any witness.
5. The chairman asks the appellant if he is going to give oral evidence as witness.
 6. The witness or the appellant makes an oath or an affirmation.
 7. The appellant's representative examines the witness or the appellant.
 8. The appellant's representative (or the appellant if unrepresented) gives evidence.
 9. The Revenue's representative cross-examines the witness or the appellant.
 10. The appellant's representative re-examines the witness or the appellant.
 11. After the examinations, the Chairman asks the representatives of the appellant and the Revenue whether a written final submission is prepared.
 12. The appellant's representative (or the appellant if unrepresented) presents the final submission.
 13. The Revenue's representative presents the final submission.
 14. The appellant's representative (or the appellant if unrepresented) gives a reply to the Revenue's submission.
 15. The Board delivers an oral decision or reserves to deliver a written decision later.

The role of court in the case stated by Board of Review

On this question, the judge in the case *Edwards (Inspector of Taxes) v Bairstow* [1956] AC 14 said this: "I think that the true position of the court in all these cases can be shortly stated. If a party to a hearing before commissioners expresses dissatisfaction with their determination as being erroneous in point of law, it is for them to state a case and in the body of it to set out the facts that they have found as well as their determination. I do not think that inferences drawn from other facts are incapable of being themselves findings of fact, although there is value in the distinction between primary facts and inferences drawn from them. When the case comes before the court it is its duty to examine the determination having regard to its knowledge of the relevant law. If the case contains anything *ex facie* which is bad

law and which bears upon the determination, it is, obviously, erroneous in points of law. But, without any such misconception appearing ex facie, it may be that the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal. In those circumstances, too, the court must intervene. It has no option but to assume that there has been some misconception of the law and that this has been responsible for the determination. So there, too, there has been error in point of law. I do not think that it much matters whether this state of affairs is described as one in which there is no evidence to support the determination or as one in which the evidence is inconsistent with and contradictory of the determination, or as one in which the true and only reasonable conclusion contradicts the determination. Rightly understood, each phrase propounds the same test. For my part, I prefer the last of the three, since I think that it is rather misleading to speak of there being no evidence to support a conclusion when in cases such as these many of the facts are likely to be neutral in themselves, and only to take their colour from the combination of circumstances in which they are found to occur.”

The role of hearing by Commissioners in UK is similar to that of Board of Review in Hong Kong. Below is a tax case concerning grounds of objection.

CIR v. The Hong Kong Bottlers Ltd.

In this case, the company took over the business of another company by acquiring its share capital. The company objected to the profits tax assessment in respect of Industrial Building Allowance. Having gathered facts during handling of the objection, the IRD also disallowed the company's claim for depreciation allowances in respect of plant and machinery. The company appealed to the court.

It was held that when an objection had been made, the Commissioner was entitled to review the whole of the assessment, and increase it if necessary. In other words, the assessment would be subject to revision in all respects and the

revision does not only apply to the grounds of objection. In his judgment, the judge said: "It may be that an Assessor, at any time within six years, has power under section 60 to correct a mistake by means of an additional assessment. But that is not what I am asked to decide on this appeal. The question is simply this: Is a taxpayer entitled to limit the jurisdiction of the Commissioner to consider an assessment by the terms of his notice of objection? In my view the answer is 'no'. Admittedly, the foundation of the Commissioner's jurisdiction under section 64(2) is the receipt by him of a valid notice of objection --- and a notice of objection is not a valid notice unless it states precisely the grounds of objection. But it does not follow that because the grounds of objection must be stated precisely in order to give the Commissioner jurisdiction to consider the assessment, that his jurisdiction is circumscribed by the grounds as framed by the taxpayer. Once the Commissioner is seized of the matter, his first duty is to consider the questions raised by the notice of objection; but it is the assessment he is concerned with. The assessment objected to is the assessment, not part of the assessment or such aspects of the assessment as the taxpayer chooses to have considered. One can readily visualize cases in which it would be utterly impossible for the Commissioner to consider one aspect of an assessment to the exclusion of other aspects. His duty is to consider the assessment made by the Assessor, and to consider it as a whole. Having done so, his powers are not confined to confirming, reducing, or annulling the assessment. The subsection states specifically that he may increase it; and, clearly, the Commissioner's power to increase an assessment is not limited to cases in which the taxpayer, by his notice of objection, may, for any reason, seek to have his assessment increased. If the taxpayer's submission in this case were well founded, it would mean that in every case in which the Commissioner considered that an assessment should be increased, his duty would be to direct his Assessor to raise an additional assessment under section 60. He would himself, be powerless to increase the assessment, although section 64(2) says that he may do so."

A diagram to show the objection and appeal procedures

Court of Final Appeal



Court of Appeal



High Court



Board of Review



CIR's determination



Objection

Author's advice

The taxpayer should mind the cost of objection and appeal. On receiving a valid objection, the IRD will generally ask the taxpayer to supply information to prove his claim --- that may cause the taxpayer a lot of trouble, time and expenses with a futile end result. So, think twice before you object to the assessment. If the objection cannot be settled at the assessor level, it will be submitted to the Appeals Section; and if there is still no agreement between the IRD and the taxpayer, the appeals officer will prepare a determination for the CIR's endorsement. If the

taxpayer does not accept the determination, then he must lodge an appeal to the Board of Review within the time limit and the format as stipulated in the Inland Revenue Ordinance. Before appealing to the Board, it is advisable for the taxpayer to seek professional advice. Indeed it is quite costly to appeal to the Board in view of the time, effort and professional charge. It should be noted that the Board may impose a charge not exceeding \$5,000 on the taxpayer if it thinks his appeal is without merits. In fact, most taxpayers' appeals stop at Board of Review because of the huge cost of a further appeal to the law court.

Hold-over of tax in dispute

If a taxpayer's objection is valid, the Commissioner will inform the taxpayer by way of a standard letter ordering the amount of tax to be held over pending the result of the objection. As stated in all notices of assessment, the IRD requires all taxpayers to pay all the tax, even though part of it is in dispute, on or before the due date unless and until the Commissioner orders otherwise. But if there is undue delay on the part of the Revenue in dealing with the objection, the surcharge as a result of the late payment of the tax will usually be waived. If the taxpayer still receives a notice for payment of surcharge, he should write to the Collector requesting for a waiver.

A taxpayer objecting to an assessment may be required to purchase Tax Reserve Certificates to cover the tax in dispute. The TRC purchased bears interest from the day of issue to the day of determination of the objection at the rate published by IRD on its web site.

If the tax is held over unconditionally and the taxpayer loses the case at last, the taxpayer will be required to pay the tax plus interest on the tax held over. The interest rate is based on the prevailing court-judgment rates. If the Commissioner orders no hold-over of tax in dispute and the taxpayer wins the case at last, then only the tax overpaid will be refunded to the taxpayer ---

there will be no interest on the tax overpaid due to the taxpayer. So, it is preferable for the taxpayer to ask for a conditional hold-over of the tax in dispute: that is to purchase tax reserve certificate for the tax in dispute. In that case, he can earn interest from the tax in dispute if he wins the case at last.

If the Revenue does not deal with your objection or your claim properly, contact the IRD's Complaint Officer by phone via 2594 5000 or by fax via 2802 7625. If you are dissatisfied with the IRD's processing of your complaint, you can complain to the Ombudsman's Office.

1.2 Correction of errors and omissions

Correction of error or omission

According to section 70, an assessment is final and conclusive in the following situations: (a) no valid objection or appeal has been lodged within the time limit; (b) the objection has been withdrawn or dismissed by the Board of Review or a court; (c) where a revised assessment has been agreed under section 64(3); or (d) where an assessment is determined by the Board of Review which refuses to refer the case to court.

Nevertheless, section 60 empowers an assessor to make an additional assessment within 6 years after the end of the year of assessment on matters that have not been determined under the objection. This 6-year time limit is extended to 10 year in case of fraud or wilful evasion.

On the other hand, section 70A allows an assessor to revise an assessment to correct an error or omission within 6 years after the end of the year of assessment.

Section 70 is only applicable to an 'assessment'. A statement of loss as agreed by the taxpayer with the assessor is not an assessment for the purpose of section 70A, see *CIR v Yau Lai Man* trading as L. M. Yau & company. In other words, the loss as

assessed is not final and conclusive under section 70 and the taxpayer can ask for adjustment of the loss brought forward in the current year of assessment.

The purpose of section 70A is to redress unreasonable hardship, if any, arising from the mistakes made by either the taxpayer or the assessor. This purpose was confirmed in the Board of Review case D6/91.

Board of Review case No. D6/91

In this case the Board rejected the CIR's argument that if a taxpayer took a different view of law on some known facts, section 70A could not be invoked. In its judgment, the Board said: "Clearly there must be finality in taxation matters. That is the clear intention of section 70... Section 70 of the Inland Revenue Ordinance states that assessments are to be final and conclusive for all purposes of the Ordinance. That is a sweeping and draconian section. It is clear that section 70A was introduced to overcome the possible hardship of section 70."

Hence, based on the aforesaid decision, the first question for reopening of an assessment by section 70A is whether there is any hardship on the part of the taxpayer. If yes, then it is very probable that section 70A can be invoked to redress the hardship.

There is no definition of 'error or omission' in the Ordinance. So, the Literal Rule may apply (see paragraph 1.7 below) --- that is to look to their ordinary and literal meaning. The meaning of 'error' given in the Oxford English Dictionary is 'something incorrectly done through ignorance or inadvertence; a mistake'. The meaning of 'omission' in Webster's New International Dictionary is: an act or instance of omitting, whether by leaving out, or by abstention from inserting, or by neglect or failure to do something. In my work experience, these meanings have all along been adopted by IRD.

Although there are no definition of 'error or omission' in the

Ordinance, there are a number of court cases on the issue. Below are two important ones.

Extramoney Ltd v CIR [1997] 2 HKTC 38

In the case, it was held that an error was something that happened inadvertently and it excluded a deliberate act. The facts of the case were complicated. In short, the company deliberately booked certain profits which it did not actually earn. The company's section 70A claim was rejected by the Board of Review on the grounds that the disputed profits were deliberately reported as taxable profits and hence there would be no error on the part of the company. The company appealed to the court and the Board's decision was upheld. On the wordings of "errors or omissions" in section 70A, the judge made the following comments: "In my view, for the purpose of s. 70A, the meaning of "error" given in the Oxford English Dictionary (p. 277) would be appropriate, that is, "something incorrectly done through ignorance or inadvertence; a mistake". I do not think that a deliberate act in the sense of a conscientious choice of one out of two or more courses which subsequently turns out to be less than advantageous or which does not give the desired effect as previously hoped for can be regarded as an error within s. 70A. It is even worse if the deliberate act is motivated by fraud or dishonesty. But the question of fraud or dishonesty need not arise. Hence, in the context of the present case, if there is a change of opinion of the auditors or accountants in respect of the accounts, the first opinion cannot be regarded as an error or omission within the section. Similarly if there is a change of mind of the directors of the company in connection with how any part of the accounts should be made up, the previous decision will not be regarded as an error or omission. Nor is it an error or omission if it is merely a difference in the treatment of certain items in the accounts by those preparing or approving the accounts. If this were permitted, the director or officer of a company will be tempted at a later stage to try and "improve" the company's accounts or change his own decisions if this is to his advantage. This would be contrary to the spirit of the Ordinance that there should be finality in taxation matters. The whole statutory scheme provided in the Ordinance simply cannot work."

The other case on ‘error or omission’ is a Board case. This case is often followed by IRD and is summarized as follows.

Board of Review case D52/99

In this case, the taxpayer bought a property in 1986 as a capital asset. In 1988, the property was divided into 87 individual units. For the years of assessment 1989/90, 1990/91 and 1991/92, 73 units were sold. The IRD was of the opinion that the division of the shop showed the taxpayer’s change of intention from investment to trade. As such, the rebuilding allowance for 1989/90, 1990/91, 1991/92 and 1992/93 were withdrawn, giving rise to additional tax assessments for 1989/90 and 1991/92 and revised loss computation for 1990/91 and an assessment for 1992/93.

The taxpayer objected to the assessments and also the revised loss computations. Furthermore, it invoked section 70A to correct the tax assessments for 1989/90 and 1991/92 on the grounds that the profits derived from the sale of the units were capital gain not chargeable to tax. On the other hand, the IRD raised additional tax assessment for the year of assessment 1990/91 to adopt the IRD’s valuation of Property 1 as at 8 November 1998 (opening stock) when the division took place for computation of the assessable profit. The taxpayer asserted the value of the property to be \$30,000,000 which was much higher than the IRD’s valuation of \$16,000,000 in order to reduce the assessable profits.

The taxpayer’s appeal was dismissed by the Board who said: “In the tax returns for the years of assessment 1989/90 and 1991/92 submitted by the Taxpayer, the Taxpayer had offered for taxation the profit earned in the sale of the forty-three units of the sub-divided Property 1 in the year of assessment 1989/90 and the seventeen units in the year of assessment 1991/92 booked in the accounts as ‘sale of properties’. The Taxpayer had changed the description of the nature of its business in its tax returns from that of ‘Property holding for rental income’ in the tax return for the year of assessment 1987/88 to ‘Property holding for rental income and property redevelopment for re-sale’ in its

tax return for the year of assessment 1989/90 and a similar description in its tax return for the year of assessment 1991/92. The financial statements of these two periods showed clearly that these respective forty-three and seventeen units were treated trading assets. In the 1989/90 balance sheet, Property 1 was re-classified to 'Property under development' which was noted as a conversion of Property 1 formerly held for rental income purpose to resale purpose. In the 1991/92 balance sheet, the seventeen units sold (and the profits of which were offered for tax) had been classified as 'Current assets - property for re-sale/letting'. It is obvious that these forty-three and seventeen units sold were treated in the tax returns and the accounts as current assets or trading stock. There was no error or omission in the two tax returns in question which were clearly prepared on the basis of the two corresponding audited financial statements. Section 70A cannot be used to correct the accounting treatment of the sale of the forty-three and seventeen units in the respective tax returns and audited accounts for the years of assessment 1989/90 and 1991/92. The Taxpayer had made a deliberate choice in the accounting treatment and in submitting the profits made on the sale of the forty-three and seventeen units for taxation. This cannot be regarded as an error or omission under section 70A of the IRO. The Taxpayer's appeal under section 70A(2) of the IRO is dismissed".

When does section 70A apply?

Section 70A is applicable when the following conditions are satisfied.

1. The assessment concerned is one made for the last 6 years of assessment; and
2. The tax charged is excessive because of :
 - (i) an error or omission in a tax return or in a statement annexed thereto, or
 - (ii) an arithmetical error or omission in the calculation of the amount of the net assessable value, assessable income or profits assessed or in the amount of the tax charged.

The practical applications of section 70A

In practice, the words “error or omission” include: (a) an arithmetical error, (b) an omission to claim an expense or a deduction or an allowance, (c) an error or omission of fact, or (d) an error of law.

An “error of law” occurs in the following examples:

- Because of ignorance of law, a taxpayer in his tax return reports some non-taxable items. For instance, a taxpayer may invoke Section 70A to claim time-apportionment on the grounds that he omitted to do so in his tax return.
- Because of ignorance of law, a taxpayer reports his business income as employment income in his tax return. For instance, an insurance agent, who has no master and servant relationship with the insurance company, reported his income under Salaries Tax. On the grounds of “error of law”, he can invoke Section 70A to have his income re-assessed under Profits Tax so as to get more expenses deduction.

An error or omission can be made by the taxpayer or an IRD officer. In some cases, an error may even be made by a third party, for example: the taxpayer’s employer or the bank.

As far as an error or omission made by a taxpayer is concerned, it must be one in a tax return or a related statement. ‘Statement’ includes the accounts submitted in support of the return as well as any related correspondence made by the taxpayer.

An act deliberately done by an assessor in arriving at the assessment is not an error. For example, the Assessor's disallowance of, say 50%, of entertainment expenses in computing assessable profits is a judgment, not an error. Nevertheless, if the assessor made the judgment based on a wrong fact or has omitted an important fact, then the taxpayer can ask for a revision of the assessment on the grounds of error or omission.

Typical examples of 'error or omission' are:

- A salaried taxpayer reported compensation for loss of an employment as taxable income in his tax return.
- A salaried taxpayer has not claimed married person allowances, child allowances or dependent parent allowance (this claim is still valid even for an estimated assessment in the absence of a tax return).
- A salaried taxpayer has not claimed home loan interest, charitable donation, contribution to recognized retirement scheme, travelling expenses from one workplace to another workplace, self-education expenses... etc. in his tax return.
- A business taxpayer has submitted an incorrect tax computation.
- A business taxpayer reported offshore profit in his tax return.
- A business taxpayer has not claimed depreciation allowances in his tax return.
- A business taxpayer added back an item which should be deductible.
- A business taxpayer made an arithmetical mistake.
- An assessor made a salaries tax assessment based on an incorrect employer return.
- An assessor made an arithmetical mistake in computing the assessable profit.
- An assessor fails to deal with a deduction claimed by a taxpayer.

Below is a court case on 'error or omission' frequently adopted by IRD.

Sun Yau Investment Co. Ltd. v. CIR 2 HKTC 17

In this case, it was held that Section 70A did not apply to an estimated assessment in the absence of a tax return. The company failed to make a profits tax return and the assessor estimated its liability for tax at \$125,981. The company purported to lodge an objection against the assessment by letter but did not include with it any profits tax return or supporting audited

accounts. The letter was not accepted by the Commissioner as a valid notice of objection because it was not made within the one-month period under section 64. Subsequently, the company filed a return for the relevant year together with the audited accounts. It then lodged an application under section 70A of the IRO to re-open the assessment on the grounds that it was excessive as it contained an arithmetical error or omission in the calculation of the amount of the assessable profits. The assessor declined to correct the assessment and his refusal was upheld by the Commissioner. On appeal direct to the court, the judge decided that section 70A had no application because the assessor had not committed any error or arithmetical error simply because his estimated assessment did not coincide with a figure he would have reached had other information been available to him. The judge said: "In my judgment, the wording of 70A is perfectly clear. It covers the case when there has been a miscasting by the Assessor on the material available to him. The Assessor is not in error, let alone arithmetical error, simply because his assessment does not coincide with a figure he would have reached had other information been available to him... The object of the Ordinance is to achieve within the timetable and procedures laid down. Various safeguards and appeal procedures are provided. One of those safeguards is provided by section 70A where in a proper case, the assessor is required to correct his own arithmetical error. That is not this case. I agree not only with the findings of the Commissioner of Inland Revenue but also with his reasons. This appeal is dismissed with costs."

Author's comments: Although the change of judgment by the taxpayer as to the taxability of a gain or the deductibility of an expense will not usually be accepted as an error for the purpose of section 70A, the taxpayer can argue that there is an omission of claim on the grounds on error of law. This argument may stand in some cases.

Prevailing practice

Section 70A is inapplicable where the return or statement was made in accordance with the then prevailing practice. In other words, the claim will not be accepted if there is a change of the

IRD's practice or there is a new court judgment. Whether there was a prevailing practice is largely a question of facts and the taxpayer is entitled to require the IRD to prove it. If the taxpayer does not accept the Revenue's assertion, he can ask the IRD to issue a formal rejection of his section 70A claim so that he can appeal to the Board of Review.

Formal notice to reject section 70A claim

The IRD should issue a formal notice of rejection if it does not accept the taxpayer's Section 70A claim. When the taxpayer receives the notice, he can lodge a formal objection in accordance with section 64 of Inland Revenue Ordinance against the notice as if it were a notice of assessment.

In practice, where a taxpayer misses the deadline for a formal objection to claim offshore profits, he can also invoke section 70A to make the claim within 6 years after the end of the relevant year of assessment. In that case, the formal procedures of objection will be followed to deal with the claim and if the IRD still rejects the claim, a CIR determination will be issued so that the taxpayer can appeal to the Board of Review to pursue his claim. If the Revenue does not issue a formal notice of rejection of section 70A claim, the taxpayer can pursue his claim by way of a complaint.

1.3 Beware of your legal obligations

If you break the tax law, you have to pay a price. The price may be tax investigation, money fines or even criminal prosecution. So, beware of the requirements of the Inland Revenue Ordinance. Here are some tips for you.

- Never file an incorrect tax return. Make sure every item you put down in the return is correct.
- File the tax return promptly. Ask for an extension of time limit if you cannot make it on time.
- Make sure all the information you supply to the Revenue is

true. If the information required is unavailable, say so.

- If any information supplied to the Revenue turns out to be incorrect, inform them right away.
- Pay tax on time. Jot down the due date in your diary. Beware: the surcharge on unpaid tax is very high, much more than the market interest rates.
- If you are liable to tax and do not receive a tax return within 4 months after the year of assessment, inform the Revenue.
- If you cease to have a source of taxable income, inform the Revenue within one month.
- If you (a salaried taxpayer) are leaving Hong Kong for good, inform the Revenue at least one month before your departure.
- If you change your address, inform the Revenue within one month.
- Keep business records for 7 years.

1.4 Tax penalties

A tax penalty may be imposed on a taxpayer if he fails to comply with the requirements of the Inland Revenue Ordinance.

Nevertheless, if the taxpayer has a reasonable excuse for his non-compliance, he will not be penalized. In some cases, even if the “excuse” cannot exempt him totally from penalty, it can still reduce the penalty substantially.

A taxpayer may be liable to penalty in the following situations.

- (a) He does not comply with the Revenue's notice of requirement to file a tax return within the specified time limit.
- (b) He fails to inform the Revenue of his tax liability within 4 months of the end of year of assessment if he does not receive a tax return.
- (c) He makes an incorrect return or statement or supplies incorrect information to the Revenue.
- (d) He makes an incorrect return deliberately to evade tax.
- (e) He deliberately omits to disclose any particulars in a tax return that are required.

- (f) He makes a false statement or entry in a tax return deliberately.
- (g) He makes a false statement in connection with a claim for any deduction or allowance deliberately.
- (h) He signs an incorrect tax return or statement or account deliberately.
- (i) He gives an incorrect answer to a question raised by the Revenue.
- (j) He prepares or maintains incorrect books of accounts to evade tax.
- (k) He uses a fraudulent act to evade tax.
- (l) He does not keep sufficient business record of his income and expenditure.
- (m) He does not keep sufficient record of his rental income.
- (n) He does not inform the Revenue of his imminent departure from Hong Kong for more than one month.
- (o) He does not inform the Revenue of his cessation of business.
- (p) He does not inform the Revenue of change of correspondence address.

The court may order the following penalties:

Items	Penalty
(a) to (c)	a maximum fine of \$10,000 + treble the tax undercharged
(d) to (k)	a maximum fine of \$50,000 + treble the tax undercharged + 3-year imprisonment
(l)	a maximum fine of \$100,000 + the court may order the taxpayer to do the act which he has failed to do within a specified time
(m) to (p)	a maximum fine of \$10,000 + the court may order the taxpayer to do the act which he has failed to do within a specified time

Where blatant tax evasion is involved, the Revenue may take criminal prosecution against the offender under common law with the offence of cheating the public revenue. If the

prosecution is convicted, the sentence will be very severe including imprisonment.

Below are my summary of some important prosecution cases.

Failing to Keep Sufficient Business Records

Mr. Ho is the precedent partner of Sun Cheung Dispensary. He was prosecuted for not keeping sufficient business records in respect of the partnership business. During 1996/1997, the business only kept records of bank statements, cheque stubs, daily income and expenditure sheets, vouchers and the cash register tapes. The records kept were insufficient to ascertain readily the assessable profits for 1996/1997. No proper accounts were maintained for its receipts and payments and for its assets and liabilities. The daily income and expenditure sheets kept were not regarded as sufficient business records for taxation requirements. Mr. Ho pleaded guilty and was fined \$80,000.

False claim of staff wages and business expenses

Ms. Pak (白小姐), a famous radio talk-show host, was found guilty of tax evasion. The sentence was a three-month imprisonment and a fine of \$200,000. Ms. Pak was prosecuted on four charges on signing fraudulent Profits Tax Returns for 1994/1995 to 1997/1998. The charges concerned the tax returns of a service company beneficially owned by her. The company's major income was derived from her hosting of radio programs from 1994 to early 1997. The IRD's investigation revealed that Ms. Pak had falsely reported an employee having been hired by the company as public relation assistant and had been paid \$208,400 for 1995/96 and 1996/97. Besides, the company falsely claimed salaries expenses of \$162,950 related to another employee and inflated the entertainment and employee benefits totaled \$735,536 and omitted to disclose a contractual bonus of \$450,000 in 1994. The inflated entertainment and employee benefits concerned a lot of false and altered restaurant receipts. The profits under-assessed were \$1,556,886 and the tax undercharged \$210,122.

Two sets of receipts record

The tax evader Mr. K M Chang was prosecuted on a 5 charges concerning wilfully with intent assisting other person to evade tax

and omitting sales income from the profits tax returns of a company. He pleaded not guilty to all the charges. Mr. Chang was the director and shareholder of an engineering company that was engaged in the trading of industrial engineering products. The IRD's investigation revealed that the Company issued two types of cash sales invoices, one with serial numbers bearing alphabetic prefix and another with serial numbers bearing no alphabetic prefix. For 1994/95 to 1996/97, the Company omitted from the profits tax returns the sales revenue from all the cash sales invoices with serial numbers bearing no alphabetic prefix. Mr. Chang signed the accounts and the tax returns for 1994/95 and 1995/96. The total tax evaded exceeds \$1,000,000. Mr. Chang was convicted on all the 5 charges. He was sentenced to 9-month imprisonment plus a total fine exceeding \$2,000,000.

Non-disclosure of profits

The tax evader, Mr. K K Lee, was a director of D F M Ltd. and a beneficial owner of Y F Co. Ltd. and N B Ltd. The three companies made huge profits since their commencement of businesses in 1990, 1991 and 1993 respectively. Mr. Lee did not report profits in the profits tax returns in respect of DFM. He also abetted his mother to file a return for NB with the profits column left blank. The IRD's investigation revealed that: DFM understated profits amounting to \$34,413,331 with tax undercharged \$5,925,619 for 1990/1991 to 1997/1998; YF understated profits amounting to \$751,628 with tax undercharged \$112,744 for 1992/93; and BN understated profits \$12,610,687 with tax undercharged \$1,891,602 for 1993/94 to 1995/96. On conviction of the tax evasion charges, Mr. Lee was sentenced to 18 months' imprisonment and a total fine of \$11,700,000.

Evasion of Salaries Tax

The tax evader, Mr. Hsueh, was the former Head (Information Technology) of the Hong Kong Monetary Authority and former Chief Information Officer of the Securities and Futures Commission. Mr. Hsueh used false document to deceive Hong Kong Monetary Authority for housing allowances. In the documents submitted, he falsely declared that he rented accommodation so that he could claim housing allowance for more than \$1,000,000. As a matter of fact, the alleged rent transaction did not exist and the accommodation was owned by

him through a shelf company. Furthermore, he filed an incorrect tax return to IRD in order to evade tax on the housing allowances. The tax evaded was \$22,233. On conviction of the offences, he was sentenced to 4-months imprisonment plus a fine of \$75,000. The judge (District Court) said the sentence of imprisonment was because of the offender's serious breach of trust. The imprisonment sentence was suspended for one year by the High Court on the taxpayer's appeal on the grounds of the taxpayer's old age and previous clean record.

Section 82A additional tax

Rather than taking prosecution, the Revenue normally issues an assessment of additional tax under Section 82A against the offender. In such case, the maximum penalty will be an additional tax of 3 times the tax undercharged. Such assessment is made where the offence is not so serious to warrant a prosecution or where the evidence is insufficient for the proof required in a criminal prosecution.

This tax is usually called Section 82A penalty. The chief purpose for the penalty is "commercial restitution" --- that is to recover the loss due to the delay in the tax collection. Other purposes include deterring the public from tax offences and educating the offender to comply with the tax law in future.

The penalty is imposed for tax offences without criminal intention of evading tax and for tax offences without sufficient evidence to take criminal prosecution. Because the degree of proof for criminal prosecution, known as "beyond reasonable doubt", requires a lot of tax investigation work, it is impossible for the Revenue to prosecute every tax offender. So, depending on the evidence adduced and the then manpower constraint, only a few offenders of blatant tax evasion are prosecuted. The remaining tax offenders are penalized by Section 82A additional tax.

Legally speaking, the maximum penalty is three times the tax undercharged and the penalty is imposed by the Commissioner or

Deputy Commissioner of Inland Revenue personally. Of course, in practice, almost all the penalties are exactly the amounts recommended by the assessors, as endorsed by the Commissioner or Deputy Commissioner. This practice is perceivable as there are so many tax cases (including all prosecution, Section 82A, appeal cases) requiring approval, not to mention all such other important duties as policy matters, administrative and public relation work, special tasks... etc. requiring their personal attention.

Before imposing the penalty, the offenders are invited to explain the tax offences. If they have a reasonable excuse, they will not be penalized. What is a reasonable excuse depends on the circumstances of each case.

The assessors' recommendations are generally based on a tax penalty table. As far as investigation and field audit cases are concerned, tax offences are classified into three groups of culpability, namely: (a) intentional disregard, (b) recklessness and (c) no reasonable care. Moreover, each group of offence is further classified into four categories of co-operation, ranging from "voluntary disclosures" to "disclosure denied". The penalty rates on the tax undercharged, before commercial restitution, are as follows.

	Voluntary disclosure	Disclosure on challenge	Belated disclosure	Disclosure Denied
Intentional disregard	15%	75%	140%	210%
Recklessness	10%	50%	110%	150%
No reasonable care	5%	35%	60%	100%

The penalty as determined above is then added to the commercial restitution which is determined by the tax undercharged times the then best lending rates. This computation is usually done by the

assessor with a computer program. In any case, the total penalty rate is restricted according to the following table.

	Voluntary disclosure	Disclosed on challenge	Belated disclosure	Disclosure Denied
Intentional disregard	60%	100%	180%	260%
Recklessness	45%	75%	150%	200%
No reasonable care	30%	60%	100%	150%

The Revenue has to advise the offender which group of culpability and which category of cooperation have been adopted. If the offender disagrees with the penalty, he can appeal to the Board of Review. But caution: If the Board opines the taxpayer's appeal frivolous, vexatious, without merit or an abuse of the appeal mechanism, the Board may impose the taxpayer to pay the cost of appeal up to \$5,000.

The Revenue states that the penalty to be imposed in a particular case depends not only on the penalty table but also upon the aggravating and mitigating factors in the case. The aggravating factors refer mainly to the un-cooperative attitude of the taxpayer. Although the IRD says the penalty may be adjusted upward by the aggravating factors, this rarely happens in practice because doing so will likely bring the case to Board of Review --- that will add a lot of workload to the investigation officer.

The taxpayer should forward the mitigating factors for a reduction of the tax penalty. The following mitigating factors are published on the IRD's website.

1. The taxpayer is not well educated.
2. The business is simple and unsophisticated.
3. The taxpayer shows genuine concern, seriousness, responsiveness and co-operation.

4. The taxpayer is sincere.
5. The taxpayer is willing to compromise.
6. The taxpayer accepts a discrepancy when quantified.
7. The understatement is an isolated case.
8. The understatement is relatively small.

Where no field audit or investigation is involved, the section 82A additional tax is as follows.

Profits Tax Cases

- (1) Failing to notify the Revenue of tax liability in case of no tax return is received or failing to file tax return within the time limit:
 - (a) First offence: 10% of the tax undercharged (or 20% of the tax undercharged where two or more assessments involved)
 - (b) Second offence within 5 years: 20% of the tax undercharged (or 30% of the tax undercharged where two or more assessments involved)
 - (c) Third or more offences within 5 years: 35% of the tax undercharged (or 50% of the tax undercharged where two or more assessments involved)
- (2) For tax offences other than failing to notify chargeability or failing to file return promptly, the penalty table for tax investigation and field audit is normally adopted. Usually the absence of no field audit or investigation is a mitigating factor for a downward adjustment.

Salaries Tax and Property Tax Cases

- (1) Failing to notify the Revenue of tax liability in case of no tax return is received or failing to file tax return within the time limit: the Revenue's normal policy is to issue a compound penalty (usually \$600) under Section 80(5) of IRO. In general, Section 82A penalty will not be issued in view of the large number of cases and the small tax amounts involved. A taxpayer disagreeing to the compound penalty should not sign to accept the compound offer --- then in the absence of

the taxpayer's acceptance, the Revenue will either take the case to court (in that case the taxpayer can voice his grievance to the judge who will decide the amount of the penalty) or will take no further action in the case.

- (2) For simple offences of omission or understatement of incorrect statement, the penalty is as follows:
 - (a) First offence: 10% of the tax undercharged.
 - (b) Second offence within 5 years: 20% of the tax undercharged
 - (c) Third or subsequent offences within 5 years: 35% of the tax undercharged.
- (3) For blatant offences such as a false claim for dependent parent allowance, the penalty is 100% of the tax undercharged.

Personal Assessment cases

Personal assessment is a kind of tax relief under which the taxpayer claims deductions and allowances. It is up to the taxpayer to elect for Personal Assessment to reduce his total tax payable under schedular taxes (i.e. Profits Tax, Salaries Tax and Property Tax). As almost all relevant incomes should have been already been assessed under the schedular taxes, an omission of income under Personal Assessment giving rise to penalty is rare. In fact, failing to file the Personal Assessment returns promptly will normally lead to disallowance of the claim for the deductions and personal relief, rather than a penalty. As for the false claims of deductions and personal relief, the penalty to be imposed will follow that under Salaries Tax and Property Tax as set out above.

All penalty cases

For the counting of offence, an offence means one for which a warning letter, a compound penalty or a section 82A penalty assessment has been issued. The Revenue points out that the above percentages are for general guidance only. Depending on the circumstances of each case, the penalty may be adjusted

upward or downward, although most adjustments are downward.

In my experience, the Revenue, for simplicity sake, generally classifies offences into 5 categories according to their culpability: (1) late submission of tax returns (2) no submission of tax returns (3) failure to notify chargeability (4) omission of taxable income or overstatement of expenses and (5) deliberately submission of incorrect information or an incorrect tax return. The penalty loading rates for the offences are 5%, 10%, 50%, 100% and 150% to 250% respectively subject to downward adjustment for the merits of the case. This serves a rough estimate of the penalty in the norm.

If the tax undercharged is small (say less than \$1,000), then the penalty as determined above will usually be less than \$300. In such cases, the Revenue will generally think it unworthy imposing a Section 82A penalty. Rather, warning letters will be sent to the offenders to warn them of the legal consequences of future offences.

Where blatant wilful tax evasions are involved, the Revenue may take criminal prosecution against the offenders instead of imposing the Section 82A penalty. A taxpayer having reasonable excuse for the offence should forward detailed written representation to the Revenue to ask for a lenient treatment.

Reasonable excuse

What is a reasonable excuse? It depends on the circumstances of the case. For example, a very small flower shop owner (with a monthly turnover of less than \$10,000) fails to keep a complete set of business accounts: His poor education may be accepted by IRD or the Board as a reasonable excuse or a mitigating factor for the offence. In fact, he may be exempt from tax under Personal Assessment (if his taxable profit is less than his personal allowance). On the other hand, if the same offence is committed by a large flower shop, then the shop owner's poor education will not normally be accepted as a reasonable excuse --- this is

because he should have hired an accountant to help him do the bookkeeping. From time to time, there are a number of Board of Review cases on what constitutes a reasonable excuse. Below are four cases that were accepted by the Board as having a “reasonable excuse” and so, the penalties imposed by CIR were annulled. But I must point out that these cases are for reference only and similar cases in future may not be ruled as such.

D13/85

A medical practitioner failed to disclose certain employment income in his tax return. He contended that the non-disclosure had been a genuine mistake of oversight as a result of change of employment and it had been just a simple slip of mind. The Board believed that he was an honest man and accepted his explanations as a reasonable excuse and hence discharged the tax penalty. It was held that in deciding whether or not a taxpayer had a "reasonable excuse", the Revenue should consider whether the taxpayer had acted as one would expect a reasonable law abiding citizen to do. A reasonable person is not a perfect person, but an average person using the reasonable skill and care in handling his taxation affairs which one would expect to see from such an average person.

D80/76

A taxpayer failed to disclose the profits derived from sale of land. He was able to convince the Board that he had relied on professional advice and honestly believed that the sales were of a capital nature.

D129/02

A taxpayer was seconded by a UK company to work for its subsidiary in Hong Kong. She did not report her employment income to IRD. She explained that she had believed the employment only liable to UK tax. The Board accepted her explanation as a reasonable excuse.

D14/98

A taxpayer had three sources of taxable income under salaries tax. In her tax return, she disclosed two sources correctly but omitted the one for which she had already resigned. The Board accepted the omission as a genuine oversight. It believed that the

taxpayer had mistakenly reported such income as having been reported by the company already. The Board's decision also relied on the taxpayer's submission that she believed the omitted income as having been "assessed" by a provisional assessment upon her application for holding over of the provisional tax. As such, the penalty was discharged.

An important Board case concerning penalty

Below is an important case concerning section 82A penalty. It summarizes the law, the history and the matters that should be considered when deciding the penalty.

D118/02

The Board of Review in the case D118/02 commented on the Revenue's penalty policy. In this case, the taxpayer appealed against a Section 82A penalty concerning failure to comply with Section 51(1) of the IRO that required the taxpayer to file a tax return within the specified time. The penalty was about 50% of the tax undercharged. Having considered the case, the Board reduced the penalty rate to 20%. The appellant's principal argument for non-submission of the return was his disagreement with the Revenue on the amount of expense reimbursement. The Board opined that this did not constitute a 'reasonable excuse'. It quoted the following comments in *Dunk v Havant General Commissioners* [1976] STC 460:

'What the taxpayer has to declare is "that the return is to the best of his knowledge correct and complete". If a taxpayer finds circumstances that make the best of his knowledge more than usually unreliable, it is open to him to put against a figure for a particular item of income such words as "Estimated", "See accompanying memorandum", or something of that kind, and explain the circumstances. If he has done his best – and, of course, he is under a duty to use all proper sources of knowledge – he will not, in my view, be guilty of making a false statement providing, as I say, he puts in a genuine estimate and, if necessary, explains that it is not very reliable'. The Revenue adopted a 100% starting point in computing the penalty. A brief history and reasoning of Section 82A penalty was given in the judgment as follows:

"The penalty was first introduced by the Inland Revenue (Amendment) Ordinance 1969. When it was first introduced, the offender was 'liable to be assessed under this section to additional tax of an amount not exceeding the amount of tax which has been undercharged in consequence of the incorrect return ...' That new section was introduced pursuant to the recommendations in Part I of the Report of the Inland Revenue Ordinance Review Committee ('the Report'). According to the Report, the new tax was intended to be an 'administrative penalty' not applicable to cases involving 'wilful intent to evade tax'. The Report was of the further view that 'the administration should not be empowered to impose a heavier monetary penalty for an offence than the maximum penalty which the Court could impose for the same offence'. The then Commissioner of Inland Revenue envisaged that 'the full penalty equal to 100% of the tax undercharged would only be imposed for aggravated offences such as might be considered as borderline cases for prosecution under Section 82(1)'.

Section 82A was amended by the Inland Revenue (Amendment) (No 2) Bill published in the gazette on 27 March 1975. The amendments empowered the Commissioner to impose additional tax at treble the amount of tax undercharged. The amendments also brought into the net for the first time the cases where the taxpayer fails to comply with the requirements of a notice given to him under section 51(1) or (2A) or fails to comply with section 51(2).

The then Financial Secretary informed the Legislative Council in the course of debates on this Bill that the amendments were introduced because the penalties are not sufficiently high to act as a deterrent to some would-be evaders. Because of high interest rates and inflation, even where the maximum penalty of 100 per cent is imposed as it is in the worst type of case, the taxpayer is often no worse off than if he had paid the tax in due time... With a standard rate of 15 per cent, except for corporations where the rate is ... 16½ per cent, the worst that can happen to an offender if he is caught is to pay tax at 30 or 33 per cent – to put it at its lowest level it is worth taking a sporting chance. The level of penalty was to serve as ... inducement to a taxpayer to make a

clean breast of things and submit corrected returns."

Section 82 of the IRO permits penalty to be imposed in relation to seven categories of acts committed by the offender 'wilfully with intent to evade [tax]'. Section 80(2) embodies offences similar to those in section 82A but envisages the same being dealt with by proceedings in Court. On conviction the offender is liable to: (a) a fine at level three (that is, \$10,000) and (b) a further fine of treble the amount of tax involved.

For the year of assessment 2000/01, the level of fine under section 80(2) was around \$2,500. Of the 33 cases dealt with in Court between 1971 and 2002, the arithmetical mean of further fine imposed for violation of section 80(2) is 97.5% of the tax involved.

According to the penalty loading statement, the Revenue took into account various factors in deciding whether prosecution is to be instituted under section 80(2). Amongst those factors is 'the strength of evidence'. The Board would caution against the use of section 82A as a soft option where there is insufficient evidence to support the violation. The 'administrative penalty' should not be used as an expedient means to shift the evidential burden onto the taxpayer.'

The Revenue says that the actual penalty to be imposed is the amount determined by the penalty table subject to a further adjustment that may be upward or downward according to the merits of each case. In practice, almost all the adjustments are downward. This is because an upward adjustment can easily lead to appeal to the Board of Review --- that will unquestionably increase the workload of the case officers. But a downward adjustment will lower the chance of appeal. So, take my advice: do ask for a downward adjustment, particularly when there are mitigating factors, such as:

1. There is indication of misconception or confusion in completing the tax return.
2. The mistake is due to a slip of the mind.
3. The taxpayer is a lay man without good knowledge of tax

and accounting.

4. The taxpayer has good compliance record before.
5. The taxpayer has taken actions to ensure the omission not to be repeated in future.
6. There are special circumstances warranting a further downward adjustment, e.g. financial difficulty, unemployment, illness... etc.

The above mitigating factors can lead to a further downward adjustment of penalty by up to 25%. So, don't forget to point out such factors in the written representation where applicable.

1.5 Privacy and Access to IRD's record

Privacy

The Revenue must observe privacy with respect to the taxpayers' information. That is to say: Every taxpayer's information must be kept secret and every taxpayer has the right to access to the information kept by IRD to check if it is correct. The authorities governing these two rights are Section 4 of Inland Revenue Ordinance and The Code on Access to information.

Official Secrecy

All IRD's officers have to take a solemn oath of secrecy under the provisions of section 4 of Inland Revenue Ordinance. Breaking the oath is a criminal offence and it may render the offender liable to criminal prosecution and internal disciplinary action. Section 4 is to promote full disclosure of information that is necessary for the Revenue to assess tax correctly.

Code on Access to Information

As a general principle, all information held by the IRD can be accessed by public unless the IRD has valid reasons, whether of public, private or commercial interest, to keep the information secret. However, the IRD cannot disclose any information if the

disclosure contravenes a law.

Subject to other legislations, Section 4 of IRO prohibits the IRD from disclosing taxpayer's information to any persons other than the taxpayer or his authorized representative.

The request for information by an enquirer according to The Code on Access to Information must be made in a specified form. On receiving the request, the IRD will examine the claim to decide what information is accessible by the enquirer. Then, it will inform the enquirer of such information and how much is the fee required. The fee is a standard charge of HK\$1.50 for every sheet of paper provided (A4 or A3 size). Then, on receiving the IRD's reply, the enquirer can decide what information he really wants. When he pays the fee, he can get the information.

By exercising the request for information, a taxpayer can know what information is kept by the Revenue and whether such information is correct. Also, by exercising such request, he can ascertain the basis on which the Revenue makes their decision so that he can make better decision of his own as to whether he should pursue his case. Such information may also help the taxpayer to decide a better and wiser strategy against the Revenue's challenges.

1.6 Election for Personal Assessment

Profits Tax and Property Tax are chargeable on a person's income from business and let-out premises respectively and separately. In general, it is advisable for the low-income earners of such incomes to elect for Personal Assessment because they can benefit from the deductions or allowances that are not available under Profits Tax or Property Tax.

Low-income taxpayers of profits tax and property tax may elect for Personal Assessment to reduce their tax payable. In fact, by virtue of the election, they can get the deductions or allowances which are not granted under Profits Tax or Property Tax. What's

more, there is no provisional tax demanded under Personal Assessment and there is only one due date for the tax payable.

But caution: Election for personal assessment is not always advantageous, particularly where high-income taxpayers are concerned because the aggregation of income under personal assessment can push up their marginal tax rates.

In practice, when a taxpayer makes the election, either in a tax return or in a standard application form IR76C, the assessing officer will turn on the election indicator of his case in the computer database and then, the IRD's computer will check with a program to see if such election is to the taxpayer's advantage. If the election cannot reduce the applicant's total tax payable, the IRD will inform the taxpayer accordingly by way of a note in the Profits Tax or Property Tax assessment and the election will not be effected. In that case, the taxpayer's election will not be accepted. Put it simply, the IRD will only accept the taxpayer's election if it can reduce the total tax payable by the taxpayer. Therefore, it is advisable for the taxpayer to make the election if he is not sure whether or not such election is to his advantage.

Who should elect for personal assessment?

In general, a taxpayer should elect for Personal Assessment in the following situations:

1. He has property income only.
2. He has business income only.
3. He pays mortgage interest on let-out property.
4. He has business losses and other incomes such as salaries, property income or business profits.
5. He does not have employment income but business or property income and he made approved charitable donations.
6. He does not have employment income but has business or property income. He wants to claim deduction for self-education expenses, residential care expenses or home loan interest which are not available under profits tax or property tax.

Who should not elect for personal assessment?

In general, the following individuals should not elect for Personal Assessment.

1. He has employment income only.
2. He has employment income and other incomes and his marginal tax rate under Salaries Tax is higher than the standard rate.
3. His business or property income is so big that it will be taxed at standard rate under Personal Assessment and he does not claim self-education expenses, residential care expenses or home loan interest.

Who can make the election?

Only those individuals meeting the following conditions can elect for Personal Assessment:

1. 18 years old or above, or under 18 if both parents have died; and
2. A permanent or temporary resident in Hong Kong. A permanent resident means one ordinarily resides in Hong Kong. A temporary resident means one stays in Hong Kong for more than 180 days in the year of assessment or for more than 300 days in two consecutive years of assessment, one of which is the year of assessment in question.

A married couple may elect if one of them meets the residence condition.

Time limit of election

Election for Personal Assessment must be made within 2 years after the end of the year of assessment or 2 months after issue of any assessment for that year, whichever is the later. Where there is an objection to the assessment, the latter time limit will be extended to 1 month after the assessment becoming final and conclusive.

Late election will be accepted by the IRD if the taxpayer has reasonable excuse for the delay. So, if you are late, do write an explanation for the delay.

Set-off of tax paid

Any tax previously paid under Salaries Tax, Profits Tax and Property Tax can be deducted from the Personal Assessment tax. If the total tax previously paid exceeds the Personal Assessment tax, the excess will be repaid to the taxpayer.

Husband and wife

There is no separate taxation for husband and wife under Personal Assessment. In other words, husband and wife are assessed jointly under Personal Assessment. The tax payable is apportioned between the husband and the wife in the ratio of their respective reduced total incomes and each will get a tax bill.

Under Personal Assessment, income from all employments, businesses or let-out premises are aggregated, and from this total income, the followings are deducted:

- interest on money borrowed for buying the let-out premises,
- approved charitable donations,
- elderly residential care expenses,
- home loan interest,
- mandatory contributions to Mandatory Provident Fund,
- contribution to a recognized retirement scheme,
- business loss,
- loss brought forward from last-year Personal Assessment, and
- personal allowances such as married personal allowances, child allowances... etc.

Then, the tax payable is computed at the progressive rates or the standard rate under Salaries Tax on the reduced total income. In other words, to compute the tax, just substitute the net assessable

income under Salaries Tax by the total reduced income (that is before deduction of personal allowances) under Personal Assessment. Thereafter, the tax computation method for Personal Assessment and Salaries Tax are substantially the same. The steps for the tax computation are: (1) Total income minus deductions minus allowances => Net chargeable income (2) Application of the progressive rates to the net chargeable income => Tax payable (3) Check if standard rate applies: standard-rate tax = standard rate * (total income minus deductions): standard-rate tax will apply if it is lower than progressive-rates tax.

An example of personal assessment (2011/12)

	<u>Husband</u>	<u>Wife</u>
Net assessable value – Property tax	0	48,000
Net assessable income before donations – Salaries tax	308,000	0
Assessable profits after donations – Profits tax	0	142,000
	-----	-----
	308,000	190,000
Less: Mortgage interest – for purchase of let-out property	0	30,000
	-----	-----
	308,000	160,000
Less: Concessionary deductions not yet allowed :		
Approved charitable donations	0	3,000
Mandatory contributions to MPF	0	12,000
Elderly residential care expenses	0	40,000
Home loan interest	50,000	50,000
	-----	-----
	258,000	55,000
Less: Business losses	8,000	0
	-----	-----
Total Income	250,000	55,000
	=====	=====

	Joint Total Income	305,000
Less:	Married person allowance	216,000

	Net chargeable income	89,000
		=====
	Tax thereon	4,680
		=====

Standard-rate tax = \$305,000 * 15% = \$45,750: It is inapplicable because it is higher than the progressive-rates tax of \$4,680.

There is no provisional tax demanded under Personal Assessment and there is only one due date for the tax payable.

The allowances and deductions applicable to Personal Assessment and Salaries Tax for 2011/12 are as follows:

(a) Table of allowances

Basic Allowance	108,000
Married Person's Allowance	216,000
Child Allowance – each (max. 9 children)	60,000
Dependent Brother / Sister Allowance – each	30,000
Dependent Parent Allowance (60+) – each	36,000
Additional D P A (60+) – each	36,000
D P A (55-59) – each	18,000
Additional D P A (55-59) – each	18,000
Single Parent Allowance	108,000
Disabled Dependant Allowance – each	60,000

(b) Table of maximum concessional deductions

The actual amounts are to be allowed subject to the following limits.

Self-education expenses	60,000
Elderly residential care expenses	72,000
Home loan interest	100,000
Contributions to mandatory provident fund	12,000

(c) Table of tax rates on various bands of net chargeable Income:

Net Chargeable Income = Total Income - Deductions – Allowances

Net Chargeable Income		Rate	Tax
On the 1 st band	40,000	2%	800
On the 2 nd band	40,000	7%	2,800
On the 3 rd band	40,000	12%	4,800
Remainder		17%	

Tax payable is restricted to: (Total income – Deductions) x Standard rate @ 15%

1.7 The legal aspects of tax administration

Power of assessor to make an assessment

The Inland Revenue Ordinance empowers an assessor to make assessment on any person according to his judgment. But according to case law, the judgment must be made by the assessor honestly and reasonably according to the information available.

Examples of unreasonable judgments

What is an honest and reasonable judgment is of course dependent on the merits of each case. Normally, when an IRD's assessing officer is making an assessment, he is presumed to be honest unless the contrary is proved. In fact and indeed, to prove to the contrary is very difficult, if not impossible. But even if an assessor's judgment is honest, it may still be unreasonable. Let's see the following examples.

Say, a taxpayer's business is very small and located in a remote area and it has been producing steady low profits over the past years. Then, in such case, the assessor should not make an estimated profit of sky-rocket figure, say \$10 million. That judgment is apparently unreasonable and unacceptable and therefore, void. Should that really be the case, the taxpayer can lodge a formal objection as well as a complaint against the unreasonable judgment.

Another example of unreasonable judgment is: Say, a taxpayer has ceased his business two years ago but has failed to report that to the IRD or file a tax return. As a result, the assessor issued an estimated assessment to the taxpayer to assess the profits for the years of assessment after the cessation of the business. These estimated assessments are invalid because of no trading in those years. Of course, the taxpayer must, in accordance with the law, inform the Revenue within one month of the business cessation. If he fails to do so, the taxpayer is liable to a penalty. But his

failure doesn't make the assessor's unreasonable judgment valid.

Power to make estimated assessments

Normally, the assessor's judgment is based on a tax return. But if the taxpayer fails to file a tax return within the time limit, the assessor can make an estimated assessment according to his judgment. Besides, the assessor can also disregard the taxpayer's tax return and make an estimated assessment based on the information available to him. But in any cases, the assessor must make his judgment honestly and reasonably although he is not legally required to disclose the basis of judgment. Nevertheless, the taxpayer can access to the information on which the judgment is made by invoking The Code On Access To Information.

Although the Revenue is not obliged to disclose how the judgment is made, the assessor must exercise his judgment honestly. In the case *Mok Tsze Fung versus CIR*, HKTC 166, the judge said, "So long as the assessor, or Commissioner, does not act capriciously or dishonestly, his assessment, being made according to his judgment, cannot be disturbed except upon the taxpayer bearing and discharging the onus of proof."

Validity of assessments

A notice of assessment must state clearly the identity of the taxpayer, the address at which the assessment is to be delivered, the charging head of the taxes, the income assessed, the tax payable and the due date for tax payment. It must also contain the name of the Commissioner and be duly served to the taxpayer either by personal delivery or by post to the taxpayer's last known address. The last known address may be his home address, his workplace, his business premises or the subject property in the case of a property tax assessment. If the assessment is sent by post, it is deemed to be served on the working day following the day of the postal delivery. In the case of *Charles C. Y. Cheng versus CIR*, HKTC 1087, the delivery of a penalty assessment to the taxpayer's last known address was held to be invalid because

the taxpayer had already informed the Department of his overseas emigration.

Burden of proof

If an assessment is made by an assessor honestly and the taxpayer disagrees with the assessment, the taxpayer will have to lodge an objection in accordance with section 64. To substantiate his objection, the taxpayer must adduce evidence to prove that the assessment is either incorrect or excessive. This burden of proof on the taxpayer is stipulated in Section 68(4) --- Indeed it is heavy.

A tax dispute (other than a prosecution) is a civil proceeding --- and so the degree of proof required is on "a balance of probabilities" under civil law. The criminal degree of proof, namely "beyond reasonable doubt", has no place in determining tax objections.

On the other hand, a prosecution of tax evasion is a criminal proceeding. In such case, the degree of proof is "beyond reasonable doubt" which is much more stringent than "on a balance of probabilities" as required in an objection case. To put it simply, a crime is an offence against the public at large and the penalty on conviction includes imprisonment. Before taking criminal prosecutions, the Revenue must collect sufficient evidence to prove that the taxpayer had a guilty mind and he deliberately committed an offence (for example cheating the IRD by false information) beyond reasonable doubts. Because of the heavy burden of proof on the Revenue for a criminal prosecution, there are just a few prosecution cases of tax evasion every year. In practice, instead of taking criminal prosecution, the Revenue is inclined to impose a Section 82A penalty on the tax offender. If the taxpayer disagrees to the Section 82A penalty, he can appeal to the Board of Review.

The three basic rules of interpretation

There are three basic rules of interpretation of tax law, namely The Literal Rule, The Golden Rule and The Mischief Rule.

The Literal Rule

Words must be given their literal, grammatical meaning. Words in old statutes are given the meaning they had when it was enacted. Words appearing more than once in the same Ordinance must usually be given the same meaning. The duty of court is to interpret the words that the legislature has used. If a statute so interpreted is clear but produces hardship, the remedy is a new statute; it is not the duty of a judge to fill in the gaps.

The Golden Rule

Words should be construed in their grammatical and ordinary sense. In the case *Becke versus Smith* 1836, the judge said: "It is very useful in the construction of a statute to adhere to the ordinary meaning of the words used, and to the grammatical construction, unless that is at variance with the intention of the legislature to be repugnant, in which case the language may be varied or modified so as to avoid such inconvenience, but no further". In other words, words should not be construed out of its context; nor should their meaning be twisted to fit in a peculiar situation.

The Mischief Rule

The court should look at the mischief for which the Ordinance is to remedy. This rule may be adopted in considering a relief or an exemption: That is to look at the true intent of the legislation: What relief or exemption is to be granted by the legislation? This rule of interpretation was adopted in an Estate Duty case, *Foo Ying v Commissioner of Estate Duty* 3 HKTC 363, which concerned Quick Succession Relief. This rule only works for a tax relief or an exemption; it does not apply to a legislation imposing a duty or a charge.

No equity in tax law

There is no equity in the interpretation of tax law. In the case *Wong Tai Wai David versus CIR* (HCIA 2/2003, BOR Vol. 18, page 510) this is said: "Tax is essentially a liability created by statute. By nature, any tax statute is inequitable in the wide sense of the word. It takes away what a person has earned by his sweat and labour and puts it in general revenue for purposes, many of which have no interest or concern to the taxpayer, such as making welfare payments to the unemployed, providing subsidised housing to a section of the general public and funding litigation for those who cannot afford it. There could be an endless list of such purposes which are of no interest to the taxpayer. Yet he has to provide funds for those purposes with the tax he pays. Thus there is no equity about a tax, as by nature it is 'inequitable' in that it takes away what one has earned by his sweat and labour. It is therefore a contradiction in terms to say that a taxing statute should be construed 'equitably'. Since a taxing statute purports to deprive a person of what he has, it should be construed restrictively so that a person would only be taxed if he is caught within the letter of the law. Apart from that, there is no room for giving any taxing statute an 'equitable construction' as suggested by the Appellants. Thus, in interpreting a taxing statute, one just looks at what the statute clearly said. Nothing is to be read in, nothing is to be implied. One just look fairly at the language used. Indeed, Lord Cairns LC had this to say in *Partington v A-G* (1869) LR 4 HL 100 at 122: 'If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.' "

A summary of interpretation of tax law

A good summary of interpretation of tax law was given in the case *Mangin versus IRC* [1971] (739): "First, the words are to be given their ordinary meaning. They are not to be given some other meaning simply because their object is to frustrate legitimate tax avoidance devices... Moral precepts are not applicable to the interpretation of Revenue Statutes... Secondly, one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can look fairly at the language used ... Thirdly, the object of the construction of a statute being to ascertain the will of the legislature it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted."

Rights to objection and appeal

The Assessor has the power to make an honest and reasonable assessment according to his judgment. On the other hand, the taxpayer, if he thinks he is aggrieved by the assessment, has the right to objection and appeal. The conditions for a valid objection are simple: (1) It is in writing (2) It is made within one month of the assessment and (3) It states the grounds of objection.

As for condition (1), the objection notice must be signed by the taxpayer or his representative. As for condition (2), if the delay is due to the taxpayer's non-receipt of the assessment, the taxpayer's late objection will normally be accepted by the IRD. As for (3), a ground of objection means a reason for the objection: In practice, the taxpayer stating that the assessable income excessive will be a good and sufficient ground of objection.

If the Commissioner of Inland Revenue (CIR) does not allow or

cannot settle a taxpayer's objection, he will issue a determination. Then, if the taxpayer disagrees, he can lodge an appeal to the Board of Review. The appeal must be made within one month after the CIR's determination and set out the grounds of appeal. Besides, the appellant should send a copy of such grounds to the CIR.

The Board of Review is part of the judicial system for hearing tax appeals. It is an independent body comprising legal experts and prominent public figures appointed by the Chief Executive. The Board hearings are informal as compared with court hearings. The taxpayers can appear in person without legal representatives. This makes the appeals affordable to most taxpayers. In fact, because of the low costs involved, many taxpayers disagreeing with the CIR's determinations will appeal to the Board and so there are a lot of cases heard by the Board every year. In order to deter taxpayers from lodging vexatious or trivial appeals, the Board may impose a fee not exceeding HK\$5,000 on the appellant taxpayer. The facts found by the Board are final and cannot be appealed to court; but both parties can ask the Board to refer the case to High Court on a point of law. Legally speaking, a point of law includes one involving a mixture of law and facts. Selected Board hearings are published periodically with the identity of the taxpayers concealed. As a common law principle, the judgment of a Board case serves a judicial precedent: It will be followed in subsequent cases on similar issues.

Although a taxpayer disagreeing with the Board's decision can appeal to the court, it is generally not advisable for him to do so in view of the very high legal cost involved unless he is rich and has very good chance to win and the tax in dispute is substantial.

1.8 Advance tax ruling

A person can ask the Revenue to make a tax ruling on a transaction which he is going to do upon payment of a fee. But according to the Revenue's published practice note, the Revenue

will not make a tax ruling on the followings:

- Prosecution
- Tax penalty
- Tax recovery action
- The correctness of a tax return
- To determine or establish a question of facts --- for example to rule on whether a trade is carried on or whether a sale of asset is taxable
- The ruling requires the Revenue to make assumption on a future event
- Any matter being processed under the objection procedures
- Any matter in a tax return which has been already filed with the Revenue
- Any matter concerning the interpretation of a generally accepted accounting principle or a commercial practice
- Any matter involving the interpretation of a foreign law
- The Revenue opines that the matter is not seriously contemplated by the taxpayer
- The Revenue opines that the matter is frivolous or vexatious
- The Revenue opines that the taxpayer has not provided all the relevant information
- The Revenue opines that the matter requires excessive resources
- Any matter being a subject of the Revenue's tax audit or tax investigation

The application must be made in a specified form and supported by the specified information and documents. The initial application fee is \$30,000 for a ruling on source of profits under Section 14 and \$10,000 for all other cases. The Revenue may ask the applicant to pay more if the case requires more time than a usual case.

The Revenue may withdraw its ruling at any time. Of course, when the ruling is withdrawn, the application fee will be repaid to the applicant. Besides, if there is a new legislation or a new court case on similar matter, the ruling will become obsolete. But

in that case, there will be no refund of the application fee.

The Revenue pledges to respond to an application of ruling within 6 weeks. But the response may just be a request for further information or a clarification on certain facts.

1.9 Tax recovery

The Revenue may take legal actions against a tax defaulter (a person who fails to pay tax). In addition to the tax and the surcharge, the defaulter is also liable to pay court fee \$630, cost of writ \$300 and interest on the judgment sum from commencement of proceedings to full payment. The Revenue may also issue recovery notices to third parties who owe money to the defaulter, requiring them to pay the outstanding tax. Such third parties include the defaulter's employers, banks, or debtors. Besides, the Revenue may also apply to court for a Departure Prevention Direction to stop the defaulter from leaving Hong Kong.

Installment payments of tax

The Revenue may accept payment of tax by installments. But beware of the high cost involved: The Revenue will charge you surcharge and interest which may cost more than the prevailing market interest rates.

How to pay tax

Tax can be paid in cash, by cheque at post offices, by mailing of cheques to IRD or by electronic means:

1. By phone: Taxpayers can phone 18011 for registration and then 18031 for payment. The merchant code of the IRD is 10.
2. By ATM: Taxpayers can use Automatic Teller Machines to pay tax.
3. Via internet: Taxpayers can visit IRD's web site for details.

4. By mailing a cheque to IRD at P.O. Box 28282, Gloucester Road Post Office, Hong Kong.
5. By payment of cash or cheque at post offices.

The taxpayer may also purchase electronic Tax Reserve Certificates to cover his tax liabilities.

IRD's usual tax-recovery procedures

Payment in default is deemed to take place at the close of business on the "due date". Then, several days later, a standard notice of surcharge of 5% on unpaid tax will be issued by the IRD computer to the defaulter, requiring full payment within 10 days of the notice. Then, if tax is still unpaid, the IRD will send recovery notice to a third party including the defaulter's bank, employer or debtor. Then, if tax still cannot be recovered, the Revenue may take legal proceedings against the defaulter to enforce payment.

If tax is unpaid for more than 6 months, a further 10% surcharge will be added to the unpaid amount.

If the outstanding tax is confirmed by the court, it will then become a judgment debt. If it still remains unpaid, execution may be levied on the defaulter's movable property or a charging order be applied against his immovable property. In some cases, bankruptcy proceedings may also be taken against the defaulter.

Where the first instalment of provisional tax is in default, the second instalment tax will become immediately due and recoverable.

1.10 Double taxation relief

Double taxation means the same income is subject to the tax of Hong Kong as well as to the tax of a jurisdiction outside Hong Kong. Double taxation relief (DTR) is a relief granted to certain taxpayers suffering from double taxation. The relief is usually

provided by the various Double Taxation Agreements (DTA) signed by the HKSAR Government with other tax jurisdictions. Among them, the most important one concerning taxpayers is the one made between Hong Kong and mainland China.

Indeed, because of the very restrictive conditions of the DTA, most taxpayers suffering from double taxation cannot benefit from the agreements. In fact, the taxpayers getting the tax relief under the DTAs are mostly the big transportation companies, such as airline and shipping corporations which have substantial operations in and out of Hong Kong. Generally speaking, the DTAs are of little practical value to a common taxpayer, even though he has paid overseas tax.

For a salaried taxpayer, if he has paid overseas income tax, he should first seek a total exemption of the relevant income on the grounds of no services in Hong Kong or visiting Hong Kong for not more than 60 days, and if such exemption is inapplicable, then he should apply for the tax exemption under section 8(1A)(c) to exclude the relevant income from the chargeable income.

For a business taxpayer, if he has made profits from overseas activities, he should first seek to exclude such profits from the charge under section 14 under the “operation test”. See Chapter 3, paragraph 3.8.

Tax credit under DTA with mainland China

According to the DTA, tax credit is granted to two kinds of mainland's taxes: (a) Individual Income Tax and (b) Foreign Enterprises Income Tax. In brief, if a taxpayer is a Hong Kong resident and has paid Hong Kong and mainland tax on the same income, he may apply for a tax credit to reduce his Hong Kong tax payable. In the event that the income is not taxable in Hong Kong, no tax credit will be granted.

Since Hong Kong adopts territorial taxation principle, the income derived from mainland is generally not taxable. On the other

hand, the Mainland only imposes tax on a person, including an enterprise, if he has a permanent establishment in mainland and derives profits attributable to that permanent establishment. Therefore, generally speaking, double taxation seldom occurs.

Nevertheless, a taxpayer should claim tax-credit under the DTA in the following situations:

1. The taxpayer pays income tax of Hong Kong and mainland on the same income.
2. Where the taxpayer pays Salaries Tax, he is not entitled to Section 8(1A)(c) exemption or the tax reduction under Section 8(1A)(c) is less than that under tax-credit computation. This situation is almost impossible for a salaried employee but it may nevertheless occur for a company director being an office holder.
3. Where the taxpayer pays Profits Tax, the income attributable to mainland's operation is not excluded by the operation test or by the 50:50 apportionment. Since mainland China does not impose tax on a business unless it has a permanent place of business there, this hardly happens.

Where double taxation relief is applicable, the taxpayer should make the claim in his tax return and then the IRD will compute the tax credit with a computer program.

Exemption from China's income tax

Apart from applying for tax credit to reduce his Hong Kong tax, a Hong Kong resident working in mainland China can also enjoy the benefits under the DTA to reduce or exempt his China's income tax. Such benefits include: (a) Only his income attributable to services rendered in the mainland is chargeable to Individual Income Tax and (b) He will be exempt from the Individual Income Tax if all the following conditions are satisfied.

1. The Hong Kong resident stays in China not exceeding 183

- days in the calendar year concerned (It should be noted when counting the 183 days, both the days of arrival and departure are taken as one whole day respectively); and
2. The income is paid by, or on behalf of, an employer who is not a resident of China; and
 3. The income is not borne by a permanent establishment or a fixed base which the employer has in China.

A Hong Kong resident may be required by the mainland tax authorities to produce a "Certificate of Hong Kong Resident Status" to prove his Hong Kong resident status. The certificate is issued by the IRD free of charge upon application. To apply for the certificate, the person should first obtain a referral letter from the mainland tax authorities stating such requirement and then he should lodge an application with the Double Taxation Section of IRD.

As for the benefit (a), the income for the services rendered in mainland China is usually computed by time apportionment. The time apportionment is usually done by multiplying the relevant income with the number of days in mainland China over 365 days in the relevant calendar year (from 1 Jan to 31 Dec). When counting the number of days of a period in China, the day of entering and leaving China are counted as one whole day. If he is also assessed under Hong Kong salaries tax on time apportionment, his day of arrival in Hong Kong or day of departure from Hong Kong may also be counted as half day each for salaries tax assessment. In case these tax assessments of Hong Kong and China gives double assessment of same income, the taxpayer can ask Hong Kong IRD to raise the issue with the China tax authority. Where he stays in China for less than 183 days, the relevant income for the time apportionment will be his income paid by the China establishment. But where the person stays in China for more than 183 days, the relevant income for the time apportionment will be the total income received by the person from the China establishment plus his income from the associated establishment outside China.

How double taxation relief applies to profits tax

As far as Hong Kong profits tax is concerned, Section 14 of Inland Revenue Ordinance stipulates that only profits arising in or derived from Hong Kong is taxable. Besides, for manufacturers operating across the border, their taxable profits are generally apportioned on 50:50. Besides, Section 16 permits deduction for mainland's / foreign taxes paid in the production of the assessable profits. In fact, all these measures make the double taxation relief practically useless. This is because the tax benefits under these measures generally exceed that available under Double Tax Relief (DTR).

The taxes that may be claimed as tax credit are: Corporate Income Tax and Foreign Enterprises Income Tax (企業 CIT 或外國企業所得稅 FEIT). However, CIT or FEIT paid on sources of income that are not covered by the Arrangement are not creditable --- such non-creditable taxes include the tax on passive income like interest, royalties and dividends. Only tax on profits from a permanent establishment (PE) in mainland is creditable. Where services are rendered in mainland without a PE, the income may still be subject to CIT or FEIT in mainland but the CIT or FEIT will not be creditable in Hong Kong.

To get the tax relief, the taxpayer must prove that an income specified in Article 1, 2 or 3 of the Double Taxation Arrangement has been taxed in mainland and that there is double taxation on the income because Hong Kong also imposes tax on that income.

Where a double taxation relief involves offshore profits claim, the tax set off can only apply to the profits taxed in Hong Kong. For manufacturing businesses taxed on a 50:50 apportionment, paragraph 48 of DIPN 32 says: "However, if income derived by a Hong Kong resident from the Mainland does not arise from Hong Kong it will not be chargeable to tax in Hong Kong. No tax credit will be allowed as the question of double taxation does not

arise. In the case of a Hong Kong manufacturer whose profits are apportioned on 50:50 basis, only half of the profits will be taxed in Hong Kong. The other half is regarded as having been derived from the Mainland thus not chargeable to tax in Hong Kong. Under such circumstances, where tax has been paid in the Mainland in respect of half or less than half of the profits, such tax shall not be allowed as a credit against Hong Kong tax payable. If more than one half of the profits are regarded by the Mainland as profits derived therefrom then the tax paid in the Mainland in respect of such profits, in excess of one half of the total profits, will be allowed as a credit against the tax payable in Hong Kong."

In fact, even if DTR is to apply --- in that case the mainland-sourced income must be brought into the Hong Kong tax computation --- the tax credit in respect of the mainland tax is restricted to the hypothetical Hong Kong tax payable in respect of the hypothetical mainland-sourced income, i.e. $\text{maximum tax credit} = \text{H. K. effective tax rate} \times \text{Mainland's income after mainland tax} / (1 - \text{H. K. effective tax rate})$. In effect, the restriction of tax credit makes Double Taxation Relief less favorable than the offshore claim for excluding the whole offshore profits from assessable profits. In computing the Hong Kong tax, the mainland tax payment not yet allowed as tax credit is allowable as a deduction from the assessable income.

An example showing how to compute DTR under Profits Tax

Mr. Chan was a sole-proprietor of a Hong Kong business operating between Hong Kong and mainland China. During 2004/05, he stayed in Hong Kong and Mainland for 80 and 285 days respectively. His total profit for 2004/05 was HK\$2,600,000. According to the Mainland's tax bills, he paid FEIT at RMB51,000 (equivalent to HK\$50,000) on Mainland's earnings of RMB200,000 (equivalent to HK\$190,000).

Year of assessment 2004/05

Computation of Hong Kong effective tax rate:

Profits tax payable on 2,600,000 at 16% is 416,000.

Effective HK tax rate: 0.16

Computation of maximum tax credit:

H. K. effective tax rate * mainland's income after mainland tax /

(1 - H. K. effective tax rate) = $0.16 * 140,000 / (1 - 0.16) =$

26,667

Mainland's tax not allowed as tax credit

= Mainland tax paid – maximum tax credit

= 50,000 – 26,667 = 23,333

Computation of Profits Tax payable under DTR:

Total profits: 2,600,000

Less: Mainland's tax not allowed as tax credit: 23,333

Adjusted profits: 2,576,667

Profits tax payable on adjusted income: 412,266

Less: tax credit 26,667

Adjusted profits tax payable under DTR: 385,599

As section 14 of Inland Revenue Ordinance assesses profits with a Hong Kong source only, therefore, if Mr. Chan claims offshore exemption successfully, his assessable profits will be reduced to 2,410,000 (i.e. 2,600,000 – 190,000) and his profits tax will be reduced to 385,600. So, Mr. Chan is advised to examine his case for a total exclusion of the offshore profits under section 14 before he seek relief from double taxation relief under section 50.

How double taxation relief affects Salaries Tax

As far as Hong Kong salaries tax is concerned, a much greater tax relief is already given under Section 8(1A)(c) of Inland Revenue Ordinance which is to exempt the income derived from non-Hong Kong services on which foreign income tax has been paid. Because the tax benefit under double taxation relief is

normally less than that under Section 8(1A)(c) exemption, DTR is almost useless.

Even if DTR is to apply -- in such case the mainland-sourced income must be brought into the Hong Kong tax computation -- the tax credit in respect of the mainland tax is restricted to the hypothetical Hong Kong tax payable in respect of the hypothetical mainland-sourced income, i.e. maximum tax credit = H. K. effective tax rate x Mainland's income after mainland tax / (1 - H. K. effective tax rate). In effect, the restriction makes Double Taxation Relief less favourable than Section 8(1A)(c).

In computing the Hong Kong tax, the mainland tax payment not yet allowed as tax credit is allowable as a deduction from the assessable income.

Author's advice: An employee working both in Hong Kong and mainland China should seek relief under Section 8(1A)(c) exemption. If he works only in mainland China, he should seek full exemption of Salaries Tax.

An example showing how to compute DTR under Salaries Tax

Mr. Heung, a Hong Kong singleton, was employed by a Hong Kong company. His duties include working in Hong Kong and mainland China. During 2004/05, he stayed in Hong Kong and Mainland for 100 and 265 days respectively. His total remuneration for 2004/05 was HK\$600,000. According to the Mainland's tax bills, he paid Individual Income Tax RMB61,000 (equivalent to HK\$60,000) on Mainland's income RMB300,000 (equivalent to HK\$290,000).

Year of assessment 2004/05

Computation of Hong Kong effective tax rate:

Salaries tax payable by Mr. Heung on 600,000 is 89,200.

Effective HK tax rate: $89,200 / 600,000 = 0.1486$ (or 14.86%)

Computation of maximum tax credit:

H. K. effective tax rate x Mainland's income after mainland tax /
(1 - H. K. effective tax rate) = $0.1486 * 230,000 / (1 - 0.1486) = 40,143$

Mainland's tax not allowed as tax credit

= Mainland tax paid – maximum tax credit

= $60,000 - 40,143 = 19,857$

Computation of Salaries Tax payable under DTR:

Total employment income: 600,000

Less: Mainland's tax not allowed as tax credit: 19,857

Adjusted income: 580,143

Salaries tax payable on adjusted income: 85,228

Less: tax credit 40,143

Adjusted salaries tax payable under DTR: 45,085

Computation of Salaries Tax payable under Section 8(1A)(c) relief:

Salaries tax payable by Mr. Heung on 310,000 (i.e. $600,000 - 290,000$) is 31,200.

In this case, it is advisable for Mr. Heung to apply for relief under Section 8(1A)(c) because the tax payable is lower.

1.11 Tax avoidance and tax evasion

Tax avoidance is legal but tax evasion is illegal. The distinction between tax avoidance and tax evasion is well established by case law. The leading case is *IRC v Duke of Westminster* [1936] AC 1 in which the basic principle is spelled out: Every person can arrange his affairs lawfully so as to reduce his tax payable. Some people called this basic principle as "form over substance" --- that means: It is the form of the arrangements done that should be based for determining the tax payable, and not the substance or the intendment of the transactions should be taxed. This basic principle lays the legal foundation for tax planning (sometimes it is called tax mitigation or tax avoidance).

Given the aforesaid principle, if a taxpayer arranges his affairs in such a way that they do not fall within any of the charging provisions of the tax law, he will pay no tax at all. As more and more people are using blatant schemes to avoid tax, the courts have introduced another famous tax principle, namely the fiscal-nullity principle. In this respect, the leading ones are *W T Ramsay Ltd. v IRC* and *Furniss v Dawson*. Under this principle, the courts will look to the end result or the substance of the transactions when determining the tax charge.

However, it is widely believed that the fiscal-nullity principle does not apply to the taxes under the Hong Kong IRO. This is because the courts have all along ruling that the fiscal nullity or Ramsay principle only applies where there are no specific anti-avoidance provisions in the relevant tax law. As there are a number of anti-avoidance provisions in the Hong Kong IRO, the fiscal nullity principle is likely regarded as inapplicable. But caution: The principle can still apply to Stamp Duty and Estate Duty as the relevant laws does not contain anti-avoidance provisions.

Although tax avoidance is undesirable to the Revenue or immoral to some people including judges, it does not constitute a criminal offence. But on the other hand, if the taxpayer reduces his tax payable by cheating the Revenue with false information or lies --- for example he claims an expense which does not exist at all or he omits to disclose a taxable income --- he will be guilty of tax evasion. Tax evasion is a crime that can render the taxpayer to very heavy punishment including imprisonment.

At times, the Revenue sees tax avoidance and tax evasion very different from a common taxpayer and his tax advisers. And that's why there are many tax avoidance cases going to the courts. Sometimes, the courts find that the scheme works and let the taxpayer go. But in some other cases, the courts rule in favor of the Revenue, declaring the scheme a sham.

From time to time, the Revenue warns that there is no single hard and fast rule to distinguish tax evasion from tax avoidance. Nevertheless, it points out that in general transactions that are artificial or fictitious likely lead to penal actions. As regards the transactions with a sole or dominant purpose to avoid tax (i.e. the Section 61A cases), the Revenue's published stance is: Those schemes, which are not properly structured, or not adequately supported by evidence or not genuinely effected, constitute a tax evasion. The Revenue also says that a transaction executed as part of an arrangement is real may not necessarily make that the total arrangement real or legal.

In my IRD experience, the distinction between tax avoidance and tax evasion is not clear. In fact, all cases fall somewhere in a continuous spectrum from full honest disclosure to fraudulent concealment. There are a lot of disputes from time to time between the taxpayer and the Revenue as to where the case lies in the spectrum. If the Revenue opines that the case is a fraudulent tax evasion, then criminal prosecution will be taken against the taxpayer, and if the prosecution is convicted, the sentence may be imprisonment plus a heavy monetary fine.

Indeed, from case law, a blatant and ineffective tax avoidance scheme can give rise to a criminal offence: the cheating of public revenue under common law. Cheating the Revenue was defined in a U.K. court case *R v Mavji* [1986] STC 508: It includes any form of fraudulent conduct which results in diverting money from the Revenue and in depriving the Revenue of money to which it is entitled. Unlike the tax penalties under IRO which are limited, the penalty on conviction of cheating the Revenue under common law is without limit --- it is, of course, at the discretion of the judge.

In law, a fraudulent act requires some element of dishonesty by the accused. In a criminal proceeding, the test for dishonesty, as laid down in the case of *R v Ghosh* [1982] 1 QB 1053, is defined as: (a) Was the act of the accused dishonest by the standards of reasonable and honest people? and (b) Did the accused realize

that his act would be regarded as dishonest by reasonable and honest people?

In many tax cheating cases, dishonesty is the crucial question in the trial. In the absence of a clear distinction between legal tax avoidance and illegal tax evasion, the court may look at the intention of the scheme. Unquestionably a tax avoidance scheme is to reduce tax and so, in some cases, the courts are inclined to regard the tax avoidance as immoral and dishonest and rule against the taxpayers.

A criminal prosecution of tax evasion takes the Revenue a lot of time and effort to gather sufficient evidence to prove the offence and the guilty mind beyond reasonable doubt. So, that is why there are just a few prosecutions every year. Before taking a prosecution, the Revenue will seek advice from the Legal Department. In general, the more concrete evidence collected, the more likely is the prosecution. Because most tax evaders are extremely cunning: They receive their revenue mostly in cash and then spend it without routing through a bank, the Revenue hardly gets the evidence to prove the understated profit, not to say to prove the criminal tax evasion. So, although it is widely believed that there are a lot of wealthy businessmen evading tax in Hong Kong, there are only a few prosecutions against them. In fact, most prosecutions of tax evasion are small and simple cases involving salaried taxpayers for such offence as false claims of dependent parent allowance, elderly residential care expenses, housing benefit... etc.

Ramsay and Furniss principles

The principles are sometimes used by the Revenue to combat tax avoidance. They have been established in a number of cases. A recent one concerning Hong Kong tax is *The Collector Of Stamp Revenue v Arrow Town Assets Ltd.*

The point at issue in this case is whether or not a memorandum of agreement executed for transferring an immovable property is

assessable to Stamp Duty. The Final Court of Appeal unanimously ruled in favour of the Collector by virtue of Ramsay principle.

This case is important because of the judges' analysis of the Ramsay principle. Below is my summary of what the judges said.

Mr Justice Bokhary:

"In this case the Collector of Stamp Revenue advances three discrete grounds in support of his claim to stamp duty... The third ground is the one based on the approach that takes its name from the decision of the House of Lords in *WT Ramsay Ltd v. IRC* [1982] AC 300... I take the view that the Collector's third ground is well-founded so that his claim to stamp duty succeeds upon a correct application of the Ramsay approach to the circumstances of this case. Accordingly I too would allow the appeal to uphold that claim with costs here and below."

Mr Justice Chan:

"The principle enunciated in *Ramsay* is 'both a rule of statutory construction applicable to revenue statutes and an approach to the analysis of the facts': Sir Anthony Mason NPJ in *Shiu Wing Ltd & others v. Commissioner of Estate Duty* (2000) 3 HKCFAR 215 at 239I. What this principle entails, as elaborated and developed in subsequent cases, is this: when faced with a tax avoidance scheme, the court's task is to ascertain the nature of the transaction or composite transactions in question and the true meaning of the relevant statutory provision having regard to the purpose and intention of the legislation and then apply it to the facts of the case, not taking into account any steps in the transactions which have no commercial purpose other than to avoid tax. The court adopts a purposive construction on the tax legislation and applies it to the end result of the transactions."

Mr Justice Ribeiro:

"The Ramsay principle is both a rule of statutory construction and an approach to the analysis of the facts. The aim of the tax-avoidance scheme in Ramsay was to create an allowable loss for the taxpayer as part of a wider plan which involved the cancelling out of that loss by a non-taxable gain. Lord Wilberforce, giving the principal speech, focussed primarily on the proper factual approach to such transactions:

'If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded: to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.'

As to the particular self-cancelling schemes with which the House of Lords was faced, his Lordship stated: "On these facts it would be quite wrong, and a faulty analysis, to pick out, and stop at, the one step in the combination which produced the loss, that being entirely dependent upon, and merely, a reflection of the gain. The true view, regarding the scheme as a whole, is to find that there was neither gain nor loss, and I so conclude."

Treating such a loss and such a gain as "self-cancelling," necessarily involved an exercise in statutory interpretation, indeed, an exercise of purposive statutory interpretation. If the loss-producing transaction in the scheme were taken alone, it would, falling within the literal words of the statute, attract the tax consequence of being an allowable loss. It would not be "cancelled out" fiscally by the scheme gain since that gain, again if taken alone would, on a literal interpretation, be non-taxable.

Therefore, when in Ramsay, the House of Lords regarded the loss and gain as "self-cancelling," viewing them as part of a larger, composite transaction, this necessarily implied that as a matter of statutory construction, the provisions which would otherwise confer the desired tax consequences on the individual transactions were not intended to apply to them in the context of the overall scheme.

Lord Wilberforce acknowledged the need for such purposive interpretation, stating :

'A subject is only to be taxed upon clear words, not upon 'intendment' or upon the 'equity' of an Act. Any taxing Act of Parliament is to be construed in accordance with this principle. What are 'clear words' is to be ascertained upon normal principles: these do not confine the courts to literal interpretation. There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded: see *Inland Revenue Commissioners v Wesleyan and General Assurance Society* (1946) 30 TC11, 16 per Lord Greene MR and *Mangin v Inland Revenue Commissioner* [1971] AC 739, 746, per Lord Donovan.'

Applying such an interpretation to the facts, his Lordship stated:

"To say that a loss (or gain) which appears to arise at one stage in an indivisible process, and which is intended to be and is cancelled out by a later stage, so that at the end of what was bought as, and planned as, a single continuous operation, there is not such a loss (or gain) as the legislation is dealing with, is in my opinion well and indeed essentially within the judicial function.'

Another way of describing the House of Lords' approach to statutory interpretation in Ramsay is to say that, applying a purposive interpretation, their Lordships disregarded for fiscal purposes the self-cancelling intermediate steps and applied the

legislative provisions instead to the scheme viewed as a composite whole.

This was effectively Lord Diplock's approach in *IRC v Burmah Oil Co Ltd* [1982] STC 30, a case also involving a planned series of self-cancelling transactions, this time aimed at converting a non-allowable loss into a loss that would be deductible for capital gains purposes. Lord Diplock stated : "It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax-avoidance schemes to assume, that *Ramsay's* case did not mark a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transaction (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable. The approach to tax avoidance schemes of this character sanctioned by *Ramsay* entitles your Lordships to ignore the intermediate circular book entries and to look at the end result ..."

It may be noted that Lord Diplock, in referring to the circular and self-cancelling book entries, spoke in more general terms of schemes involving the insertion of "steps that have no commercial purpose apart from the avoidance of a liability to tax." While this expression is apt to describe the self-cancelling transactions in question, it is plainly of a wider import. This was seized upon in *Furniss v Dawson* [1984] AC 474, where the tax-deferment scheme in question did not involve self-cancelling transactions.

In *Furniss v Dawson*, the Dawson family wished to sell the whole of the issued capital of two operating companies to an outside purchaser called Wood Bastow Holdings Ltd. They embarked upon a scheme which essentially involved incorporating and interposing a Manx company called Greenjacket Investments Ltd between themselves and Wood Bastow, followed by an exchange of their shares in the operating

companies for the issue of shares in Greenjacket and the on-sale of those operating company shares by Greenjacket to Wood Bastow for cash. The object of this scheme was to defer liability for capital gains tax which was charged on capital gains accruing on the disposal of assets. It relied on paragraphs 4(2) and 6(1) of Schedule 7 to the Finance Act 1965 which deemed there to be no disposal in cases of company amalgamations, that is, where a company's shares were transferred to another company which thereby acquired control of the first company in exchange for shares in the transferee company. The scheme's contention was accordingly that the share exchange between the Dawsons and Greenjacket led to the latter obtaining control of the former and therefore was deemed by those paragraphs of Schedule 7 not to involve a taxable disposal of the operating company shares. It would follow that any charge to capital gains tax would be deferred until such time as the taxpayers disposed of their shareholdings in Greenjacket realising a chargeable gain.

The House of Lords decided that the Ramsay principle was not confined to self-cancelling transactions and, applying it to the scheme, held: 'The result of correctly applying the Ramsay principle to the facts of this case is that there was a disposal by the Dawsons in favour of Wood Bastow in consideration of a sum of money paid with the concurrence of the Dawsons to Greenjacket. Capital gains tax is payable accordingly.' "

Lord Millett :

"Ramsay was followed and applied by the House of Lords in *IRC v. Burmah Oil Co. Ltd* [1982] STC 30. This also concerned a circular and self-cancelling transaction which was entered into for the sole purpose of obtaining tax relief. In this case it was designed to convert a bad debt into an allowable loss. At pp.32-33 Lord Diplock described the case before the House as concerning 'a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the

absence of those particular steps would have been payable ... The approach to tax avoidance schemes of this character sanctioned by Ramsay entitles your Lordships to ignore the intermediate circular book entries and to look at the end result ...' "

1.11 Anti-avoidance provisions in the IRO

Since criminal prosecutions are difficult to succeed, the Revenue relies more often on the anti-avoidance provisions in the IRO to counteract the tax benefits of a tax avoidance scheme. The anti-avoidance provisions are as follows.

1. Section 61: The assessor may disregard any transaction that is artificial or fictitious, or any disposition that is not given effect to.
2. Section 61A: It applies to any transaction having the sole or dominant purpose of enabling a person to obtain a tax benefit. This section empowers the Revenue to make an assessment as if the transaction had not been carried out or in such manner as to counteract the tax benefit.
3. Section 61B: It is to restrict the trafficking in loss companies for tax avoidance. To avoid tax, a profitable company buys a company with accumulated tax losses, and then it injects profitable business into the loss company to absorb the losses. This section empowers the Revenue to deny setting off the losses brought forward if it is satisfied that the sole or dominant purpose of the purchase is to obtain a tax benefit.
4. Section 9A: It is to combat tax avoidance scheme in which an employee disguised himself as an independent service provider.
5. DIPN 24 (this is an administrative pronouncement only): It is to restrict deduction for management fee paid to a related company. The legal backing for the pronouncement is Section 16 that grants deduction to an expense only to the extent it is incurred in the production of assessable profits and Section 61 and 61A that concerns tax-avoidance schemes.

6. Section 20: It is to combat tax avoidance scheme involving pricing arrangements with non-residents.
7. Section 16(2): It is to combat tax avoidance involving payment of interest.
8. Section 39E: It is to deny depreciation allowance on plant and machinery under certain lease arrangements including sale and lease back.

Section 61

The Revenue may disregard certain transactions which are artificial or fictitious or not given effect thereto and then, to assess the taxpayer as if there had been no such transactions. Of course, it concerns only those transactions which have reduced tax. There are a number of tax cases on this issue. Below are some important ones.

Rico Internationale Limited v. CIR

In this case, certain payments of commissions were held to be artificial and fictitious. This was because no work had been done for the so-called transactions. In other words, transactions would be a sham and could therefore be disregarded if they were not carried out.

Kum Hing Land Investment Company Limited v. CIR

The company claimed a deduction of commission which was paid to a related company. CIR disallowed the deduction by Section 61. It was held that "transaction" included the whole of any particular transaction, and not merely part of it. CIR, therefore, lost the case. The court said that "transaction" was not just the payment and receipt of the commission but also covered the process from the inception of the idea to pay commission up to the final completion of the service. This implies that for a tax efficient scheme to withstand the challenge of Section 61, all the steps within the scheme must be genuine, of commercial substance and carried out. Otherwise, it is vulnerable to be disregarded by the court upon IRD's challenge.

In that case, the undesirable consequences, such as the legal wrangle and cost, or even penalty, can outweigh the anticipated tax benefit.

Mangin v Inland Revenue Commissioners

In this case, it was held that if there were more than one way to structure his affairs, the taxpayer had the right to choose the more tax efficient way. The court said: "If a bona fide business transaction can be carried through in two ways, one involving less liability to tax than the other, their Lordships do not think that (an anti-avoidance legislation) can properly be invoked to declare the transaction wholly or partly void merely because the way involving less tax is chosen."

Board of Review case D85/02

The taxpayer is a solicitors' firm. It appealed to the Board to pursue its claim for certain management fee paid to its related companies deductible. The Board disallowed the taxpayer's claim and made the following comment: "The deduction of outgoings and expenses is governed by section 16(1) of the IRO: In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period...Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessed accordingly."

CIR v. Douglas Henry Howe

In this case, an author assigned his right to receive royalties worth of \$1,200,000 to an overseas company for \$1. CIR assessed the taxpayer on the royalties, invoking Section 61 to disregard the transaction. The Board found that the transaction

was not commercially unrealistic and so ruled against CIR. CIR appealed to the court. The court dismissed the appeal and said this: “ ‘Artificial’ is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees’ first contention that its use by the draftsman of the subsection is pleonastic, that is, a mere synonym for “fictitious”. A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. ‘Artificial’ as descriptive of a transaction is, in their Lordships’ view a word of wider import. Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed ... Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as ‘artificial’ within the ordinary meaning of that word.”

Author’s comments: In this case, the word ‘artificial’ was construed strictly. It was held that the \$1 consideration for assignment of copyright was not ‘artificial’ within the meaning of section 61. The judge said this in his judgment: “In this situation it does not necessarily follow that the transactions are commercially unrealistic. The overall position remains the same.... Looked at purely from the aspect of gross income the transactions seem unnecessary and unproductive. But the Taxpayer may well have other matters in mind.” Although the judge did not say what “the other matters in mind” were, it made clear that the scope of section 61 was rather limited --- If the tax avoidance transaction could be explained with an ordinary business sense, it should not be disregarded.

Board of Review case D68/90

In the case, the taxpayer claimed a deduction of prepaid interest in respect of a complex series of loan transactions within the group companies. The Board found that there was no serious

intention to carry out the terms of agreements “to the full” and that the interest “was a payment made in discharge of a purely artificial liability which was created in order to achieve a tax advantage”. Therefore, the Board ruled that the loan and interest transactions were artificial.

Board of Review case D32/94

In this case, the Board ruled that the arrangement between a medical practitioner and his service company were be largely fictitious --- it was a sham within the scope of Section 61.

It should be noted that Section 61 only empowers the Revenue to delete the tax-avoidance transaction; it does not enable the Revenue to un-do it so as to levy tax on the “original position”. Because of this defect, Section 61A was enacted.

Section 61A

Section 61A has been enacted to plug the loophole of Section 61. It applies to transactions that are done chiefly for tax avoidance. Section 61 only empowers the Revenue to disregard such transactions whereas Section 61A extends the Revenue's power to make an assessment as if the transaction had not been carried out or in such other manner as the Revenue considers necessary to counter the tax benefit concerned. The tax-avoidance transactions are defined as ones with a sole or dominant purpose of enabling a person to obtain a tax benefit.

As established form case law, tax mitigation is acceptable, although from the Revenue's perspective, undesirable. However, tax avoidance is not acceptable by the Revenue because it seriously undermines the principle of fairness and public's confidence in revenue policy.

Section 61A applies when all the following questions give a “yes” answer.

(1) Was there a transaction?

- (2) Was it done with a sole or dominant purpose of obtaining a tax benefit?
- (3) Was a tax benefit obtained?

Sole or dominant purpose of obtaining a tax benefit

Section 61A(1) says that in deciding the purpose seven matters are to be considered:

1. The manner in which the transaction was entered into or carried out
2. The form and substance of the transaction
3. The result achieved by the transaction
4. Change in the financial position of the subject person
5. Change in the financial position of the other party to the transaction
6. Whether the transaction has created rights and obligations which would not normally be created between persons dealing with each other at arm's length
7. The participation in the transaction of a corporation resident or carrying on business outside Hong Kong

The court's comments on the seven factors

In an Australian tax case *Peabody* 25 ATR 32, this was said: “In arriving at his conclusion, the Commissioner must have regard to each and every one of the seven matters... This does not mean each of those matters must point to the necessary purpose... Some matters may point in the direction and others may point in another direction. It is the evaluation of these matters, alone or in combination, some for, some against ...”

Author's note: The seven matters of the Hong Kong's section 61A follows the Australian law on the same topic.

Besides, in a Hong Kong tax case re *Tai Hing Cotton Mill Development Ltd*, it is held that if the effect of a transaction shows “the tax liability to tax is less than it would have been on some other appropriate hypothesis”, the taxpayer can be regarded

as having obtained a tax benefit. Then, the IRD can adopt the market value to replace the transaction price for profits tax assessment.

Section 61B

Section 61B is to counteract avoidance of tax through purchase and sale of loss companies. See the following example.

A company ABC Ltd. has been making large profits for many years. To avoid profits tax, it paid \$10,000 to buy all the shares of a dormant company which had no valuable assets but accumulated tax losses of \$5,000,000. Then, it changed the name of this dormant company to, say ABC & Co. Ltd., one like its own name, and then injected its own business into the new company. After setting-off all the losses with its own business profits, it had the dormant company wound-up so that all its assets (bank balances) were distributed to ABC as dividends on liquidation. The dividends on liquidation are not taxable under Section 17. The cost of liquidation was \$10,000. By so doing, it avoided to pay tax on \$5,000,000 profits ($\$5,000,000 * 17.5\% = \$875,000$), with a total cost of \$20,000, thus giving a net tax saving of \$855,000.

To deter taxpayers from avoiding tax, Section 61B empowers the Commissioner of Inland Revenue to deny the loss set-off if he is satisfied that the sole or dominant purpose of the change in shareholding of a company was to avoid tax. In that case, the new company ABC & Co. Ltd. has to pay tax on the business profits injected without the loss set-off.

Section 9A

Section 9A is to combat avoidance arrangements involving the use of service companies to disguise what are in substance master-and-servant employment relationships. For more, please read the topic “Employed versus Self-employed” under Chapter 2.12.

DIPN 24 - Management fee paid to a related company

This is an administrative pronouncement of IRD. It is to restrict deduction for management fee paid to a related company. For details, please read the topic “Management Fee” under Chapter 3.34.

1.12 The IRD's performance pledge

The Revenue's performance pledge sets out the standard processing time of tax cases. If your case falls below the standards, you are entitled to an explanation from the Revenue. If you are dissatisfied with their explanation, you can phone their Complaints Officer at 2594 5000. Below is a summary of performance standards pledged by the Revenue.

	Standard Response Time
Reply to written Enquiries	
• Simple matters	7 working days
• Technical matters	21 working days
Processing of objections or allowances claims	
• Acknowledgement of receipt	18 working days
• Notify taxpayers of the Revenue's decision	4 months
Processing of tax hold-over claim	12 working days
Tax Audit and Investigation	
• Completion of audit / investigation	2 years

1.13 Complaints to IRD

If a taxpayer suffers from delay or is improperly or unfairly treated by an officer of IRD, he can lodge a complaint with the Complaints Section. On receiving the complaint, the case will be reviewed by a senior officer of a rank equal to senior assessor or above. The advantages of complaint are as follows.

1. It will speed up finalization of the case. Indeed the more the time of processing, the longer the trouble and the greater torment the taxpayer will suffer from the tax enquiry.
2. It will remove the unfair and improper treatment by an individual IRD officer. Of course, the well-established official practice will not easily be changed by an unjustified complaint; but indeed the complaint can remove the bias or harsh judgment of a particular IRD officer and so bring the case at least up to the prevailing practice and judgment of the IRD.
3. In my work experience with IRD, the taxpayer will often get the most favourable treatment within the ambit of the law and the prevailing practice. This is evident by a famous idiom: Only the crying babies get the milk! Instinctively, most IRD officers are averse to trouble and they want to settle the case as quick as possible within the limits of their authority.

Chapter 2 Salaries Tax Tips

- 2.0 Overview of salaries tax
- 2.1 The basic charge
- 2.2 The basis period of charge
- 2.3 What are taxable emoluments
- 2.4 Housing benefit
- 2.5 Holiday benefit
- 2.6 Granting Shares and Share Options to employees
- 2.7 Payments at the end of an employment
- 2.8 Retirement benefit
- 2.9 Pension
- 2.10 Children education benefit
- 2.11 Non-taxable incomes
- 2.12 Deduction of expenses
- 2.13 Home loan interest
- 2.14 Self-Education Expenses
- 2.15 Donations to charity
- 2.16 Elderly residential care expenses
- 2.17 Husband and wife
- 2.18 Married Person's Allowance
- 2.19 Child allowance
- 2.20 Dependent Parent Allowance
- 2.21 Dependent Brother or Sister Allowance
- 2.22 Computation of Salaries Tax
- 2.23 Hold over of provisional tax

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