

Handling tax audit involving cross – border transactions

26 July 2006/ 16 Aug 2006 (Re-run)

6:30pm to 8:30pm

Presented by : Joe Chan

Senior Manager, Ernst & Young Tax Services Limited

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AGENDA

1. Introduction
2. Procedures of tax audit
3. Settlement methodologies
4. Penalty
5. Case studies including cross border transactions
6. The strategies and tactics in handling tax audit cases
7. Latest development in tax audit

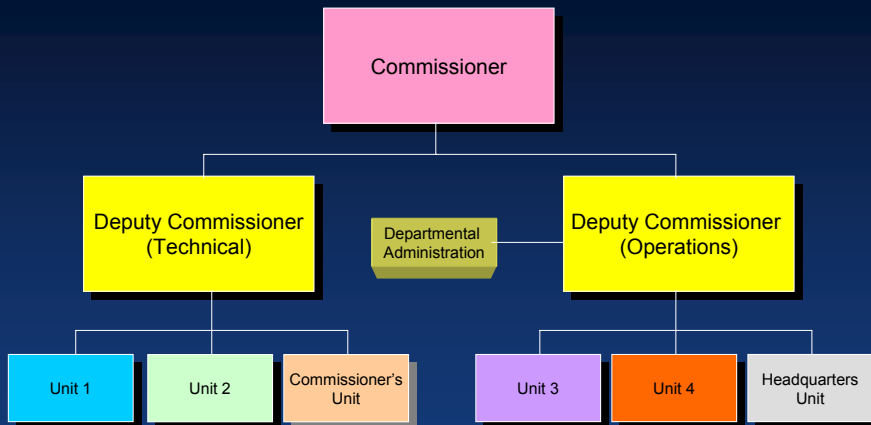
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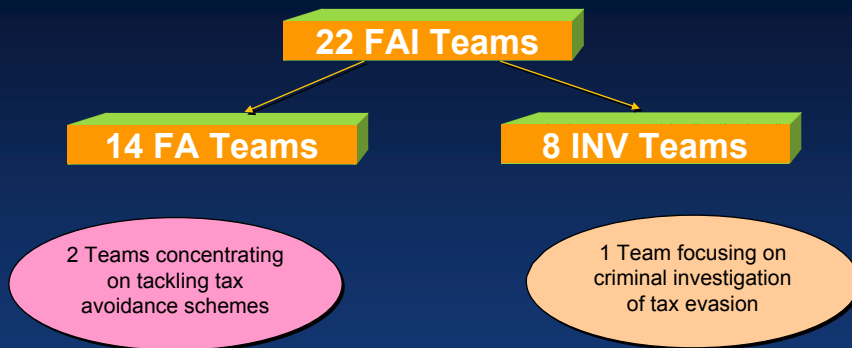
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1. Introduction

IRD Organization Structure



Overview of Field Audit & Investigation Unit



Headcount: Around 180 Professional staff (Assessors or above)
>25% of Total

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File No for Field Audit and Tax Investigation

Different from the Profits Tax and Salaries Tax file numbers

Profits Tax File No:	Trade Cat & BR No.
Salaries Tax File No:	Starts with 6 + Section No. + HKID No.
Tax Audit File No:	Starts with 4+Section No. +... 4B1-C012345 KFC (10)

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Results of Field Audit and Investigation Unit

	1991-1992	1995-1996	2002-03	2003-04	2004-05
Number of cases completed	715	1,611	1,862	1,863	1,863
Understated earnings and profits (\$m)	1,428.5	6,302.9	9,316.3	9,744.8	13,814.3
Average understatement per case (\$m)	1.9	3.9	5.0	5.2	7.4
Back tax and penalties assessed (\$m)	455.5	1,773.4	2,052.5	2,059.2	2,828.2

(Source: Annual Reports of Inland Revenue Department)

Revenue from Anti-Tax Avoidance Cases

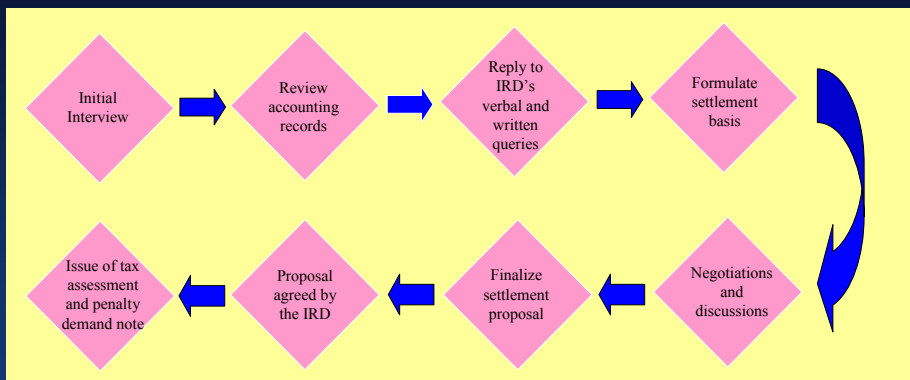
	2001-02	2002-03	2003-04	2004-05
Number of cases completed	202	200	196	213
Understated earnings and profits (\$m)	2,783.7	3,131.0	3,769.3	7,507.6
Average understatement per case (\$m)	13.8	15.7	19.2	35.2
Back tax and penalties assessed (\$m)	510.2	565.4	636.2	1,375.7

(Source: Annual Reports of Inland Revenue Department)

2. Procedures of Tax Audit

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Tax Audit Procedures



* Years under review: normally 6 years

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Case Selection Methods

1. Referrals from Desk Audits
 - Payment of substantial management fees
 - Transactions with closely connected non-resident persons
2. Irregularities noted in the financial statements
 - Heavily qualified auditor's reports (e.g. closing stock qualified)
 - Large unidentified liabilities (=> fictitious purchase/expenses)
3. Annual Reports of Listed Companies



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Case Selection Methods

4. Import Processing / Contract Processing
5. Internal information / referrals indicating concealed assets or profits (e.g Police, ICAC, Consulate)
6. External information
 - Informer cases, newspaper/magazine cutting
7. Affidavits filed with Estate Duty Office
8. Off-shoot case
9. Anomalies of taxpayers
 - Repeated delay in filing Tax Returns
10. Others
 - IPO case with substantial profits during the track record period



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Initial Interview - Purpose

1. Review tax position – Select one audit year
2. Explain the IRD's Penalty Policy & Secrecy Provision
3. Preliminary understanding on the group/ companies' business operations & accounting system
4. Related party transactions and transfer pricing policies
5. Directors'/ shareholders' personal background and assets
6. Chance to admit irregularities promptly upon challenge
7. Placement of deposit in CIR Deposit Account
8. Confirm signature on tax returns

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Initial Interview - Preparation

1. Business information (e.g. group structure, operation)
2. List of
 - Bank accounts and statements (Companies, directors / partners)
 - Companies and properties owned by directors / partners
 - Other personal assets/ liabilities (e.g. stocks, motor vehicles)
3. Family background – spouse's income, dependent etc.
4. Personal expenditure and cost of living

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Areas that the IRD Pays Particular Attention on Individuals

1. Housing arrangement
2. Dual employment / offshore employment
3. Bank accounts of directors, partners and their spouses and even the Accountant
4. Property income

Review of Accounting Records

1. Sales accounts
2. Purchase accounts
3. Directors'/ shareholders' current account
4. Current accounts with related companies
5. Accounts payable
6. Salaries expenses
7. Entertainment
8. Commission payments
9. PRC factory expenses

3. Quantification of understatement and settlement methodologies

Methods of quantification of understatement

- Specific Method
- Indirect Methods
 1. Assets Betterment Statement (ABS)
 2. Bank Deposits Method
 3. Business Economic (Percentage Computation) Method

Methods of quantification of understatement

Methodologies – Specific Method

To establish the specific transactions omitted/ overclaiming of deduction

- Analysis of director's current account to identify/ reconcile:
 - omitted sales
 - fictitious purchase
 - fictitious employees
 - rebates to proprietor/ directors/ employees
 - stock adjustment
- Rental income / salaries income omitted
- Access the risk of prosecution

Methods of quantification of understatement

Methodologies – Indirect Method

1. Assets Betterment Statement (ABS)

- Opening/ closing assets
- Overseas assets
- Unidentified withdrawals
- Opening/ closing liabilities
- Non-taxable income

Methods of quantification of understatement

Methodologies – Indirect Method

1. Assets Betterment Statement (ABS)

Increase in Net Assets
+ Private Expenditure
+ Unidentified Withdrawals
- Non-taxable Receipts

Betterment Profits
=====

Disadvantages

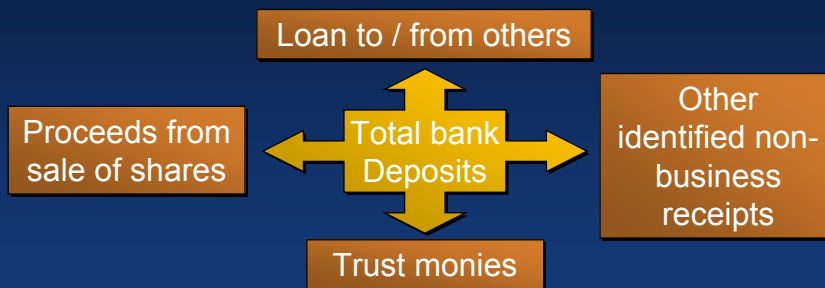
- Complicated
- Time-consuming
- Unidentified withdrawal

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Methods of quantification of understatement

Methodologies – Indirect Method

2. Bank Deposits Method



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Methods of quantification of understatement

2. Bank Deposits Method

Total Bank Deposits Analysis (Cash & Cheque)				
	1999	2000...2004	2005	Total
Total Deposits of Individual Bank A/C Bank A/C No. 1 Bank A/C No. 2				
Total Deposits				
Less: Interbank Deposits Returned Cheques/Repurchase of Cashier Order Gift Cheques Sales Proceeds of Property Rental income				
Unexplained Deposits				
Add: Debtor's Closing Balances				
Less: Debtor's Opening Balances				
Less: Reported Turnover				
Turnover Understated				

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Methods of quantification of understatement

3. Business Economic (Percentage Computation) Method

Typical Percentage/ Ratio Used:

- Gross Profit on Sales
- Percentage on commission
- Percentage on drugs

Gross profit ratio determined by large randomly representative sample transactions and check the sales price against the purchase price

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Methods of quantification of understatement

Example on Business Economic Method
(HK\$'000)

Gross Profit on Sales

Sales (after discount & returns) 5,000

Gross Profit Ratio 30%

Gross Profit 1,500

Less: Returned Gross Profit (700)

Profits Understated 800

4. Penalty

Overview

- Penalties vary according to nature of offence, strength of evidence & sophistication of the scheme
- CIR may
 - Institute prosecution under Section 80 or Section 82
 - Compound the offences (Accept monetary settlement) (Section 80 (5) or Section 82 (2))
 - Impose Additional Tax under Section 82A
- Common Law & Criminal Procedure Ordinance

Penal Actions under Part XIV of the IRO

- Prosecution under S.80(2) - maximum penalty
 - Level 3, \$10,000 plus
 - 3 times the tax undercharged
- Prosecution under S.82(1) - maximum penalty
 - Level 5 -- \$50,000 for each offence +
 - 3 times the tax undercharged +
 - Imprisonment for 3 years

Penal Actions under Part XIV of the IRO

- Additional Tax under S.82A
 - An administrative penalty if no prosecution has been instituted
 - Maximum penalty -- 3 times the tax undercharged
 - CIR/DCIR issues notice to T/P for submission of written representation

Penalty Policy for FA & INV Cases

Calculation of Penalty

Basis of calculation of Penalty for FA & Inv Cases

- Penalty = Minimum loading (%) on tax undercharged + Commercial Restitution (C.R.)
[limited to a maximum % of tax undercharged]
- Commercial Restitution (C.R.) is the interest element for delay in payment of tax
 - Periods up to 30 Nov 2003 – 7% p.a. compound monthly
 - Periods from 1 Dec 2003 – Best lending rate compound monthly

Penalty Policy for FA & INV Cases

Penalty Loading Table

Category of Disclosure and Work Involved								
Nature of Omission/ Understatement	Full Voluntary Disclosure		Disclosure with FULL Information Promptly ON Challenge		Incomplete/ Belated Disclosure		Disclosure Denied	
	Min. Loading %	Max. incl. C.R.	Min. Loading %	Max. incl. C.R.	Min. Loading %	Max. incl. C.R.	Min. Loading %	Max. incl. C.R.
Group (a)	15	60	75	100	140	180	210	260
Group (b)	10	45	50	75	110	150	150	200
Group (c)	5	30	35	60	60	100	100	150

Penalty Policy for FA & INV Cases

Multiple Offences

Penalty for Multiple Offences for the same year

- Example – Understatement as well as late filing of the tax return
- Normally CIR penalizes the most serious offence
- For Understatement – penalty only on the tax for the understatement
- For late filing of the return – penalty on the total tax (i.e. amount reported + understatement)
- Hence late filing of return can have very serious consequences

Penalty Policy for FA & INV Cases

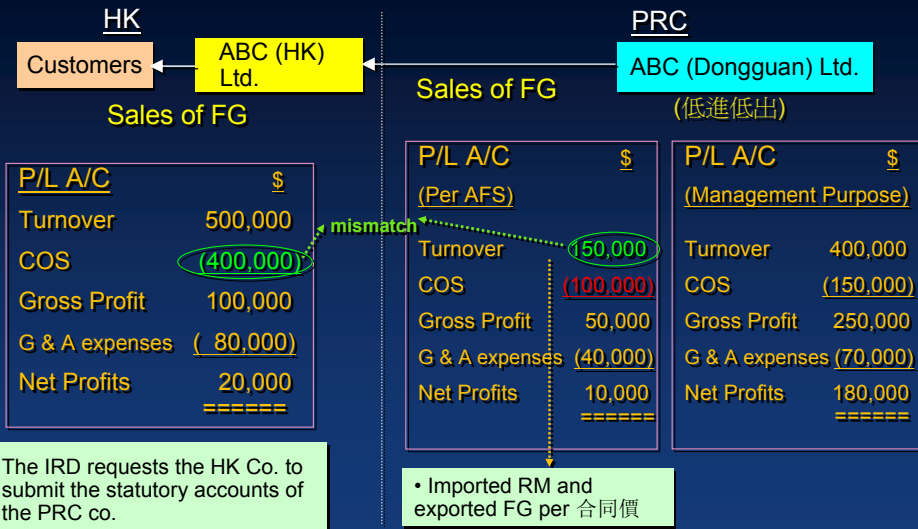
Penalties for Second & Subsequent FA & INV cases are more severe than that for the first FA & INV

Time Limit

- S.80 – Within 6 years after the year during which the offence was committed.
- S.82 & S.82A – No time limit

5. Case Studies

Case 1 – Mis-match between HK Co. & PRC Co. Statutory Books



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Case 1 – Mis-match between HK Co. & PRC Co. Statutory Books

- Discrepancy between purchase costs of finished goods in HK Co's books and the sales in PRC Co's books
 - HK Co: Resale price method (80%)
 - PRC Co: Custom price
- Overstatement of purchase price from IRD's perspective / Understatement of sales price from PRC tax bureau's perspective
 - => Double taxation
- Scenarios: Overall 50:50
 - Transfer pricing adjustment

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Case 1 – Mis-match between HK Co. & PRC Co. Statutory Books

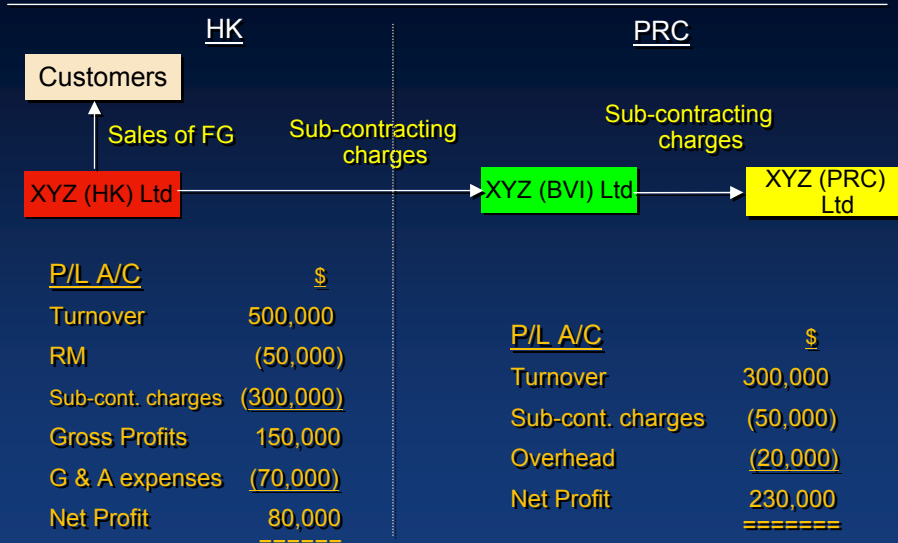
4. The IRD insists to fully assess the total profits as reduced by the amount of profit already reported to PRC tax bureau
 (i.e. $20,000 + 180,000 - 10,000 = 190,000$)
 => Risk: PRC transfer pricing audit resulting in double taxation
5. Latest Scenario: Voluntarily report additional profit to PRC tax bureau before settlement with IRD
 - Pending agreement from the IRD

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Case 2 – Subcontracting arrangements



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Case 2 – Subcontracting arrangements

- The IRD considered the subcontracting charges paid by HK Co. to BVI Co. excessive
- The dispute dragged on for nearly 10 years and we took up the case last year
- Documents submitted to the IRD by ex-T/R to substantiate the arm's length nature of the subcontracting charges included:
 - Price of similar products purchased from third parties (minus raw material costs and overhead)
 - Transfer pricing study report for HK Co.

Case 2 – Subcontracting arrangements

- 50:50 settlement proposal submitted by ex-T/R but rejected by the IRD
- As no agreement reached, the IRD threatened to disallow the subcontracting charges in full
- After lengthy negotiations and discussions, the IRD finally agreed to allow Cost plus 25%
- Pure for settlement purpose and not binding on future years.

Case 3 – Macao Offshore Company

General background

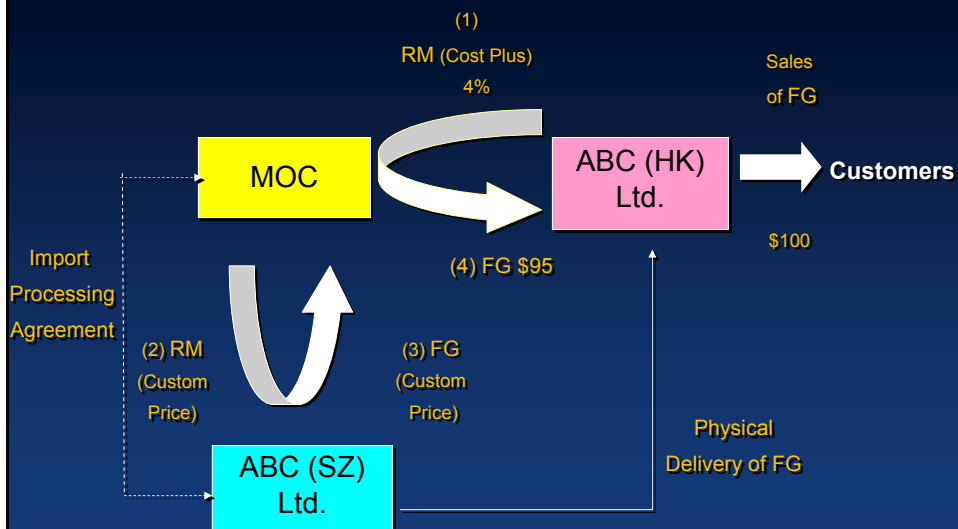
- Offshore law introduced in November 1999
- Incorporation of MOC after obtaining a permit
- Basic requirements:
 - Use only non-Macao currency in the activities
 - Target only non-Macao residents as customers
 - Focus only on non-Macao markets
- Tax incentives:
 - Exemptions from income and other taxes in Macao
 - Stationed manager and specialized technicians (non-Macao residents) who are authorized to reside in Macao are exempt from salaries tax for three years

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Case 3 – Macao Offshore Company



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Case 3 – Macao Offshore Company

MOC

1. Directors : HK Resident
 - most of the time in Hong Kong
2. Employees
 - Technicians : All HK Residents (mostly stationed in the PRC)
 - Admin. Staff : Macao Residents
3. Profit Spilt MOC : HK Co
 80% : 20%
4. Issues
 - MOC Carries on business in HK?
 - Profit of MOC sourced outside HK?
 - Transfer Pricing issue with HK Co ?
 - S.61A

6. Strategies and Tactics in handling tax audit cases

The Strategies & Tactics

1. Phone calls / informal meetings with the IRD to understand the IRD's view-point & thoughts
2. Discuss with client to get the true & whole picture and identify contentious areas
3. Manage client's expectations – the IRD would look for tax & penalty under all tax audit cases
4. Estimate the tax and penalty exposure
5. Get the IRD's agreement on the approach
6. Be cooperative and take initiative
7. A "Give & Take" process
8. Obtain the case officer's verbal agreement before submitting formal settlement proposal

7. Latest Development in Tax Audit

Latest development in tax audit

- Import processing with 50:50 claim
 - (D111/03 & D56/04)
- Leasing arrangement under S.39E
 - DIPN 15 (Revised)
- Macau Offshore Company
 - (Annual Reports, PTR disclosure and the website of IPIM)



Questions and Answers

Reconciliation Between Tax Expense & Accounting Profit

Profit before tax	XXX
	=====
Tax at the domestic tax rates applicable to profits in the countries concerned	XXX
Income not subject to tax	(XXX)
Expenses not deductible for tax	XXX
Tax losses utilized from previous periods	(XXX)
Others	<u>(XXX)</u>
Tax charge for the year	XXX
	=====



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Import Processing 進料加工



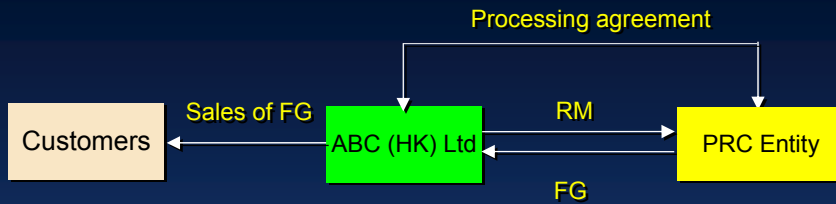
- ABC (SZ) Ltd. takes titles of the RM & FG
- => ABC (HK) Ltd. is only a trading company
- => Form vs Substance

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Contract Processing 來料加工



ABC (HK) Ltd.

- Equipment
- Raw materials
- Technical know-how
- Design

PRC Entity

- Factory premises
- Labour
- No title to RM & FG

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S.39E(1)(b) – Plant or machinery

- DA is denied to lessor if the plant and machinery, while the lease is in force, is:
 - used wholly or principally outside HK by a person other than the taxpayer; or
 - the whole or a predominant part of the cost of acquisition or construction of the machinery or plant was financed directly or indirectly by a non-recourse debt (i.e. leveraged leasing)

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S.39E(1)(b) – Plant or machinery

Lease, in relation to any plant and machinery, includes:

- any arrangement under which a **right to use** the machinery or plant is granted by the owner of the machinery or plant to another person;

S.39E(1)(b) – Plant or machinery

- DIPN 15 (Revised)
- **Contract processing with 50% manufacturing profits assessed:**
 - DA 50% allowable by concession
 - Section 16G not applicable

