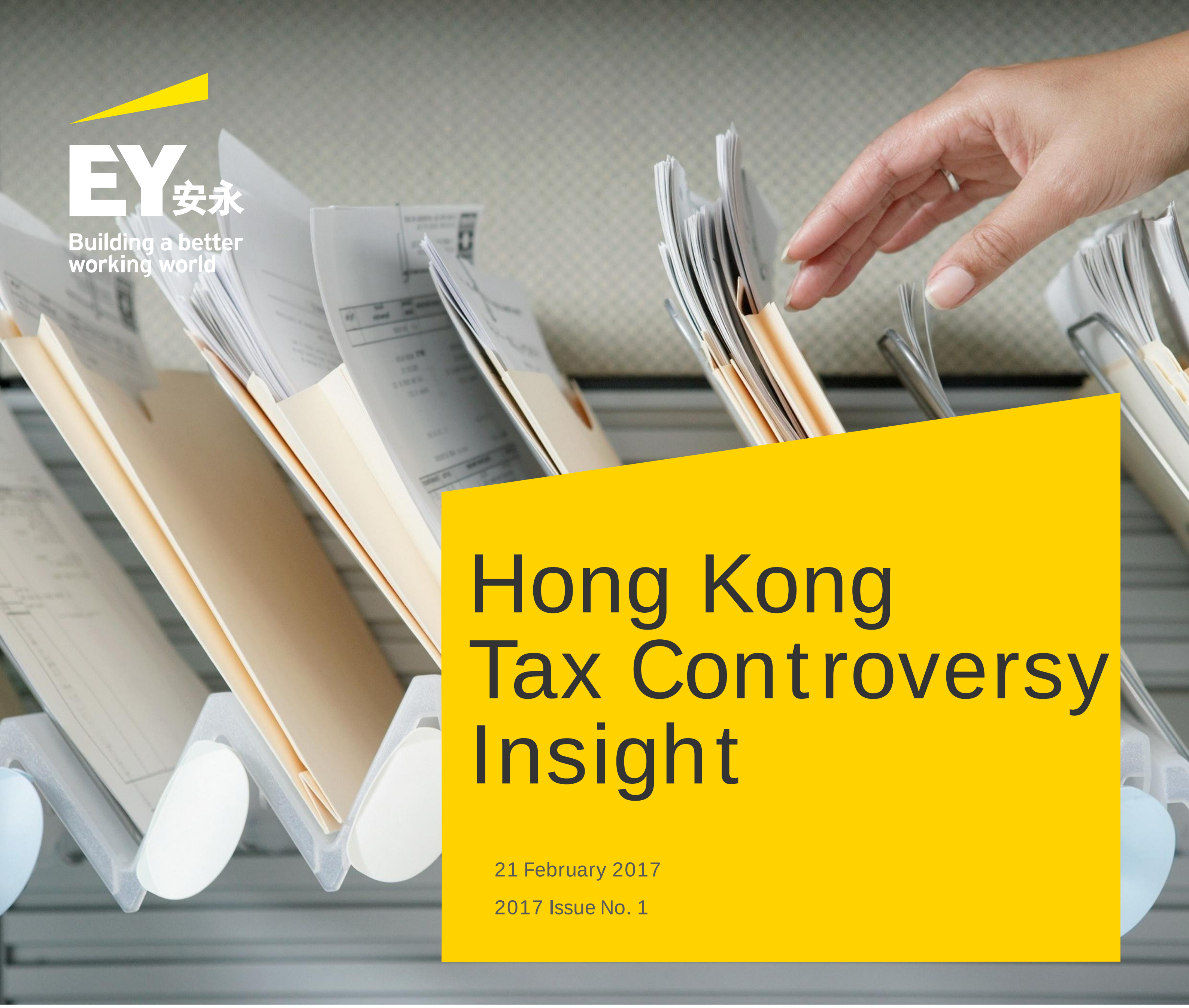

Hong Kong Tax Controversy Insight

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Am I under the Inland Revenue Department's (IRD) radar for tax audit?

Have you ever had the "why me" or "am I at risk of being selected" question when it comes to tax audit? Have you ever wondered how does the IRD do their cherry picking for cases to conduct tax audit? If these questions have skipped your mind before, this first issue of our Tax Controversy Insight will be able to shed some light on your mysteries.

In this issue, we will be providing some insights on the case selection process of the IRD and factors that are likely to trigger a tax audit by the IRD. We will also be discussing some of the readily available information in your financial statements, tax filings or the media that may prompt the IRD to conduct further investigation.

Examination of tax filings

The IRD has implemented a computerised "Assess First Audit Later" (AFAL) system for more than 15 years to streamline its assessing process. The AFAL system screens tax returns based on criteria pre-set by the IRD and selects cases for post assessment desk audit, field audit and investigation. Broadly, tax returns containing the following features are more likely to be identified by the AFAL system for further review:

- Abnormal fluctuation in financial performances/accounting ratios, e.g. significant increase/decrease in turnover, gross profit, profit before tax and so on
- Significant deviation from prior years or the industry norm, e.g. the gross profits ratio or turnover is substantially below the norm in the same trade
- Utilization of brought forward tax losses from prior years of assessment
- High volume of related party transactions
- Change in tax filing basis, e.g. first year lodging/ceasing to lodge offshore claims

  or
- Significant one-off transaction, e.g. capital gain

Desk audits are conducted by the assessing sections of the IRD, i.e. Unit 1 and Unit 2, while field audits and investigations are carried out by the Field Audit and Investigation (FAI) Section of the IRD, i.e. Unit 4. Most cases selected by the AFAL system are initially followed up by the assessing sections. However, depending on the findings from desk audits, cases maybe referred by the assessing sections to the FAI Section as a result of further information being revealed during the course of desk audits, such as:

- Persistent losses for an extended period of time but the taxpayer has not ceased the business
- Significant director/shareholder current accounts
- Inappropriate association between the living standard of an individual and his/her income
- Persistent non-compliance in returns submission, e.g. repeated late tax filings
- Abnormal/significant fluctuation in effective tax rate
- Change in the nature of business/accounting notes disclosure
- Significant variance between salaries disclosed in the financial statements and reported in the Employer's Returns
- Unreasonably significant expenses, e.g. travelling, entertainment, staff benefits and so on

  or
- Long outstanding account payable balances

Special projects

Apart from the AFAL system, the IRD sometimes undertakes special projects aiming at certain professions or certain behaviours of taxpayers.

For example, the IRD conducted an industry-wide review on insurance agencies targeting at underreporting of commission income in the past. We have also seen rapid increase in the number of tax audit cases involving investment fund managers in recent years.

You may also notice in the news that the IRD prosecuted taxpayers who has understated or omitted in reporting their rental income or overstated their self-education or donation expenses. These are actually resulted from the IRD conducting property tax compliance check and specific tax deduction claim reviews.

Other case selection methods

If you consider you or your company are safe from being selected for tax audit by the IRD because none of the above selection criteria seems applicable, you may want to think again as there are other publicly available or IRD internal information that may attract the FAI Section's attention, including:

- Public information

  Information disclosed in annual reports, public announcements, internet homepage and so on will be of interest to the FAI Section.

  For example, a company announcing a new major investment project or a generous dividend distribution for the period while reporting significant tax losses in its tax return. The IRD may like to ensure there is no understatement of chargeable income by understanding the source of funds.
- Initial public offering (IPO) documentations

  Companies should ensure that the information disclosed in their IPO documents, such as turnovers, profit margins and operation model, are consistent with the information reported to the IRD in their tax filings as any inconsistencies may trigger the IRD's interest to conduct further investigation.
- Property transactions

  Unusual correlation between a person's income and purchasing power may attract FAI Section's attention.

  The FAI Section would also be interested in the frequency of transactions. If a taxpayer is frequently involved in property transactions, this may suggest that the profits arising from the property transactions could be considered to be revenue in nature and subject to Profits Tax.

- Exchange of Information (EOI) and Common Reporting Standard (CRS)

  Hong Kong's tax treaty partners may make a request for exchange of information to the IRD under the Exchange of Information article in the Comprehensive Double Taxation Agreements/Arrangement (DTAs) and Tax Information Exchange Agreements (TIEAs). The IRD may take the request as a signal that there may be issues with the relevant entities' tax affairs and decide to conduct a review.

  For example, if a Hong Kong company's trading partner in the UK is under tax audit by the local tax authority and the UK tax office sends a request to the IRD for information on the payments made by the Hong Kong company to the UK partner, the IRD may suspect that the dealings between the Hong Kong Company and the UK partner may not be properly reported for tax purposes and therefore conduct a review on the Hong Kong company.

  In addition to EOI, from January 2018, financial account information of Hong Kong tax residents will be reported by financial institutions in overseas tax jurisdiction with which Hong Kong has entered into a Competent Authority Agreement (CAA) under the new CRS regime.

  If a Hong Kong company maintains substantial balances in bank accounts located overseas, this may trigger the IRD's interest to understand the source and purpose of the funds.

- Incomplete and long outstanding reply to IRD queries

  The IRD may consider that a reply submitted to them is incomplete if they are not satisfied that the taxpayer has provided them with the relevant information in full.

  In this case or in cases where taxpayers delay the response to the IRD, IRD may consider that these taxpayers are being uncooperative and further investigations may be triggered.

- De-registration/Liquidation

  A company is required by law to obtain tax clearance from the IRD as part of its de-registration or liquidation process. The IRD would perform a final review of the company to ensure that its tax affairs are in order and that the company has no outstanding tax reporting obligations.

- Informer

  Tax audit exercise requires a lot of important information to analyse. If there is reliable information provided by individual close to the taxpayer, the FAI Section will have more grounds to commence a tax audit case. Hence, informer is also one important source of the FAI Section to select audit targets.

  If the IRD considers that the information provided by the informer appears to be reasonable and valid, further investigation will be conducted.

- Other government departments

  Government departments may refer cases to the IRD if they suspect that a person's tax affairs may not be in order during their daily encounter.

  For example, there could be circumstances where other government departments may sense that a person's income or profits have not been properly reported to the IRD as a result of other information provided to them, such as their source of income, net wealth and involvement in transactions, and report the person to the IRD for further investigation.

What should you do?

Companies are recommended to review their tax and transfer pricing attributes and tax compliance history to assess their tax audit risks, and to formulate the strategy and approach to prepare for defence before the IRD commences a tax audit. Such pre-controversy review may also indicate need for voluntary disclosure which could be a solution to manage potential penalty exposure.

Based on the outcome of the review, companies may consider reshaping their transaction arrangement to enhance the tax defensive grounds from both tax and transfer pricing perspectives.

If a company has already been targeted by the IRD for a tax audit, there are some important steps to take, including

1. Identify the possible causes of the tax audit
2. Ascertain tax risk areas and quantify tax exposure if possible
3. Seek professional advice to assist in handling the tax audit

Proper handling of a tax audit case can significantly contain the scope of the audit and expedite the settlement of the audit.

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