

Hong Kong Tax Controversy Insight

**Issuance of protective assessment
under tax audit by the Inland
Revenue Department (IRD)**

2023 Issue No. 2

Tax investigation and tax audits can be highly complex and complicated. The time required to agree a settlement basis with the IRD could be prolonged due to a number of factors such as complexity and extensiveness of the subject issues, cooperativeness of the taxpayer in providing the requested information and the time required to gather and review the historical documents.

Due to the statutory time limit in Hong Kong for issuing tax assessments (see below for more details), as a revenue protection measure, it is common for the IRD to issue estimated assessments for the “time-bar” assessment year (generally referred to as “protective assessments”) in a tax or investigation situation.

In this insight, we will give an account of protective assessments and the actions that should be taken by taxpayers upon receipt of protective assessments.

What is protective assessment?

As introduced in our Hong Kong Tax Controversy Insight 2017 Issue No. 2, a field audit / investigation starts with gathering taxpayer's information, followed by conducting initial interview and reviewing documents to thoroughly understand the potential tax issues. This is usually followed by a negotiation process with the aim to reach a compromised settlement between the taxpayer and the IRD. The entire process could take months or even years to complete. Where the tax audit result could not be readily ascertained, for the purpose of protecting the Government's revenue, it is a common practice for the IRD to raise back years assessments during the course of tax audit or investigation pursuant to section 60 of the Inland Revenue Ordinance (IRO) in order to keep the assessment year open within the six-year statutory limitation for general tax audit cases or 10 years for cases of fraud or willful evasion.

For instance, in a general tax audit case, tax assessments for year of assessment 2016/17 cannot be issued after 31 March 2023. As such, protective assessments for this year must be issued before 31 March 2023, being the six-year statutory time-bar deadline.

How does the IRD formulate the basis for issuance of protective assessment?

Ongoing tax audit cases

For ongoing cases, the IRD would usually make reference to the facts and information gathered during the investigation process to come up with an initial settlement basis that is considered justifiable to the taxpayer. This initial settlement basis will form the basis for the estimated assessable profits in a protective assessment.

IRD may explain to the taxpayers about the facts and circumstances which have been considered in arriving at the basis for the protective assessment.

New tax audit cases

As shared in our Hong Kong Tax Controversy Insight 2017 Issue No. 1, the IRD can use different approaches to identify cases for tax audit, including examining prior year tax filings and researching on publicly available or IRD internal information. Taxpayers are highly recommended to regularly review their tax filing position, especially when there are significant changes in the mode of business operation.

For newly selected cases, the IRD would usually issue a notification letter together with protective assessments for the time bar year. Taxpayers will be informed of the initial covered period for the tax audit and they will be invited to arrange an initial interview with the IRD. Henceforth, a series of field audit and investigation work as aforementioned will be performed by the IRD.



What are the rights of taxpayers?

Lodgment of objection

The basis of formulating protective assessment could only represent the initial opinion or estimation of the IRD based on its preliminary fact-finding. Such basis is most likely tentative and subject to further revision as the taxpayers may have a different view toward the basis and they may be able to provide documentary evidence to defend the case.

Therefore, upon receipt of the protective assessment, taxpayers should consider lodging an objection against the protective assessment in order to keep the matter open and protect their own interest before the said assessment becomes final and conclusive under section 70 of the IRO.

It is important to note that written objection must be lodged within one month from the date of issue of the protective assessment, with the grounds of objection clearly stated in the objection application.

Request for holdover of payment of tax in dispute

Once a valid objection is lodged, it is possible for taxpayers to request for a particular course of action regarding the holdover of tax in dispute. Nonetheless, it is at the Commissioner's sole discretion to decide whether to allow the payment of the tax in dispute to be held over pursuant to section 71(2) of the IRO. The following table summarizes the IRD's policy on the issuance of stand-over orders:

Type of stand-over orders	Circumstance that the request of stand-over order would be allowed	Payment when the tax in dispute is discharged	Payment when the tax in dispute is payable
Unconditional stand-over	The objection is immediately apparent to the Commissioner that should be allowed forthwith.	No further action.	Tax payable with judgement interest on tax payable at a rate specified by the Chief Justice.
Conditional stand-over - Purchase of tax reserve certificates (TRC)	The objection has some merits but it is not completely in favor of the taxpayer.	TRC will be refund with interest.	TRC will be used to settle tax payable with remaining unused amount be refunded with interest.
Conditional stand-over - Banker's undertakings in lieu of the purchase of TRC	To the satisfaction of the Commissioner that the purchase of TRC would cause financial hardship to the taxpayer.	Bank undertaking will be returned.	Tax amount being held over with judgement interest on tax payable at a rate specified ⁱ by the Chief Justice.

Based on our practical experiences, it has been observed that purchase of TRC is the most preferable option to the IRD. In addition, it is worth noting that as reiterated in a recent Court of First Instance decision, the Judge clearly pointed out that the IRD must identify a possible positive basis on the assessment raised and explain why it is not immediately apparent that the taxpayer has not made the assessable profit in the assessed amount before ordering a conditional holdover upon purchase of TRC. In other words, the basis of the protective assessment issued by the IRD ought to be realistic and justifiable to taxpayers with known facts and evidence before ordering for a conditional holdover. Although purchase of TRC may impose cash flow hardship to taxpayers, doing so can protect the taxpayers from charging high judgment interest in case tax is payable at the closure of the tax audit or investigation. Taxpayers should consider their individual circumstances and strike a balance for their best interest.

Conclusion

Lodging objection against the protective assessment and requesting for holdover of tax payment are part of the negotiation process with the IRD in reaching a compromised tax audit result. The way on how taxpayers defend their tax position in objections involves technical analysis and may affect the tax audit results. Taxpayers are highly recommended to seek professional advice from tax consultants in this respect for an early finalization of tax audit.



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