## ¶1-010 Tax Evasion

Tax evasion is an illegal action or omission which avoids, reduces or postpones the payment of tax. It may be the submission of incorrect tax returns or information to the IRD or deliberate or negligent failure to report income or profits to the IRD. A tax return is incorrect if there has been an omission or understatement of taxable income or an overstatement or claiming of fictitious expenses. Tax offenders may have prepared false accounting records, invoices, sales or purchase orders or other documents. Alternatively, they may have carried out arrangements, schemes or transactions for the purpose of concealing tax liabilities from the government.

Negligence of a taxpayer in handling his/her tax affairs may constitute tax evasion and is subject to penalty. A taxpayer may be negligent or even reckless if he/she fails to take care in ensuring the accuracy of his/her tax returns. For example, a taxpayer was advised by a friend that if he/she arranged his/her property transaction in a certain way, the profit arising therefrom would be capital in nature and exempt from profits tax. If he/she then arranged his/her transaction as advised by his/her friend, he/she would be negligent in not seeking proper professional advice as to whether the profit was in deed capital in nature. Believing that the profit was not taxable and not reporting it to the IRD could render him/her liable to penalty for not reporting the profits.

A broader definition of tax evasion is the failure to comply with a taxpayer's obligation which includes the failure to submit tax return in time or at all, or failure to inform the IRD that he/she is chargeable to tax. These failures will lay the taxpayer open to penalty under the IRO.

A person who has submitted a tax return which turns out to have understated or omitted certain income may still be absolved from penalty if he can establish reasonable excuse for doing so. For instance, a taxpayer may make a claim that certain profits were offshore and therefore not subject to tax. The IRD may hold a different view and tax the profits. If the taxpayer has reasonable grounds for forming the opinion that the transactions were in deed offshore, for example, that there were substantial activities carried out of Hong Kong, he/she may not be liable for penalty.






## ¶1-020 Tax Avoidance

Tax avoidance is the attempt to obtain a tax benefit (meaning reduction, elimination, or postponement of tax) by legal means. The IRD holds the view that a tax avoidance scheme is tax evasion in substance if its possibility of success is entirely dependent upon the Department never discovering the true facts (i.e. the facts have not been disclosed in the return, accounts or any statement submitted to the Department). See paras 58-62 Departmental Interpretation and Practice Notes No. 15 issued by the IRD ("DIPN 15" (revised)).

Many taxpayers make arrangements to reduce their tax burden, for example, by setting up offshore companies, transferring pricing or using services companies to charge management fees. Some of these arrangements aim to achieve the purpose of tax reduction by non-disclosure or concealing information from the IRD. These arrangements would amount to tax evasion and are subject to penalty if discovered. Arrangements by legal means are popularly called tax avoidance and in many cases entered into at the advice of tax consultants. In the event that these arrangements fail to achieve the purpose of tax mitigation, the question will arise as to whether the taxpayers will be liable for penalty. Tax avoidance cases, if unsuccessful, may expose the taxpayer to penalties unless he/she is able to establish a reasonable excuse. As pointed out above, negligence may render a taxpayer liable to penalty. If he/she fails to exercise care in making his/her tax arrangements, he/she is exposed to such risk. (In regard to criminal prosecution, in the case of *R v Radofin Electronics (Far East) Ltd. and Another* (1982) HKTC 1252, the taxpayer was acquitted because the standard of proof in a criminal prosecution is much higher than an administrative penalty under s82A IRO (see Chapters on Penalties)). In the Board of Review case *D17/08* 23 IRBRD 301, the taxpayer was penalised under s82A for the filing of incorrect returns. The Board opined that acting on advices given on the tax scheme which, for its success, depended on concealment, or not giving the Commissioner full and frank disclosure, did not constitute a reasonable excuse. The distinction between tax avoidance and tax evasion can be difficult to define in some cases. The test is whether the taxpayer is acting honestly as well as carefully in dealing with his/her tax affairs.

## ¶1-030 How field audit/investigation cases are initiated

No government has the resources nor is it desirable to audit or investigate every taxpayer. Only cases that bring about suspicion or evidence of tax evasion will be audited or investigated. A case may be selected for audit in order to achieve a deterrent effect or where the evasion is substantial. There are a wide variety of sources for the initiation of such back duty cases. The major sources are comprised of:

(1) Examination of tax returns

There are two channels, namely:

(a) The operation of the "Assess-First-Audit-Later" (AFAL) system. The majority of tax returns are accepted without enquiry and assessments are issued electronically, accordingly. The IRD operates a three tier audit system – desk audit, field audit and investigation. After automatic assessments, some cases are selected for desk audits, field audits and investigations respectively. Desk audits are conducted by the assessing sections (Unit 1 and Unit 2) by issuing written enquiries to the taxpayers on specific areas of the tax returns. Field audits and investigations are more in depth and are handled by Unit 4, the special unit dealing with tax evasion and avoidance. Some cases which fail to meet certain criteria will not be eligible for automated assessments and in-depth examinations will be conducted prior to assessment.

(b) Cases may be selected, by information revealed in the course of desk audits or in the tax returns themselves. Examples of relevant factors are:

(i) persistent losses for a number of years and yet the taxpayer does not cease the business;

(ii) insufficient income to sustain the living standard of a sole proprietor/partner and/or if the proprietor/partners earn less than his/their junior employees;

(iii) the gross profits ratio or turnover is substantially below the norm in the same trade; or






(iv) substantial increase in the fund provided by the sole proprietor /partner/ shareholder to the business which could take the form of an increase in capital, an advance or loan;

(v) persistent feature to submit returns.

(c) Special projects such as:

(i) property speculators (such as confirmors);

(ii) certain professions (e.g. cash trades like health businesses, insurance agencies);

(iii) Property Tax Compliance Check – to detect understatement or omission in reporting rental income for property tax purposes. In some cases, criminal prosecution was instituted on property tax evaders.

(d) Purchase of expensive immovable properties

(2) Other government departments

Government departments may refer cases to the IRD. See *Lee Sap Pat CACV165/1997* and *Lee Ma Loi* CACV 8/1992 which were initiated by police information.

## ¶1-040 Departmental Interpretation and Practice Notes No. 11 (October 2007) ("DIPN 11")

IRD issued DIPN 11 to explain its policy and practice as regards field audit and investigation. The practice notes inform the public how cases are selected for audit or investigation, policy and process of audit, methods of audit, settlement and finalisation, anti-tax avoidance and penalties. A major theme is to encourage the co-operation of taxpayers. Instead of sitting back and waiting for IRD to do the audit, tax evaders are encouraged to appoint a tax representative to carry out examination of their clients' affairs and report the quantum of understatements to the IRD. DIPN 11 salaries, supplemented by worked examples, the process and method of audits. It is of considerable value to tax representatives.

## ¶1-050 Full Voluntary Disclosure

Taxpayers are encouraged to make disclosure should there be incorrect returns or failure to submit tax returns as soon as possible. The policy of full voluntary disclosure is expounded in paras 27 to 29 of DIPN 11. The IRD does not explain what amounts to voluntary disclosure but it may be inferred as disclosure made before any challenge by the IRD. Perhaps the IRD may take a more lenient view and accept that a disclosure is voluntary if it is made as soon as an enquiry has commenced (e.g. a disclosure made in the initial interview). A disclosure is not voluntary if it is made after an assessor has made extensive enquiries or after the assessor has identified and pointed out to the taxpayer irregularities in the returns.

A full voluntary disclosure will be a mitigating factor in determining the penalty. Para. 27 of DIPN 11 states:

> "Although no general undertaking can be given for such cases in relation to the basis on which penalty or additional tax would be imposed, or whether prosecution action would be taken, it is the practice of the Commissioner to be influenced where a person has made a full confession in respect of any offence to which he/she has been a party, has facilitated investigation and has provided correct returns accompanied by detailed supporting statements."

A disclosure is not full if the taxpayer only partially discloses the understatement. If the purpose is to forestall any further investigation by IRD, this will be viewed as a serious aggravating factor.

Paras 30 to 80 of DIPN 11 are intended to provide guidance to tax representatives appointed by taxpayers to prepare revised tax computations for the purpose of making disclosure.

## ¶1-060 Penalty Policy

The IRD publishes its penalty policy on its website (see Tax Information), which is very useful in enhancing certainty in this vital area of tax administration. See Chapter 12 on "Penalty Policy" for details.






## ¶1-070 Field Audits and Investigation Unit

Unit 4 is primarily responsible for conducting field audits and investigations on businesses and individuals to combat tax evasion and avoidance. Simple tax evasion cases may be handled by other units of the Department. Unit 4 is headed by the Assistant Commissioner who is assisted by Chief Assessors. There are a number of Field Audit sections and a number of Investigation sections of which special Field Audit sections are assigned to tackle tax avoidance schemes.

## ¶1-080 Field Audit and Investigation Cases Handled in 2014-15

According to the IRD Annual report 2014-15, the following results were achieved for that period:

| Field Audit and Investigation | |
|---|---|
| No. of cases completed | 1803 |
| Understated earnings & profits | 12,875.9M |
| Average understatement per case Completed | 7.1M |
| Back tax and penalties assessed | 2533.1M |

## ¶1-090 Period covered by an Audit & Protective Assessment

Section 60 of the IRO authorises an Assessor to raise assessment or additional assessment within the year of assessment or within 6 years after the expiration thereof. A field audit or investigation can therefore deal with assessments for the previous 6 years of assessment. For example, the Assessor is empowered to raise on or before 31 March 2017 an assessment or additional assessment for back years of assessment up to and including 2010/11. Hence if the tax audit or investigation cannot be settled on or before 31 March 2017, IRD will issue protective assessment for 2010/11 before 1 April 2017. A set of protective assessments will usually be raised on an estimated basis on the relevant businesses and their sole proprietor, partners, or directors. The auditor/investigator officer is not

able at that stage to ascertain the quantum of understatement accurately because the required information is not yet fully available.

## ¶1-100 Process of an Audit

For most cases, the IRD will issue a letter informing the taxpayer that his returns are subject to an audit. A letter will be issued to the taxpayer requesting for information relating to his/her accounting records, bank accounts and his/her business. This will be followed by the initial interview. In exceptional cases, the investigation commences with a search of the taxpayer's premises. The search will be conducted with the authorisation of a search warrant issued by a magistrate. After the initial interview, the auditor or investigator continues the process by collecting information. Accounting records and bank statements will be asked for from the taxpayer. Enquiries on bank transactions will be carried out and information may be gathered from third parties — banks, trade debtors or creditors or other government departments etc. Protective assessment for the time barred year will be issued if the case cannot be settled on or before 31 March. The IRD officers will try to ascertain if there is any evasion and if the answer is yes, they will arrive at a basis of ascertaining the understatement. The length of the audit or investigation depends on the degree of cooperation of the taxpayer and on the availability of information. Sometimes even if a taxpayer is willing to cooperate, he/she may find it difficult to quantify the understatement because he failed to keep proper business records. The basis of assessment may either be formulated by the taxpayer's tax representative where business records are sufficient for such purpose or formulated by the IRD officers upon analysis of records and information from various sources. Once a basis of assessment is arrived at, negotiations will be conducted by the officer with the taxpayer, often through his/her tax representative. Very often agreement can be reached but in the exceptional event when agreement cannot be reached, assessments for all years covered in the audit or investigation will be issued to collect the tax considered to be due. The taxpayer may object to the assessments and the case would then be put up to the Commissioner for determination. The taxpayer may appeal to the Board of Review from the Commissioner's determination. This is expected to happen only after a protracted period of audit or

 



investigation. Various aspects of this process will be elaborated further in later chapters.

## ¶1-110 Difference between Field Audit and Investigation

A field audit focuses on the most recent year of assessment for which a tax return has been submitted. The result reviewed for that year e.g. the net profit ratio, will usually be adopted for projecting the assessable profits for back years. An investigation is much more in depth and normally covers the 6 years prior to the year of assessment in which the investigation commences.

## ¶1-120 File Number

The file number of IRD suggests that a case may be a field audit/investigation case. For such cases, the file number sets out the unit (Unit 4), the Group (A, B or C), nature of case (A = anti-tax avoidance, B= Tax Investigation C= Field Audit), taxpayer's serial number, name of case officer and floor of IRD. For example:

> 4A1 — C123456 — XXX (35) denotes:
>
> Unit 4, Group A1, C = Field Audit, 123456 serial number of taxpayer, Name of Assessor in charge, 35th floor.

### ¶3-100 Information from Other Government Departments or Public Bodies s52(1)

The CIR may give notice to any government officer or persons employed by any pubic body, requiring him/her within a reasonable time to provide information (other than such particulars as to which the officer or employee is under an express statutory obligation to observe secrecy) which may be in the possession of such an officer or employee.






# CHAPTER 4 METHODS OF DETERMINING THE UNDERSTATEMENT



This chapter sets out the methods of field audit/investigation and to expound the methods which the IRD utilises to ascertain the quantum of understatement. This information is vital to the taxpayer and their tax representative when preparing revised tax computations for disclosure to the IRD.

## ¶4-010 Specific or Indirect Approach

IRD officers endeavor to ascertain any understated profit or income by examining the accounting records (the Direct method (or Specific Omission Method)) or using Indirect methods such as an assets betterment statement ("ABS"), bank deposit or gross profits rate. The IRD's usual practice utilises one of the aforesaid methods to assess the assessable profits of one year and then uses the net profit ratio or gross profit ratio for that year to project the assessable profits of other years (the projection approach).

Even though one method has been adopted, other methods may still be used to collaborate the adopted method. For example, in a case of understatement of sales, IRD is able to get hold of the account books and quantify the correct amount of sales. This is the specific method. The officer may still use other methods like bank deposit or top and tail ABS (see the chapter on Assets Betterment Statement) to check if the understatement disclosed by specific method is adequate.

## ¶4-020 Direct Method (Specific Omission)

The direct method is adopted when the IRD is able to obtain direct evidence as to the quantum of income profits understated or omitted such as the true accounting books and this is usually the most accurate method. For example, if a salaries taxpayer omitted income from a part-time employment, the IRD ascertained the amount of income omitted from his part-time employer. Where a taxpayer selling on credit or COD evades tax by omission of cash sales, the IRD may obtain the records which show the cash sales.

### Nature of specific omission

For salaries tax, specific omissions may be:

a) omission of income from part time jobs;

b) omission of taxable fringe benefits, e.g. reimbursement of medical expenses, lunch allowances;

c) not informing the IRD that the taxpayer is chargeable to tax as required by s51(2);






d) a false claim for personal allowances, self education expenses or home purchase allowance.

For Property tax, the most common tax evasion is falsely informing the IRD that the land and/or building is not let out (failure to inform chargeability as required by s51(2)).

For Profits tax, evasion may be by:

a) failure to inform the IRD of chargeability to tax as required by s51(2). For example, a taxpayer who carries on a business in Hong Kong does not obtain a business registration with the result that the IRD is unaware of the existence of the business;

b) understatement of business receipts like sales, consultancy fee, or omission of other income such as sale of scrap materials, commission etc.;

c) overstatement of purchase;

d) understatement or incorrect valuation of trading stock;

e) overstatement of expense;

f) fictitious expenses e.g. management fees, wages to relatives.

## ¶4-021 Failure to notify chargeability s51(2)

A person who has income or profit chargeable to tax for any year of assessment is required to notify the IRD that he is so chargeable in writing no later than 4 months after the end of the basis period for that year of assessment unless he is already required to furnish a tax return for that year. Failure to comply is an offence punishable by a maximum fine of three times the tax which would have been chargeable (s80(2) and s82A).

## ¶4-022 Accounting records

For profits tax cases, specific omission requires examination of account books, supporting vouchers and documents. A successful application of the special omission method depends on whether the correct accounting records are available to the IRD officers. The accounting records may range from true and complete accounting books

supported by vouchers which fully disclose the understatements to books of income or expenditure secretly kept by the taxpayer which uses codes to camouflage the accounting information. Very often, the IRD obtains the correct accounting records by a search under the authority of a search warrant obtained under s51B. See *R v HO Lui* (1990) 3 HKTC 289 and *R v Kwok Hing For* (1991) 3 HKTC 447.

## ¶4-023 Adjustments to tax computations

The IRD officers, in carrying out a field audit or investigation, will investigate whether expenses deducted in the tax computation do qualify for deduction under the IRO or whether the expenses claims are supported by documentary evidence. Should any expenses be found to fail to qualify for deduction, adjustments will be made, followed by penalty if there has been failure to make full disclosure, deliberate concealment or negligence in ensuring that the tax claims are indeed justified. Tax representatives and auditors should therefore take care in preparing tax computations to avoid such unfortunate consequences. In case of doubt, full details should be provided to the IRD in order to clarify whether the expenses are deductible.

Common items of adjustments are listed below.

(a) Bad debt

The officers will ensure that s16(1)(d) is compiled with. The area which causes the most difficulty is whether the debt has indeed become bad. The IRD may not accept that a debt has become bad simply because the debt has been outstanding for a considerable amount of time. There must be evidence justifying the conclusion that a debt has become bad, e.g. such as if the debtor has become bankrupt or liquidated or legal action has been taken without fruitful result. Many bad debt claims have been disallowed with adverse consequences to clients in the form of penalties if the clients were being subject to a field audit/ investigation

(b) Entertainment

Entertainment expenses not supported by vouchers or without details as to the nature of business, identity of persons entertained etc. are

 



non-deductible (see *Stanley So Kai-tong v CIR* 6 HKTC 38). It is a common misconception of taxpayers that all that is required to support a claim for entertainment expenses is the invoices or vouchers issued by for example, the restaurants or night clubs. However, these are insufficient and full details such as the identity of persons entertained and the business concerned should be kept and made available if required. Expenses of entertainment which are predominantly social in nature are non-deductible.

(c) Commission

Adjustments will be made if the taxpayer is unable or unwilling to give full details of the recipients of commission or if the commission is not supported by documentary evidence. The IRD may also challenge whether the commission is a genuine expense if the commission is not actually paid over a number of years but remains as an outstanding liability in the accounts of the taxpayer.

(d) Expenses for private purposes

Private expenses such as electricity and water bills of the residence of the sole proprietor or wages paid to aged parents which are in reality living allowances provided by children, are non-deductible.

(e) Interest expenses

Interest expenses which fail to fulfill s16(1)(a) and any one of the conditions of s16(2) or contravene s16(2A)(collateral deposit), s16(2B) or s16(2C) (interest flow back) will be wholly or partly disallowed. A common example is interest incurred on bank borrowings where the loans were provided interest free to associated persons or corporations.

(f) Other non-deductible expenses

Expenses incurred in the production of capital profits or offshore profits are non-deductible.

## ¶4-024 Prosecution

Specific omissions provide a potential source for prosecution cases. It is extremely difficult, if not impossible, to prosecute solely on the evidence derived by indirect methods e.g. assets betterment statement. Where a

tax representative is instructed by the client to make disclosure of specific omissions, the IRD will require the submission of the correct accounting records and documents to support the specific omissions. The client should accordingly be advised to seek legal advice before making the disclosure.

## ¶4-030 Where accounting records are incomplete

The taxpayer may fail to prepare proper accounts, which has become a common phenomenon of SME businessmen who neglect the importance of proper accounting and devote little resources to such area. Alternatively, a taxpayer may have complete accounting records but if the records show understatements of income or profits, the taxpayer may falsely claim that no accounting records are kept.

Where accounting records are incomplete or where none is provided by the taxpayer, indirect methods would have to be adopted. For some indirect methods such as Bank Deposit Method, what we learn from elementary accounting on "Incomplete Records" would be relevant. See "Bank Deposit Method" below.

## ¶4-040 Assets Betterment Statement ("ABS")

An ABS is only used in full investigation cases due to its complexity. However, a rough ABS (a "Top and Tail ABS") may be used in field audit cases to quantify the understatement or to cross check whether the understatement computed by another method is adequate. See Chapters 5, 6 and 7.

## ¶4-050 Bank Deposit Method

For tax matters, it is for the taxpayer to prove that the assessment is incorrect (s68(4)). In a field audit/investigation, deposits into business bank accounts will be treated by the IRD as business deposits, unless evidence is available to the contrary. This may also apply to private bank accounts where IRD officers find that some business receipts are banked therein. The following illustration demonstrates how the bank deposit method operates:






*[Illustration]*

Mr. Wong operates a convenience store called "Square D". He has two bank accounts:

(i) a current account with the Bank of Guinea in the name of "Square D";

(ii) a savings account with the Shark Bank in his own name.

The assessable profits may be ascertained as follows:

| | | Note |
|---|---|---|
| Closing trade debtor balance | $ 500,000 | |
| Total deposits into both bank accounts | 4,000,000 | |
| Add Payments made in cash | 300,000 | 1 |
| | 4,830,000 | |
| Less | | |
| Inter-bank transfer | 200,000 | 2 |
| Non-business receipts | 130,000 | 3 |
| | 4,500,000 | |
| Less | | |
| Opening trade debtor balance | 230,000 | |
| | 4,270,000 | |
| Add | | |
| Closing trade debtor balance | 310,000 | |
| Estimated sales for the accounting period | 4,580,000 | |
| Sales per return | 3,000,000 | |
| Deemed Understatement of sales | 1,580,000 | |

Notes:

1. This is the sum of all receipts which have been paid out before being banked. It covers both business and private payments.

2. Inter-bank transfer - a sum of $200,000 being transferred from the "Square D" account to the personal bank account.
3. Non-business receipts.

These may be:

- short term or long term loans by a friend or relative;
- injection of fund into the business by the proprietor;
- remittances or gifts from friends or relatives;
- sale of non-trading assets e.g. shares, gold, immovable properties,
- dividend;
- rent;
- gambling wins; or
- repayment of loans.

The bank deposit method is only an estimated indirect investigation method. It may not be fair to treat the entire bank deposits as business receipts. A taxpayer usually has numerous bank transactions during the investigation period (normally 6 years). Where the total bank deposits exceed the gross sale or income by a substantial amount, an explanation is needed by the taxpayer. It may be difficult for a taxpayer to explain all transactions through all bank accounts for the following reasons:

a) there are no statutory requirements to keep accounting records in respect of private bank transactions;

b) the transactions took place long ago;

c) documents relating to the transactions may not be retained;

d) no documents to prove the nature of a transaction.

It is impossible to identify what evidence is acceptable to the IRD to prove that the receipts are not business receipts as each case depends on its own facts. A mere written confirmation, say, from a person in Mainland China that large sums of deposits in the taxpayer's bank account belong to him/her, without other supporting evidence, is usually not sufficient.

 



The bank deposit method is useful in investigating cash trades (i.e. trades in which the goods or services are supplied on a cash on delivery basis) such as restaurants, retail shops, and medical practitioners. An example is D21/05 20 IRBRD First Supplement.

## ¶4-060 Business Economics (Percentage Computation) Method

This method ascertains the profits of a business by reference to the estimated volume of business, the sales prices or service charges and the estimated expenses.

*[Illustration]*

Cafeberg is a retailer of coffee beans. Its product mix for the year ended 31 December 2012 was:

| | % of purchases | Mark-up on cost | Cost of Sale for 2015 |
|---|---|---|---|
| Columbia coffee | 30% | 25% | $1,200,000 |
| Chinese coffee | 70% | 15% | $2,800,000 |
| | | | 4,000,000 |
| Estimated gross profits: | | | |
| Columbia coffee | | | 300,000 |
| Chinese coffee | | | 420,000 |
| | | | 720,000 |
| Gross profits per return | | | (200,000) |
| Understated gross profits | | | 500,000 |

The mark up on costs may be ascertained from the taxpayer's sample transaction or based on accounting data of traders of similar business.

*[Illustration]*

Blind Wong is a famous fortune teller. He charges $5,000 for each consultation. In the initial interview, he informed IRD that on average, he only served two clients a day.

totality which is well recognised in criminal sentencing, even if the IRD's interpretation is correct, it is contrary to sentencing principles to subject an offender to the maximum penalty for EACH year.

### ¶11-050 Tax Evasion Offences

Tax evasion may be prosecuted under s80(2), s82(1) and also under the common law offence of cheating the revenue. Like many countries, the IRO authorises the Commissioner to impose an administrative penalty for tax evasion under s82A instead of prosecuting the offender in court. Formerly, tax offences were prosecuted under the Theft Ordinance but this is no longer the practice.

Tax offenders naturally are averse to the publicity of being prosecuted in court and indeed, most tax evasion cases are settled by negotiation. The settlement would, apart from the basic tax, include the penalty by compounding. This affords an expedient manner to settle the case and avoid the embarrassment of being prosecuted in court. See Chapter 10 for the procedure for compounding an offence. Compounding may be in respect of penalties under s80(2) or s82(1).

If the issue of penalty cannot be settled by compounding because both sides fail to agree on the quantum of penalty, the penalty will be dealt with by s82A. An assessment to penalty under s82A affords the taxpayer an opportunity to appeal to the Board of Review.

See Chapter 14 for s82A additional tax and Chapter 15 for prosecution of taxevasion.






# CHAPTER 12 PENALTY POLICY OF THE IRD



This chapter deals with the penalty policy of the IRD which is published on its web site. The penalty policy is applicable to compounding under s80(2) and s82A additional tax.

### ¶12-010 The IRD's Penalty Policy - Field Audit/ Investigation Cases

The IRD in its penalty policy adopts different policies in relation to field audit or investigation cases, profits tax cases, salaries tax and personal assessment cases. (This differentiation has been criticised by the Board of Review in *D118/02*).

The IRD computes penalty on the basis of the following factors:

(1) the degree of co-operation;

(2) nature of evasion;

(3) interest on delay in payment of tax due to evasion (Commercial Restitution ("CR")).

The degree of co-operation is classified into 4 categories:

(1) full voluntary disclosure;

(2) disclosure with full information promptly on challenge;

(3) incomplete or belated disclosure;

(4) disclosure denied.

The IRD encourages taxpayers to make full voluntary disclosure of their offences and offer reasonable proposals for the Department's consideration. Where a taxpayer fails to make full voluntary disclosure under the Penalty Policy, field audit cases (including anti-avoidance cases) closed within 3 months from the date of initial interview as well as investigation cases closed within 6 months from the date of initial interview, can be classified as falling into the category of "Disclosure with Full Information Promptly on Challenge" (para 5 Section C Penalty Policy of Assessing Additional Tax under s82A, Penalty Policy IRD).

The nature of evasion is classified into 3 categories:

Group (a) — cases where the taxpayers show intentional disregard to the law and adopt deliberate cover-up tactics involving the preparation of a false set of books, padded wage rolls and fictitious entries or multiple omissions over a long period of time.

Group (b) — cases with slightly less serious acts of omission resulting from recklessness including the "hand in the till" type of evasion, failure to bring to account sales of scrap and sheer gross negligence.

Group (c) — cases where the taxpayers fail to exercise reasonable care and omit profits or income such as lease premium or one-off commission.

Commercial Restitution

In respect to tax evaded, the public has lost the use of the tax thus the IRD will seek to recover the interest lost for the period from the time when the tax is normally due to the due dates of the tax to be recovered. The interest element is called commercial restitution. It is incorporated in the overall penalty and is not separately shown.

For cases completed after 30 November 2003, the CR is at the best lending rate monthly compounded.






*IRD has published a penalty table on its web site which is reproduced below:*

## ¶12-020 Category of Disclosure and Work Involved

| Nature of Omission/ understatement | Full voluntary disclosure | | Disclosure with Full information promptly on challenge | | Incomplete or belated disclosure | | Disclosure denied | |
|---|---|---|---|---|---|---|---|---|
| | Normal Loading | Max incl CR | Normal Loading | Max incl CR | Normal Loading | Max incl CR | Normal Loading | Max incl CR |
| 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 Table (reproduced from IRD website)*

IRD indicates that this penalty table applies to profits tax, salaries tax, property tax and personal assessment cases where field audit or investigation has been conducted.

A higher than normal penalty loading will be imposed for second or more offences but subject to the maximum including CR.

In the generality of cases, subject to various aggravating or mitigating factors, a penalty of approximately 100% of the amount of tax undercharged is considered appropriate in the following circumstances (see *D118/02*):

(a) where there has been no criminal intent and the taxpayer has totally failed in his or its obligations under the Ordinance;

(b) where the Commissioner has had to resort to investigations or the preparation of assets betterment statements or has otherwise had difficulty in assessing the tax; or

(c) where the failure by the taxpayer to fulfil his or its obligations under the Ordinance has persisted for a number of years.

For s82A cases, taxpayers will be advised of the category and/or the group of penalty loading applicable to them in the relevant additional tax assessments.

The penalty will be increased due to aggravating factors or decreased due to mitigating factors. The maximum adjustment is limited to 25%. Further adjustment will be made where exceptional circumstances exist. (para 4 Section C, Penalty Policy IRD).

Aggravating factors include:

- sophisticated taxpayer;
- established and sophisticated business;
- attitude of taxpayer:
  - i. undue delay or obstruction to the progress of audit and investigation;
  - ii. passiveness, unwillingness to compromise, evasiveness and
  - iii. belated acceptance of the discrepancy quantified.






- multiple or repeated evasion acts over a consecutive number of years (e.g. persistent default in rendering returns and making of incorrect returns when pressed with estimated assessments);
- substantial quantum of understatements having regard to the operating scale of the business;
- discrepancy consisting of specific fictitious items with cover-up tactics.

Mitigating factors include:

- being illiterate or having a low standard of education;
- simple and unsophisticated business;
- genuine concern, seriousness, responsiveness and co-operation;
- sincerity and willingness to compromise;
- readiness to accept the discrepancy when quantified;
- casual or one-off understatement;
- relatively small cases;
- accepted discrepancy includes substantial contentious items.

Strictly speaking, each offence should be considered separately. However, if multiple offences were committed by the taxpayer in respect of the same year of assessment, the Commissioner would normally penalise the taxpayer for the offence of the most serious nature only.

## ¶12-030 Late Returns

As s82A makes no distinction between, among other things, transgression for understatement of income and late filing of return, the exposure to treble the amount of tax undercharged is applicable to both. Furthermore, the rule mentioned in para 9 above is equally applicable. However, as the majority of the late return cases do not involve these factors, the level of penalty is much lower.

i. For cases involving late filing of returns with no omission or understatement of income or profit detected after field audit or

investigation, the penalty policy under Parts E to G of the Penalty Policy is to be applied. However, a higher penalty loading will be applied if the taxpayer intentionally delays the submission of the returns pending the result of the field audit or investigation.

ii. The penalty for a second or subsequent offence uncovered during an audit / investigation would be more severe.

## ¶12-040 IRD's Penalty Policy – Non-investigation/Field Audit Cases

*Profits Tax Cases*

For failure to notify chargeability to tax or late returns:

(a) First offence

Group (i) 10% of tax undercharged.

Group (ii) 20% of tax undercharged if the return is filed after two or more estimated assessments are issued.

(b) Second offence within 5 years

Group (i) 20% of tax undercharged.

Group (ii) 30% of tax undercharged if the return is filed after two or more estimated assessments are issued.

(b) Third or subsequent offences within 5 years

Group (i) 35% of tax undercharged.

Group (ii) 50% of tax undercharged if the return is filed after two or more estimated assessments are issued.

The penalty may be adjusted by reference to factors such as the length of delay, the amount of tax involved, the reasons for committing the offence, the attitude of the taxpayer and the remedial steps taken by him.

For the purpose of calculating the number of offences within 5 years, "offence" means one in respect of which a warning letter, a compound, a court fine or a s82A penalty assessment has been issued.

In the event that there is omission of understatement of profits, the penalty table set out above will apply. However the fact that no field

 



audit or investigation has been conducted will be considered as a mitigating factor.

## ¶12-050 Salaries tax and Property tax Cases

For failure to notify chargeability or late returns cases, compounding under s80(5) will be adopted rather than imposing s82A additional tax. Prosecution may be instituted under s80(2) for repeated offences or serious cases.

For simple and inadvertent omission or understatement of income or the making of an incorrect statement in respect of a claim for an allowance or deduction:

(a) First offence

10% of tax undercharged.

(b) Second offence

20% of tax undercharged.

(c) Third or subsequent offences within 5 years

35% of tax undercharged.

For blatant cases, a higher percentage, currently at 100% will normally be imposed.

Adjustments may be made depending on the circumstances including the time span over which the offence is committed, the amount of tax involved, the reasons given for committing the offence, the attitude of and the remedial steps taken by the taxpayer.

For the purpose of counting the number of offences within 5 years, "offence" means the same as above i.e. one in respect of which a warning letter, a compound, a court fine or a section 82A penalty assessment has been issued.

## ¶12-060 Personal Assessment Cases

For incorrect statements in respect of a claim for an allowance or deduction, the penalty scale for salaries tax will be adopted.

investigated again or even for the third time. Naturally, the penalty will be a lot higher should discrepancies be found in the second or third audit. Even for personal assets and non-business income, it will be a good practice to keep the relevant documents just in case the IRD carries out another audit, such as stock transactions records, records of remittances from overseas, income from overseas, rental income, dividends, legacies or gifts.

### ¶17-100 Professional Fees

A tax professional will be of great help. Appointment of one is strongly recommended to any taxpayer subject to an audit. However, the fees will be substantial since audit cases are time consuming and call for a great deal of attention from the professional adviser. If the charge is on the basis of an hourly rate, taxpayers should take care to take a careful control of the fees incurred. There has been a case where a taxpayer engaged a professional accountant to deal with an audit at an hourly rate of $2,500. The case dragged on for a number of years and when the case was finally settled, the bill received by the taxpayer ran over $4 million.






# CHAPTER 18 CASE STUDIES



The facts are modified to protect the secrecy of all parties involved excepted for published tax cases.

### ¶18-010 Omission of Income and Overstatement of Purchases

A partnership operated a food business and it was managed by one junior partner who submitted on behalf of the partnership, incorrect accounts understating its profits. The IRD initiated an investigation and the junior partner instructed a CPA to submit a report to the IRD. The CPA carried out a 100% check of the entries in the accounting books and the entries in business bank accounts. He made no discoveries of errors and duly reported to the IRD. The junior partner had in fact failed to deposit some sales into the business bank account. The sales proceeds were deposited into an undisclosed bank account belonging to the partners. The lesson is that even a full audit is often impossible to discover deliberate tax evasion. What is crucial is that records may not be shown in the account books. A tax representative should thus take full and careful instructions from his/her client with a view to identify the direction for investigation and ultimately formulate a suitable basis for settlement. Carrying a full audit in this case may waste valuable time and professional cost. The resulting delay in settlement caused a higher penalty for the client.

## ¶18-020 Excess Deposit and Gross Profits Approach

A taxpayer operated an electronic appliance business in a tourist shopping area in Tsim Sha Tsui. A field audit disclosed that the bank deposits for 6 years exceeded the reported sales by many millions of dollars. The taxpayer explained that the deposits comprised of sales proceeds from property speculation and shares but was unable to explain the source of the remaining excess deposits which amounted to a total of $40 million. The taxpayer resisted the suggestion of the IRD to treat the $40 million as understated profits. His/her tax representative offered to apply the gross profit ratios as shown in the profit and loss accounts submitted to the IRD to the excess deposits and treat the sums so derived as understated profits. The tax representative sought to justify the aforesaid gross profit ratios by providing analysis of sales and costs of sales of sample transactions. After protracted negotiation, the understatement was quantified by an agreed gross profit ratio for all years concerned.

A taxpayer operated a metal trading business and the bank deposits were found exceed the reported sales by $10 million. The taxpayer explained that these were proceeds from the sale of scrap metals by contending that the scrap metals were purchased from wasted goods merchants and sold at a profit. He claimed to be unable to give the names and addresses of the wasted goods merchants due to the lapse of time. The investigation officer thus treated the whole of the $10 million as understated profits.

## ¶18-030 *R Wong Yue Hung Johnson* (1992) 3 HKTC 733

The defendant operated a sole proprietorship business (JWC) and a corporate business. JWC earned commissions paid by two factories which supplied shoes and handbags to the sole customer of JWC. Having been aware of the payment of commission by one factory, an assessor made an inquiry. The defendant confirmed receipt of commissions and that there was no omission of other income from other sources in the tax returns. Upon further inquiry by the assessor, the defendant admitted that he had in fact only reported somewhere in between 10.07% to 20.87% of the total commission in the tax returns for 1983/84 to 1986/87. The amount of commission omitted amounted to approximately $6.7 million and the tax






evaded totalled approximately $1.1 million. Subsequently the defendant was prosecuted for tax evasion. He pleaded not guilty. He alleged that his wife dealt with all account matters and all returns were prepared by his wife and he was not aware of the contents therein.

After trial, the judge convicted him of all charges as having submitted incorrect returns wilfully, with intent to evade tax or wilfully, with intent to evade tax signing returns without reasonable ground for believing the returns to be true. The judge pointed out that the defendant himself presented the debit notes for the commissions to the factories. The payment cheques were disguised as 'exchange covered cheques' or advance by the defendant and channelled from the business bank account to his personal account. The judge did not believe that he was not aware of the contents of the profits tax returns in view of the magnitude of the omission, the close relationship with his wife, the fact that the primary accounting records were well kept and that he still denied omission after the assessor's initial inquiry. He was sentenced to 18 months imprisonment suspended for 24 months in view of the young age of his children and that a custody sentence would cause closure of business. He was also fined for nearly $3.5 million

## ¶18-040 *The Queen v Ng Wing Keung, Paul* (First Defendant "D1") *and Choi Sin-biu* (Second Defendant "D2") 4 HKTC 264 (see Appendix A)

D1 was a Senior Agency Manager of an insurance company and the sole proprietor of a business, Paul Ng & Co. D1 signed the profits tax returns of Paul Ng & Co and in relation to these, was charged under s82(1)(g) for using a fraud, art or contrivances wilfully with intent to evade tax and s82(1)(c) for making a false claim for deduction or allowance wilfully with intent to evade tax. The prosecution alleged that D1 claimed deduction of payments to phony subagents and that D2, his personal assistant, aided and abetted D1 in committing these offences.

In the accounts in support of the returns, commissions were stated to be paid to 39 subagents. The IRD located 37 of them who all denied that they knew D1 and D2, had received commission or that they took

out any insurance policy. D1's secretary gave evidence that she asked her brother to gather up names, addresses of friends and acquaintances which were used to comply the list of subagents. When D1 signed the returns, the accounts attached thereto included deductions for these alleged commissions. The secretary of D1 faxed a breakdown of the commissions (Schedule 3) to the accountant after D1 had signed the returns.

D1's defence was that he had engaged D2 to pay entertainment expenses, gifts to agents, and various expenses on his behalf. He used his secretary's bank account to reimburse D2 and in addition, paid out of his own pocket, cash incentives to agents. His case was that he gave two sets of figures to the accountants every year – one sum for the aforesaid expenses paid by D2 on his behalf and one sum for the cash incentives. He understood that the subagent commission was in respect of these two sums but it was not his instruction to send the list of names of subagents to the accountant. The judge found that D1 wilfully caused ghost sub-agents lists to be forwarded to his accountant for incorporation into Schedule 3. The defence lawyer submitted that Schedule 3 was added to the tax returns only after D1 had signed them so he could not be held to be aware of the details therein. The court found that this argument did not aid D1 because it was clear that no commission at all was paid to any sub-agent (per Court of Appeal at 304). D1 was convicted and sentenced to 3 months' imprisonment and fined. D2 was acquitted.

## ¶18-050 *HO Lui* 3 HKTC 289 (see Appendix B)

The defendant was the sole proprietor of a business and was charged under s82(1)(d) for signing profits tax returns without reasonable grounds for believing them to be true and with the wilful intent to evade tax. In his business, some goods were set aside to be sold later and the sales proceeds, accordingly to the defendant, would contribute towards the payment of commission expenses. The purchase prices of these goods were claimed as deductions in the tax returns while the sales proceeds were not treated as sales in the tax returns but were credited to the Temporary Loan Account (which was a current account operated by the defendant). A separate series of invoices were kept for these sales with details kept in Sut Yip Accounts. The defendant claimed that






commissions were paid out of these transactions but he refused to disclose the recipient(s) or details of the commissions. The IRD discovered upon a raid, a file containing profit and loss accounts ("the Phillips Accounts") disclosing much larger profits than those in the tax returns submitted to the IRD. The defendant claimed that the Phillip's Accounts were for the purpose of credit ratings. The tax returns were prepared by a proprietor of a street stall Ah Cheung. The judge did not believe that he had paid the commissions or that Ah Cheung existed. The defendant could not have reasonably believed that the returns were true. He was convicted and sentenced to 12 months imprisonment and fined $1,955,000, being 50% of the basic fine under s82(1)(d) plus 200% of the additional penalty.

## ¶18-060 *Yu Kam Sing* DCC640/1994, 4 HKTC 68 (see Appendix C)

The defendant ran a brassieres and swimsuits business through a limited company, York Industries, of which he kept firm control of its operations. He devised a fraudulent scheme to evade tax by concocting 4 unincorporated companies whereby purchases of clothes were purportedly made through these companies. Cheques were drawn out of York's bank accounts supposedly to these companies but were deposited into his or his wife's bank accounts or cashed and paid to the defendant. The defendant gave invoices and receipt to his bookkeeper purportedly for purchases from these companies. His employees gave evidence in court that they had knowledge of these companies. The trial judge did not believe that the transactions with these companies occurred due to the following:

(a) the absence of business records of these companies e.g. business registration;

(b) the absence of telephone records;

(c) no trace of the companies at the addresses printed on the invoices;

(d) the extent of the purchases and the time span they covered;

(e) payments to the personal bank accounts of the defendant/his wife;

(f) similarities of signatures on invoices from different companies;

(g) similarities in the layout of the invoices of different companies;

(h) the purchases were all in cash except one;

(i) some invoices went to NZ dollars purchases.

One employee gave evidence that he personally received the cloth represented in every one of the invoices. But the judge did not accept his evidence having considered many adverse evidence on his credibility, for example, the pattern of the signatures on the doubtful invoices, the fact that his signatures did not appear on any of these invoices although he claimed to have received delivery, his signature on other invoices for goods received by him and his answers given in cross examination.

The judge found that the defendant had knowledge of the contents of the accounts submitted to the IRD and that he signed the returns. He knew that the invoices were false and he wilfully overstated purchases for the purpose of tax evasion. He made use of fraud, art or contrivances contrary to s82(2)(g). A sentence of imprisonment for 15 months and a fine of approximately $3 million was imposed.

## ¶18-070 *HKSAR v Chan Kin-man Ivan* 5 HKTC 535 (see Appendix D)

The defendant, a director of the taxpayer company, omitted sales by arranging the preparation of 3 types of sales invoices – "A invoices" for credit sales, "C invoices" and no-prefix invoices for cash sales. Only the sales per A invoices and C invoices were recorded in the general ledgers and daily sales ledgers. The no-prefix invoices sales were deposited into a separate savings account. The accountant of the company gave evidence that the defendant was in charge of the accounting procedure. The defendant signed the profits tax returns except for one year which was signed by the majority shareholder but the defendant signed the balance sheets. He gave a cautioned statement that the no-prefix invoices were in respect of sales of pre-incorporation stock and stock of some Taiwanese. They were not trading stock of the business so the profits therefrom should not form part of the company's profits. Such goods were different products from those of the company or were inferior






goods. Transfers from the saving account to his personal bank account were claimed to be temporary loans. The total amounts of such transfers amounted to $2 million while his monthly salary was less than $20,000 and no money had been paid to the Taiwanese parties. The goods were in fact similar to those of the company and sold at similar prices, although the defendant claimed that they were inferior goods. The defendant was convicted of assisting the company to evade tax by omitting sums which should be included and wilfully using a fraud, art or contrivances to assist the company to evade tax.

## ¶18-080 *Asia Master Ltd v CIR* [2006] HCAL 114/2005 (see Appendix E)

Goods were manufactured in Mainland China and sold to a BVI company which then on-sold to the Hong Kong company ("the taxpayer"). The Group was subject to an investigation and the IRD took the view that the profits of the taxpayer had been siphoned off to the BVI company which was interposed between the Mainland factory and the taxpayer. The profits of the BVI company were assessed as being part of the profits of the Hong Kong Company by the application of s61 and s61A by the Assistant Commissioner. The case was settled by agreement between the IRD and the taxpayer whereby the taxpayer was subject to additional assessments and a compound penalty of $15 million being 82% of the tax undercharged. The taxpayer later applied for judicial review to reopen the assessments. The taxpayer contended that not all activities of the BVI company were attributed to the activities in Hong Kong i.e. that part of its profits should be attributed to manufacturing in Mainland China and that the Mainland China factory reported a loss. To tax the whole of the BVI company's profits therefore resulted in double taxation of that part of the profits. The tax representative prepared a transfer pricing analysis attempting to justify the pricing within the Group. The High Court refused to grant late objection and rejected the transfer pricing analysis as not being sufficient justification to support the taxpayer's case. As for the double taxation argument, since there was at that time no comprehensive double taxation arrangement between the Mainland and Hong Kong, it was not feasible to consider any relief under this aspect.