

Field Audit and Tax Investigation



FIELD AUDIT AND TAX INVESTIGATION

Under the Hong Kong Inland Revenue Ordinance (“IRO”), the lodgment of an incorrect return, without reasonable excuse, is an offence. In order to recover back year taxes, provide a deterrent to tax evasion, and educate taxpayers on the need to file proper and correct returns, the Hong Kong Inland Revenue Department (“IRD”) sets up the Field Audit and Investigation Unit for conducting field audits and investigations on business and individuals with the view to combating tax evasion and avoidance.



In this article, we would like to provide you with a brief introduction of the field audit and investigation process and settlement methods.

Audit Trilogy

Since April 2001, the IRD has implemented the “Assess First, Audit Later” (“AFAL”) system to automate tax returns screening and assessment processes. Under the AFAL system, tax returns submitted will not be examined immediately. The IRD will issue Profits Tax Assessments / Statements of Loss in the first instance based on reported figures if some pre-set conditions are satisfied. With the aid of computer programs, tax returns assessed under the AFAL system may be selected for Desk Audit / Field Audit / Investigation at a later date.

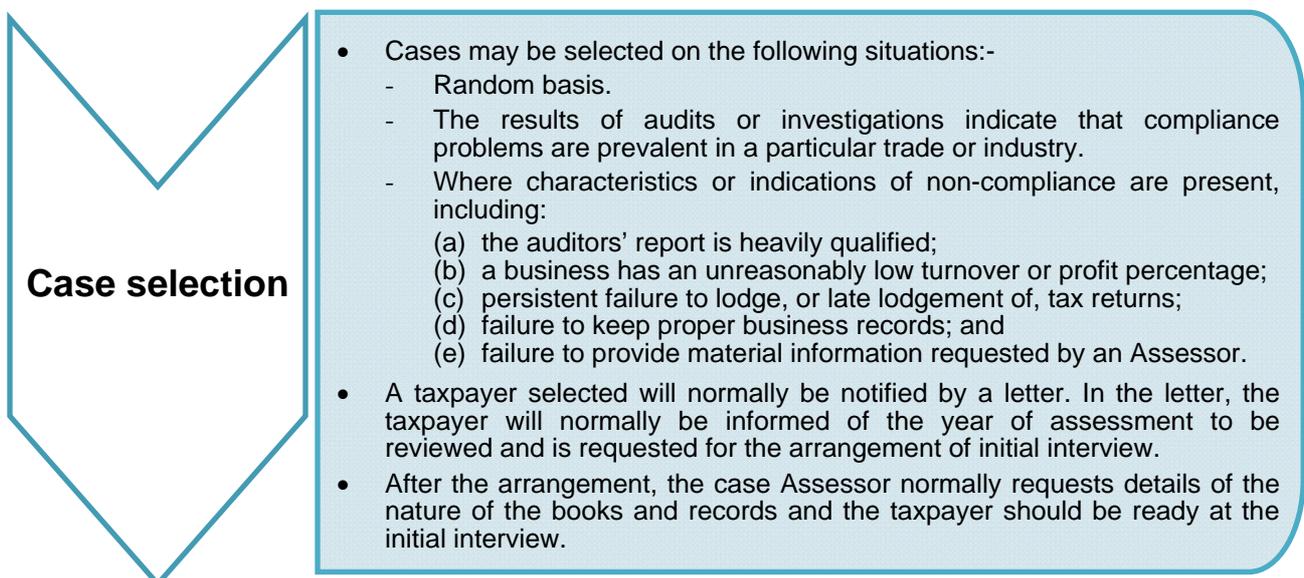
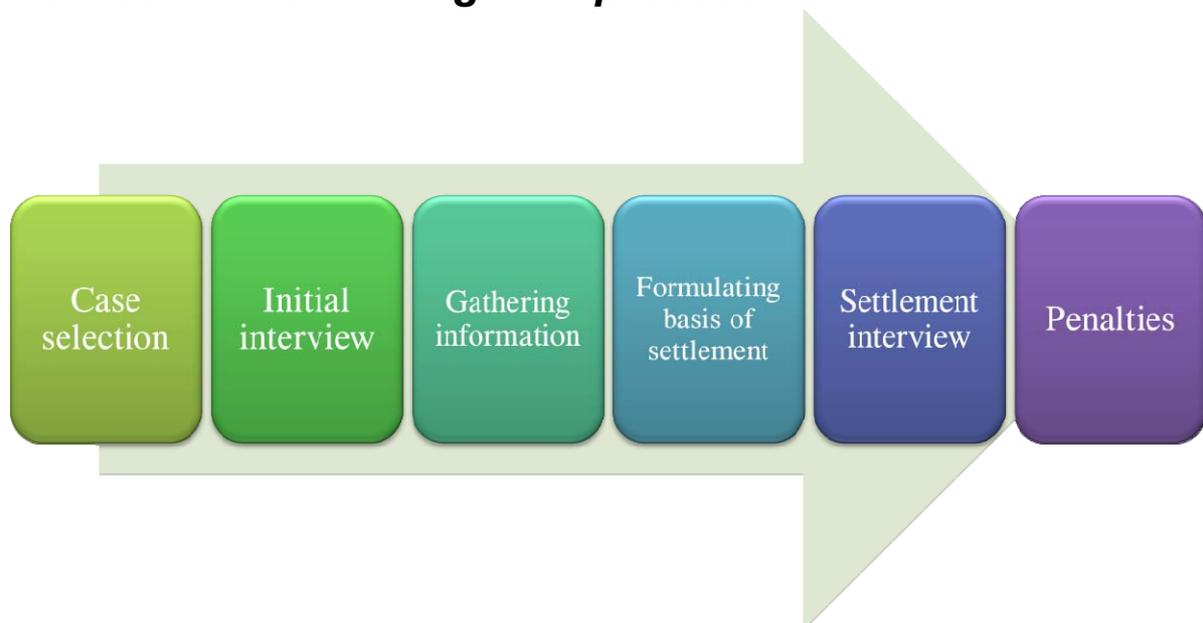
	Situation	Letters issued by IRD?	Year(s) of assessment covered	Settlement method
<i>Desk Audit</i>	When clarifications are to be sought in an automated assessment case	√	1 – 6 years	Taxpayers have to comply with the notice issued and furnish the required information.
<i>Field Audit</i>	When irregularities or indications of non-compliance with the requirements of the IRD are detected	√	Normally 6 years	Where appropriate and when agreed with the taxpayers, the Assessor will project the discrepancies for back years based on the field audit findings. Other quantification methods may also be employed.
<i>Investigation</i>	Where tax evasion is suspected	√	Normally 6 years; extended to 10 years in case of fraud or wilful evasion	Similar to field audit; but the Assessor will assess the case based on actual findings.

Tax evasion

Though the IRO does not contain a definition of “tax evasion”, IRD expressed its view in Departmental Interpretation and Practice Notes No. 11 that the term “evasion” includes the following:-

1. Deliberate non-lodgement of a return;
2. Deliberate understatement of income or over-claiming of deductions;
3. Understatement of income or over-claiming of deductions owing to ignorance of taxation obligations (even if without any conscious intention to undermine compliance or to understate assessable income); and
4. Overly aggressive tax planning.

Field audit and investigation process



Before the initial interview

- Before the initial interview, the taxpayer should invite his or her tax representatives to understand his or her business operation and review the details of the business records.
- Normally, the following documents will be requested by the case Assessor:

A list of the business books
(i.e. general ledger, invoices and vouchers etc.)

A list of the taxpayer's bank accounts in operation in Hong Kong or overseas, both business and private (including those held on behalf of the taxpayer in the name of another person)

A list of properties, investments, business assets and other assets owned by the taxpayer (including any such item acquired on behalf of the taxpayer in the name of another person (e.g. his spouse or another nominee))

A list of bank accounts which have been closed and particulars of properties etc. which have been sold in Hong Kong or overseas during the period covered by the field audit or investigation

Initial interview

- In order to have a thorough understanding of the taxpayer's business operation, an initial interview will normally take place at the taxpayer's office.
- During the initial interview, at least two Assessors will be present (i.e. Senior Assessor and Assessor) and they will:
 - (a) explain the penalty provisions of the IRO;
 - (b) obtain a preliminary understanding on the business operations;
 - (c) raise queries on items in the tax computations; and
 - (d) ask the taxpayer to confirm signature on tax returns and whether the tax returns previously submitted were correct.
- The taxpayer can invite his or her *tax representatives* to attend the interview.
- After the interview, a record of the interview will be issued by the case Assessors to the taxpayer for comment and confirmation. The taxpayer is requested to inform the case Assessors in writing if he does not agree with the contents of the record of the interview.

Gathering information

- Following the initial interview, the taxpayer is usually asked to provide accounting books together with supporting source documents e.g. trial balances, year-end adjustments and stock lists for examination.
- In particular, the case Assessor will pay special attention to the following:
 - (a) sales account;
 - (b) purchases account;
 - (c) director's proprietor's current account with the company;
 - (d) any account with an abnormal balance;
 - (e) any temporary account; and
 - (f) any account with a long outstanding balance.

It is sometimes necessary for the case Assessor to have access to statements and passbooks in respect of bank accounts operated by directors or proprietor and immediate family members.

- The case Assessor may sometimes make enquiries with third parties e.g. bankers, stockbrokers, suppliers and customers in order to obtain the required verification or clarify the nature of transactions.
- However, to avoid causing embarrassment, the case Assessor will normally seek information from the taxpayer in the first instance. To minimize the need for extensive third party enquiries, the taxpayer should respond promptly to any request for information from the case Assessor.

Protective assessments

- During the course of investigation, it is often for the case that the Assessor raises estimated assessments based on the information available, particularly in the following circumstances:
 1. to meet the 6 year time limit for raising back year assessments under section 60 of IRO;
 2. in deceased cases;
 3. where the taxpayer is about to leave Hong Kong; and
 4. where there are indications that the taxpayer is delaying the investigation process.
- The taxpayer can lodge a notice of objection to a protective assessment in order to keep the matter open and accordingly protect his interests.

**Basis of settlement -
Direct & indirect approaches**

Direct approach

- It is used when books and records are properly kept and the entries recorded in the books are reliable.
- In such circumstances, the taxpayer should prepare revised financial statements on the basis of the books and records to reflect errors and irregularities identified.

Indirect approaches

- They are used when it is not possible to construct revised accounts because of the inadequacy or even complete absence of records.
- Different methods illustrated below are used, depending on the circumstances of the case.

Assets Betterment Statement Method

- This method may be applied when the books and records in respect of a period are inadequate or are not available.
- Formula:
$$\text{Betterment profits} = \text{Increase in net assets} + \text{Disallowable expenditure} - \text{Non-taxable}$$

Bank Deposits Method

- It is a means to ascertain gross receipts where it is established that most of the taxpayer income is deposited into the bank accounts.
- In adopting this method, coverage will be extended to all bank accounts, including those held by nominees of the taxpayer.

Business Economics (Percentage Computation) Method

- This method involves the application of percentages or ratios (considered typical of business operations similar to those of the taxpayer) to particular known amounts in order to determine individual items e.g. sales, cost of sales, gross profits or even net profit.
- Any change in the taxpayer operations or business environment should be taken into

Projection Method

- When the Assessor is confident that the taxpayer assessable profits have been correctly determined for a particular year of assessment, the relevant figure may be used to estimate assessable profits for years where profits have been understated (provided that a more accurate means cannot readily be used).

Settlement interview

- A settlement interview will be held when a basis of settlement has been formulated by the case Assessor or the taxpayer.
- Where agreement is reached, the taxpayer is asked to sign a settlement form in the presence of a witness, usually the taxpayer's representatives. Also the signed interview note is submitted at this stage.
- The settlement form specifies, for each year of assessment, the amount of additional assessable profits or income. It also covers the taxpayer's basic tax liabilities for the years in question.
- However, it is clearly stated on the form that the acceptance does not conclude the whole matter and that the case will be put up to the Commissioner or a delegated senior officer for consideration of penalty action.

Penalties

- In assessing penalties, factors including the gravity of the case, the loss suffered by the IRD, the level of co-operation given by the taxpayer, the sophistication of the business and the presence of any evidence to suggest that the irregularity was deliberate will be taken into consideration.

Section 80 of the IRO (Prosecution)

- Imposed on person who, without reasonable excuses, makes incorrect returns or fails to submit returns within the time limit.
- A fine at level 3 (HK\$10,000) plus 300% of tax undercharged.
- The Commissioner may compound the penalty to a smaller amount.

Section 82 of the IRO (Prosecution)

- Imposed on person who wilfully with the intent to evade tax by making any false statement in returns.
- On summary conviction: A fine at level 3 (HK\$10,000) plus 300% of tax undercharged, and imprisonment of 6 months.
- On indictment: A fine at level 5 (HK\$50,000) plus 300% of tax undercharged, and imprisonment of 3 years.

Section 82A of the IRO

- Imposed if no prosecution has been instituted under Sections 80 and 82 of the IRO.
- Additional tax.

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. C.R.	Normal Loading	Max. incl. C.R.	Normal Loading	Max. incl. C.R.	Normal Loading	Max. incl. C.R.
deliberate cover-up tactics	15	60	75	100	140	180	210	260
slightly less serious acts of omission	10	45	50	75	110	150	150	200
failure to exercise reasonable care and omission profits/income	5	30	35	60	60	100	100	150

<http://www.ird.gov.hk/eng/pol/ppo.htm#C>

Conclusion

A field audit and tax investigation can be a time consuming exercise and could possibly take more than a year to complete. In this regard, it is highly recommended that you invite a professional to accompany you to attend the initial interview, to assist in the preparation of the settlement proposal and to speed up in reaching settlement with the IRD.



If you would like further advice or information in relation to the issues outlined above, please contact any of **HLB Hodgson Impey Cheng Taxation specialists** listed below:

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