



Tax audit on Small and Medium-sized Enterprises

28 September 2021

Publications

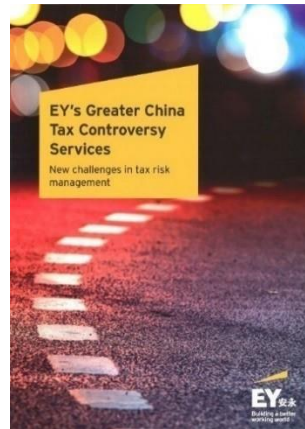
EY Tax Controversy Covid-19 Response Tracker

The regularly updated EY COVID-19 Tax Controversy Response Tracker helps you monitor related tax enforcement changes across the globe.



EY Greater China Tax Controversy Services

Describes EY approach to the changing tax environment and challenges faced by taxpayers.

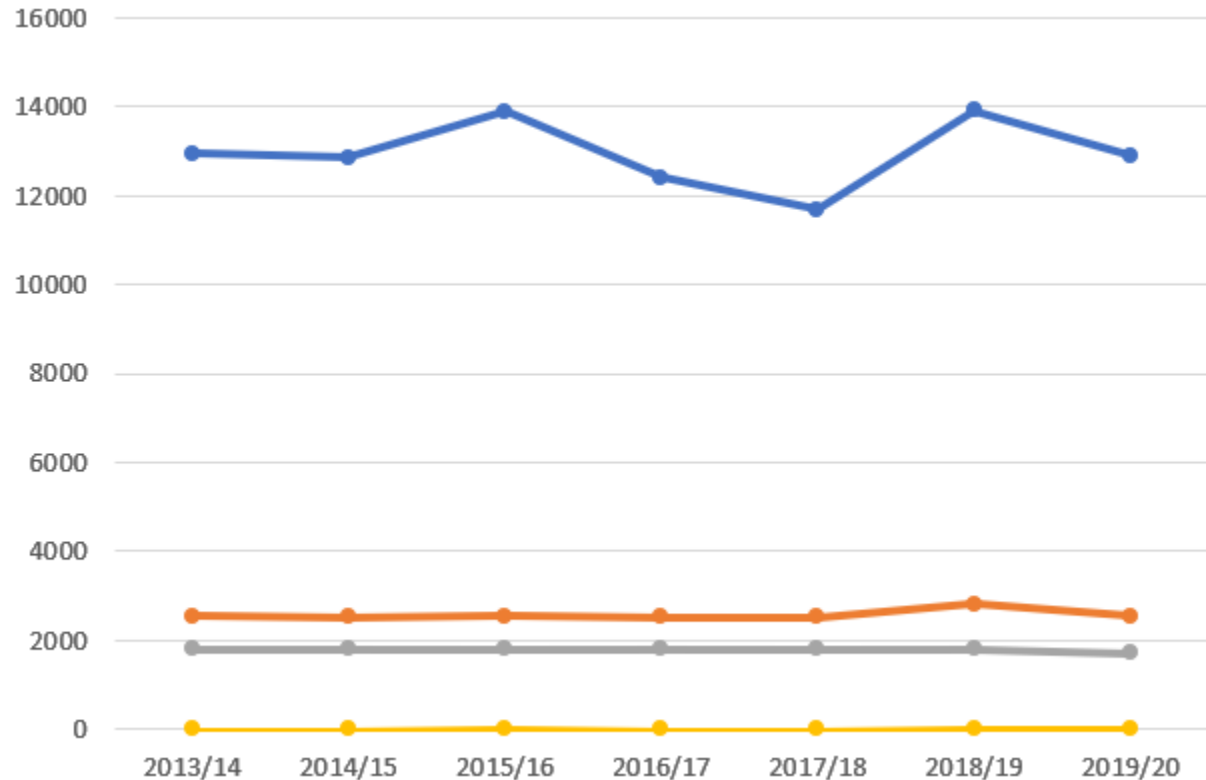


Hong Kong Tax Controversy Insight

Provides a practical perspective on the tax controversy environment and procedures in Hong Kong. Designed to introduce readers what tax controversy involves and stay connected with the latest Hong Kong tax controversy development and trends.



How much the IRD is chasing after?



Understated profits (HK\$m)	12936	12858	13889	12409	11688	13910	12893
Tax and Penalty (HK\$m)	2540	2533	2538	2528	2526	2827	2549
No. of cases completed	1802	1803	1804	1801	1804	1802	1716
Average Understatement (HK\$m)	7	7	8	7	7	8	8

Source: The IRD Annual Reports

Agenda



What's tax audit?



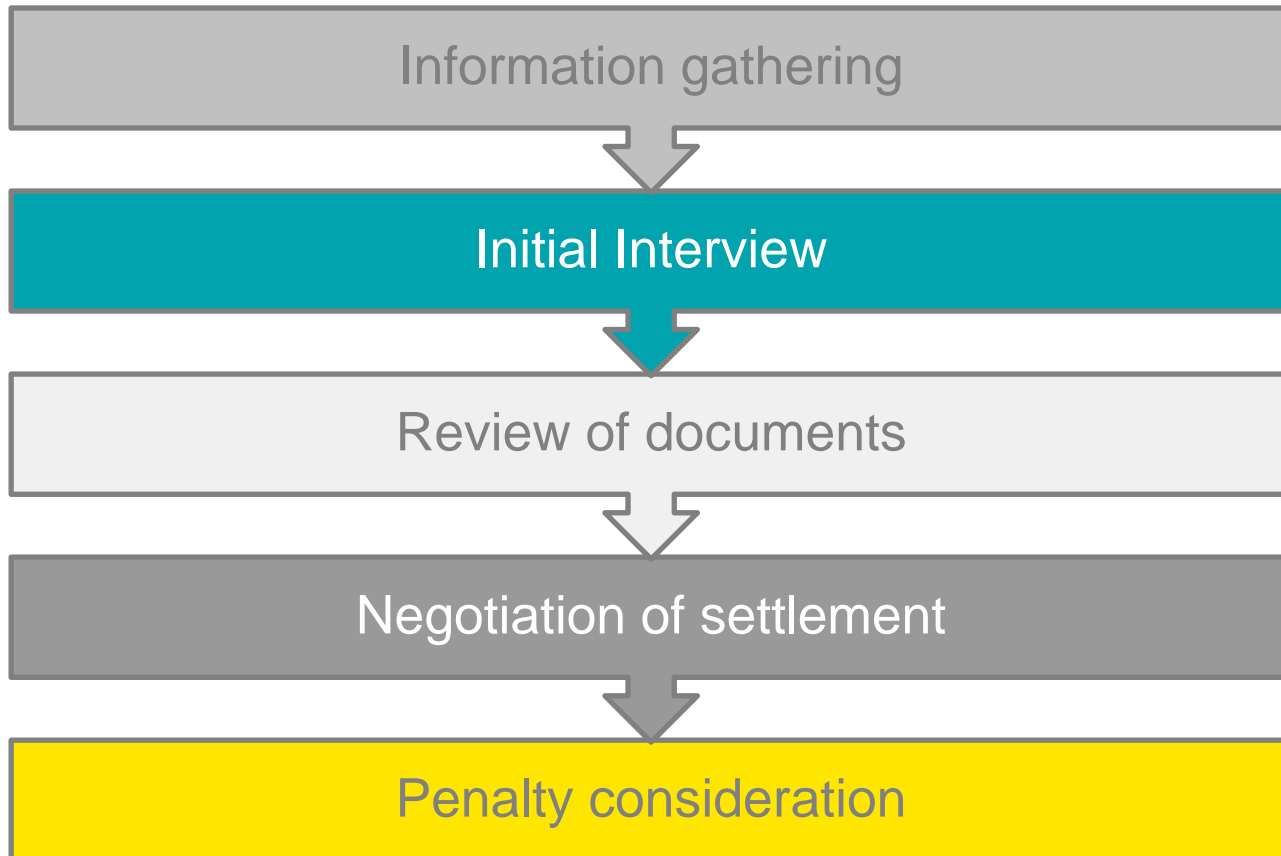
Audit trilogy by the IRD

	Performed by the IRD's unit	Focus of the audit	Methods	Suggest to settle within
Desk Audit	Unit 1 / 2	Risk areas identified	Written enquiries	N/A
Field Audit	Unit 4	Normally a particular year of assessment for which a tax return has been submitted	Written enquiries + site visits + interviews	3 months
Investigation	Unit 4	More in-depth examination which normally covers all 6 years of assessment prior to the year of assessment in which the investigation commences	Written enquiries + site visits + interviews	6 months

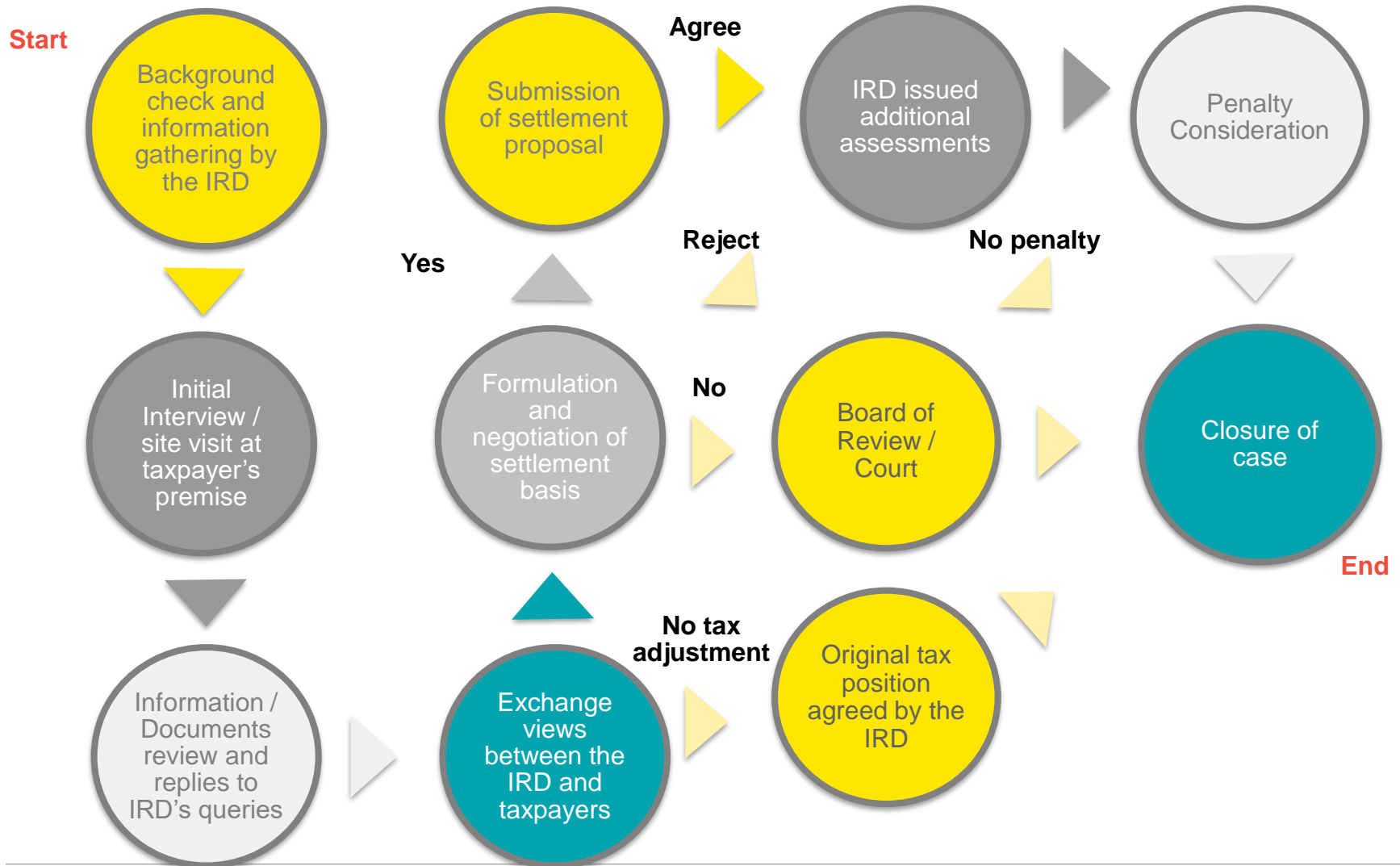
IRD case selection method

Traditional method	Additional method
<ul style="list-style-type: none">▶ Incomplete and long outstanding reply to IRD queries▶ Informer (<i>e.g., ex-employees</i>)▶ Property transactions (<i>e.g., Unusual correlation between a person's income and purchasing power</i>)▶ Newspaper and magazines (<i>e.g., news re celebrities</i>)	<ul style="list-style-type: none">▶ Exchange of Information (EOI)▶ Automatic Exchange of Financial Account Information (AEOI)

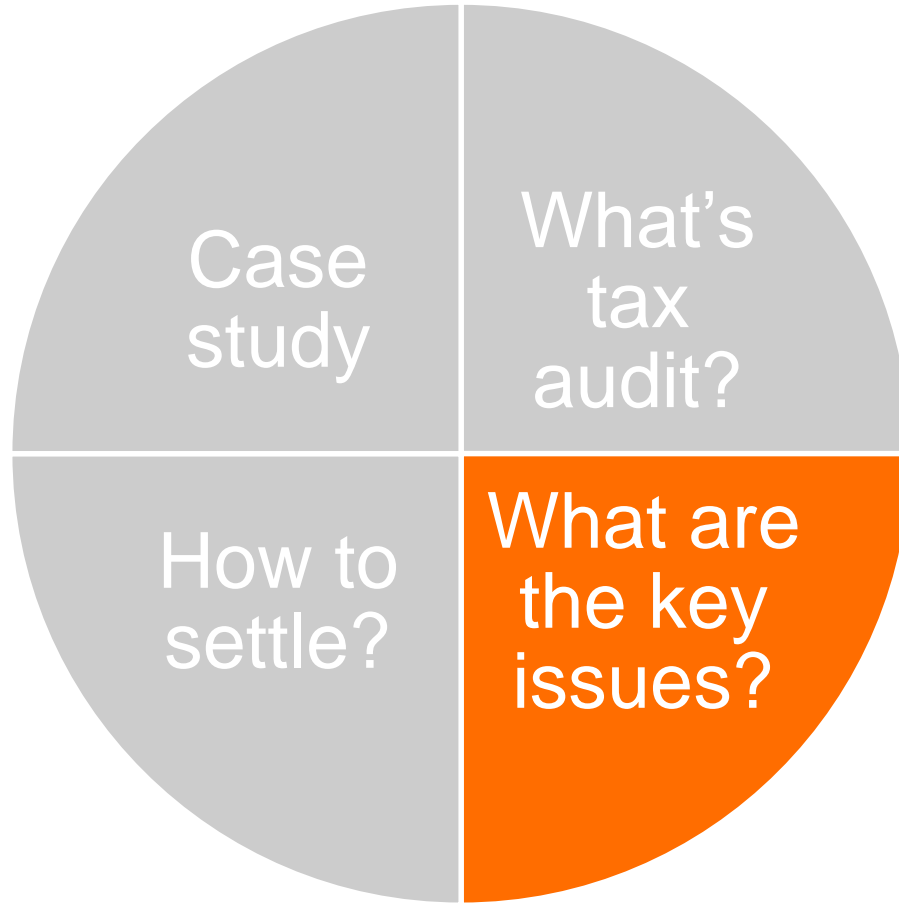
Key elements of tax audit



Process of the tax audit in Hong Kong



What are the key issues?



What are the key issues?

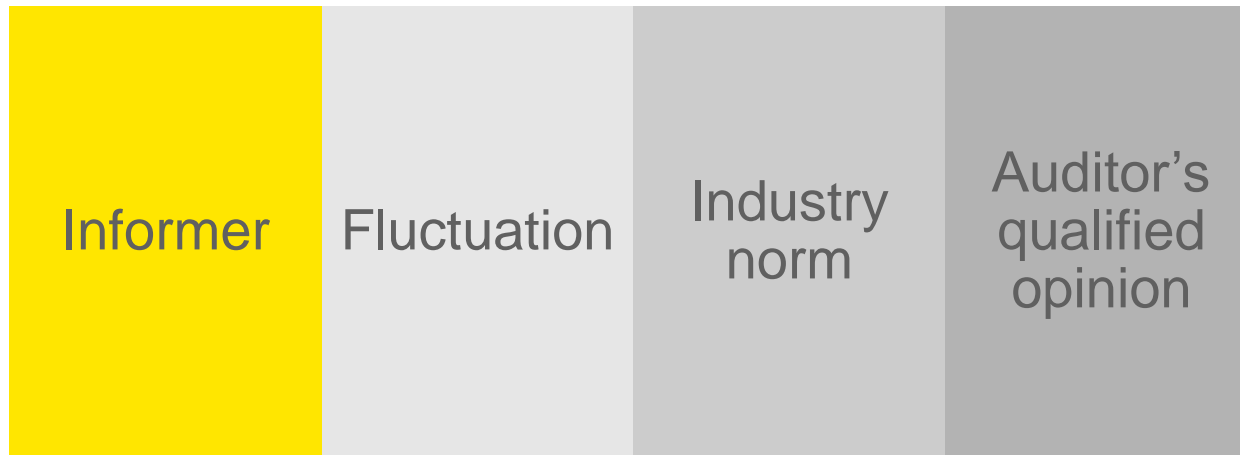
Understatement of
profit

Expense
deductibility

Property
transactions

Employer's filing
obligation

Understatement of profit



Key issues – Expense deductibility

- ▶ Section 16(1) of IRO:

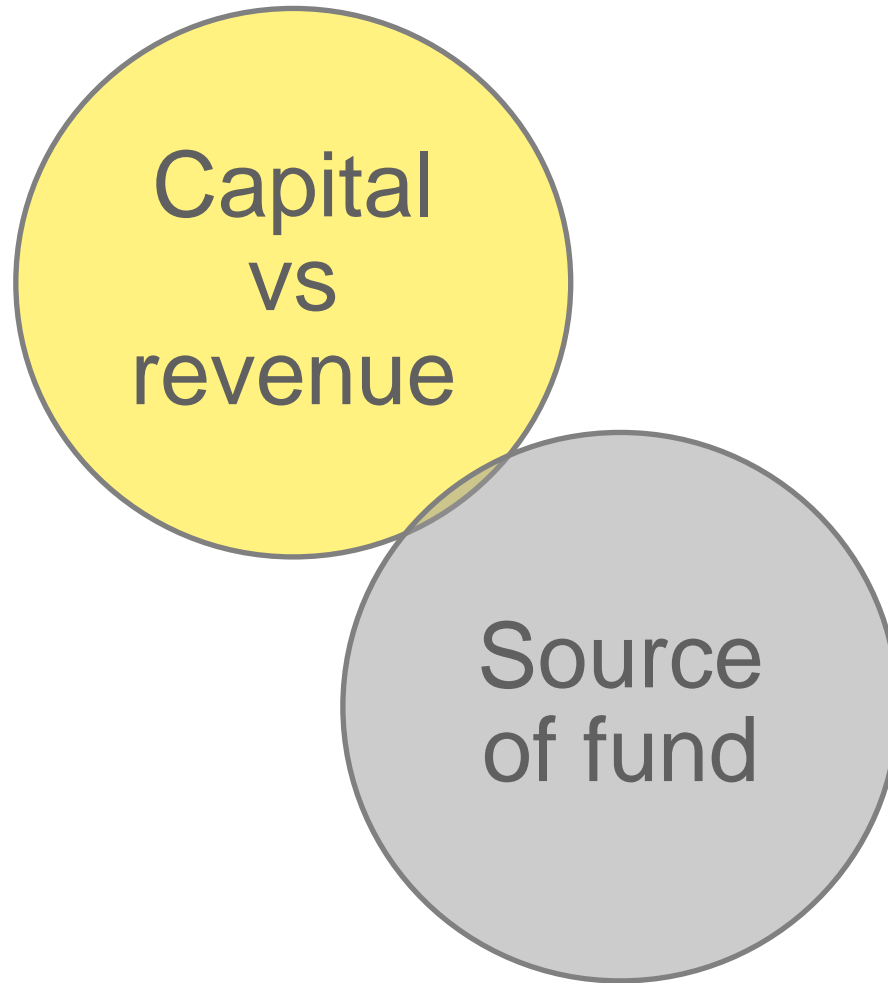
*“In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment **there shall be deducted** all outgoings and expenses **to the extent to which they are incurred** during the basis period for that year of assessment by such person **in the production of profits** in respect of which he is chargeable to tax under this Part for any period”*

- ▶ Under section 17(1) of IRO, among other things, no deduction shall be allowed for:
 - ▶ domestic or private expenses
 - ▶ any expenditure of a capital nature or any loss or withdrawal of capital

Hot expense items under IRD's scrutiny

- ▶ Allocation of expenses
- ▶ Salaries to relatives
- ▶ Management fee
- ▶ Entertainment expenses
- ▶ Legal and professional fee
- ▶ Sub-contracting fee
- ▶ Commission expense
- ▶ Consultancy fee

Property transactions



Capital vs revenue

Burden of proof

- ▶ Advertisements for lease/sales
- ▶ Contract signed with property agency showing the taxpayer's intention
- ▶ Board resolution
- ▶ Public documents
- ▶ Document to support the reason for disposal

Change of intention

- ▶ Date of change of intention
- ▶ Reference to market price for the property as at the date of change of intention

Mortgage arrangement

- ▶ Long-term financing vs short-term financing
- ▶ Financial viability to repay the monthly mortgage repayment

Employer's filing obligations

An employer has an obligation to report or notify the following to the IRD:

Circumstances	Form	When to report
Remuneration paid to employee	IR56A & IR56B	Within 1 month from the date of issue of IR56A
Commencement of employment	IR56E	Within 3 months of the commencement of employment of an employee
Cessation of employment	IR56F	1 month prior to the cessation of employment of an employee
Employee departure from Hong Kong	IR56G	At least 1 month before the expected date of departure of an employee (at the same time withhold all amount due to be paid to the employee)
Remuneration paid to person other than employee	IR56M	File together with IR56A

(Source: The IRD website)

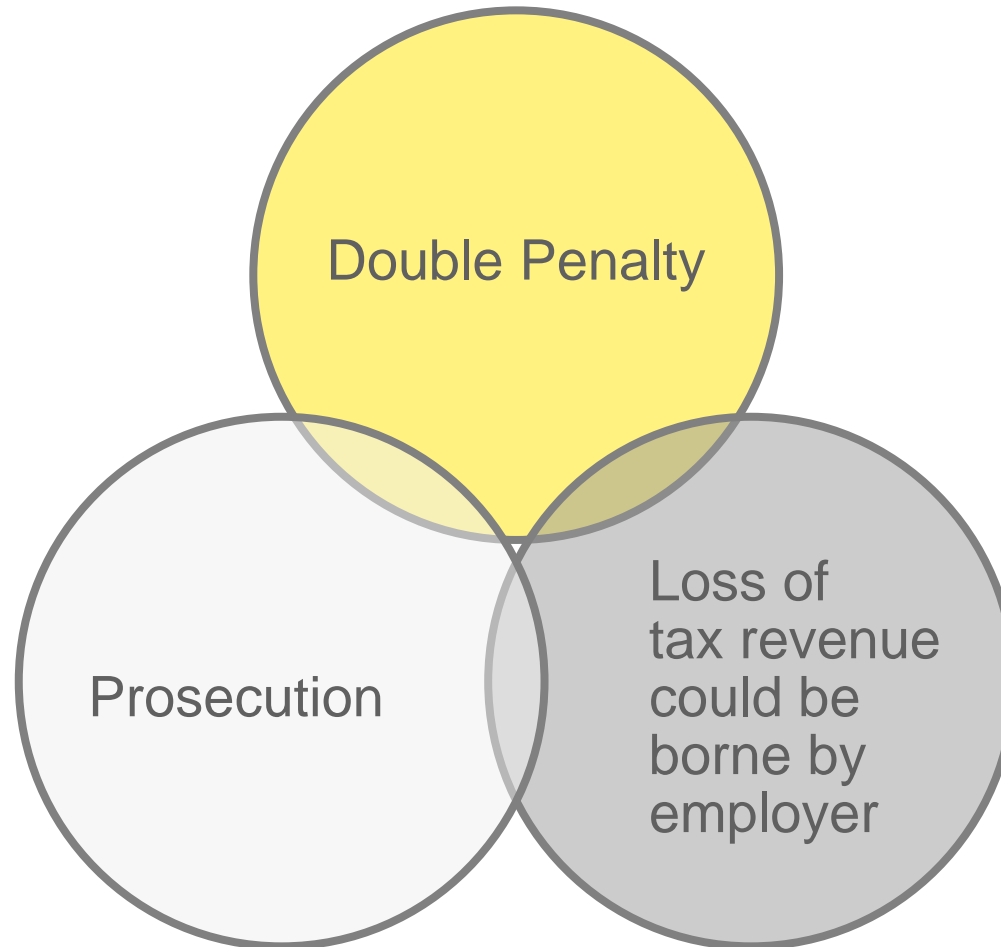
Employer's filing obligations – Typical findings

Salary expense deduction claim exceeds amounts reported in IR56B / IR56M

Reporting of benefit in kind

Persistent failing the reporting obligations of IR56E, IR56F and IR56G

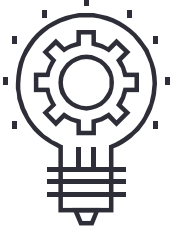
Employer's filing obligations – Consequences



How to settle?



Tips in handling tax audit conducted by the IRD



- ▶ Understand the areas of concern and try to limit the review scope
- ▶ Know the IRD's case officers and their practices
- ▶ Ensure sufficient records and supporting documents are available to defend the tax position
- ▶ Be time conscious and try to keep the momentum of the review
- ▶ Seek tax professional advice
- ▶ Prepare for the meetings and initial interview with the IRD

Formulation of settlement basis

Actual vs. projection

Alternative/
combination of
methods

Apportionment

Availability of
supporting
documentation

All inclusive

Package deal

Room for
negotiation/buffer for
adjustments

Section 82A Penalty Policy (FAI)

The most common offences for Field Audit & Investigation (FAI) cases

Omission or understatement of income or profits

Making incorrect statement in connection with a claim for any deduction or allowance

Failure to notify chargeability to tax

Penalty loading table

Category of Disclosure and Work Involved								
Nature of Omission / Understatement (see Note 1 below)	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.
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

(see Notes 2 and 3 below)

Note 1 : **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/ income such as lease premium, one-off commission, etc.

Note 2 : The penalty loading is expressed as a percentage of the tax undercharged.

Note 3 : For cases completed after 30 November 2003, the CR (commercial restitution) is at 7% per annum monthly compounded for periods up to and including 30 November 2003 and at the best lending rate monthly compounded for periods after 30 November 2003.

(Source: The IRD website)

General factors to be considered in determining the ultimate penalty

Factors for Consideration	Mitigating	Aggravating
1. Background of the Taxpayer and Sophistication of the Business	<ul style="list-style-type: none"> being illiterate or having a low standard of education 	<ul style="list-style-type: none"> sophisticated taxpayers
	<ul style="list-style-type: none"> simple and unsophisticated business 	<ul style="list-style-type: none"> established and sophisticated business
2. Attitude of the Taxpayer	<ul style="list-style-type: none"> genuine concern, seriousness, responsiveness and co-operation 	<ul style="list-style-type: none"> undue delay or obstruction to the progress of audit and investigation
	<ul style="list-style-type: none"> sincerity and willingness to compromise 	<ul style="list-style-type: none"> passiveness and unwillingness to compromise
	<ul style="list-style-type: none"> readiness to accept the discrepancy when quantified 	<ul style="list-style-type: none"> evasiveness and belated acceptance of the discrepancy quantified
3. Time Span	<ul style="list-style-type: none"> casual or one-off understatement 	<ul style="list-style-type: none"> 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)
4. Scale of Business and Quantum of the Understatements	<ul style="list-style-type: none"> relatively small cases 	<ul style="list-style-type: none"> cases with substantial quantum of understatements having regard to the operating scale of the business
	<ul style="list-style-type: none"> accepted discrepancy includes substantial contentious items 	<ul style="list-style-type: none"> discrepancy consisting of specific fictitious items with cover-up tactics

(Source: The IRD website)

Tax filing procedures

Inform chargeability on time

- ▶ Inform the IRD for chargeability of tax in writing not later than 4 months after the end of the basis period (i.e., on or before 31 July)

File the tax return on time

- ▶ File the tax return within one month from the date of issue of the return
- ▶ For election of the electronic submission of tax return, one month extension for filing the tax return would be automatically granted

Maintain good records for all the transactions

- ▶ Business records shall be retained for a period of not less than 7 years

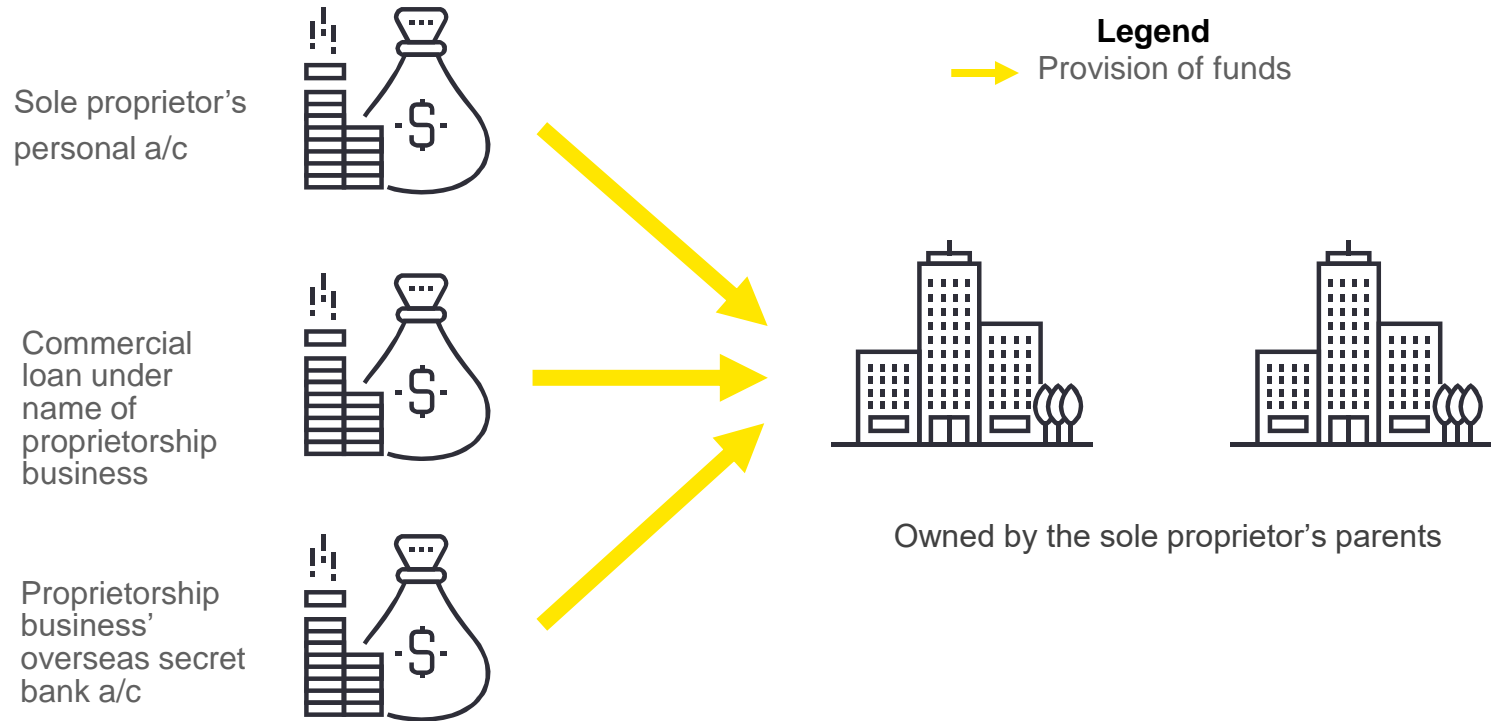
Seek professional advice when needed

- ▶ Once IRD issued enquiries/additional tax assessments/penalty etc., the taxpayer should seek professional advice at once

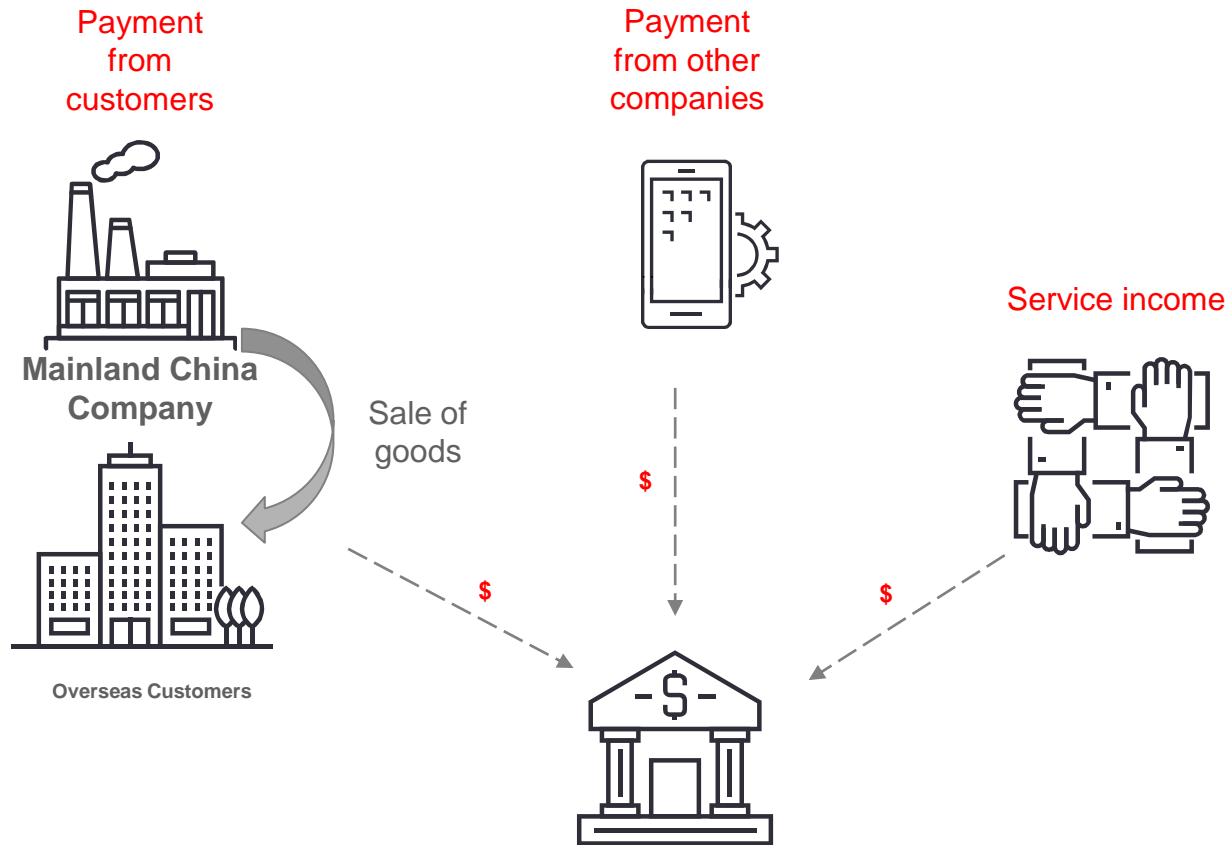
Case study



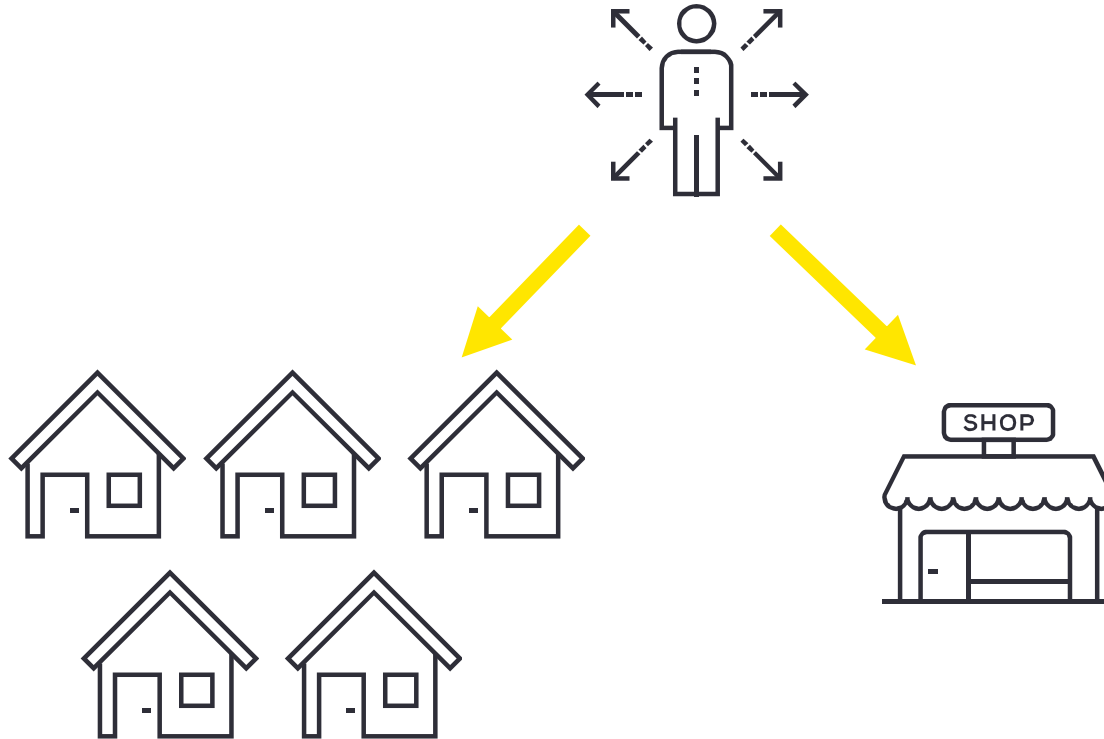
Case sharing 1 - Source of funds



Case sharing 2 – Offshore company [with bank account in HK]



Case sharing 3 – Underreporting of income



Key takeaways



Inform chargeability on time



Maintain good records for all the transactions



Seek professional advice when needed

Questions and answers



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