

CHAPTER 2

Inland Revenue Department

Assessment and collection of property tax
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**Audit Commission
Hong Kong
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This audit review was carried out under a set of guidelines tabled in the Provisional Legislative Council by the Chairman of the Public Accounts Committee on 11 February 1998. The guidelines were agreed between the Public Accounts Committee and the Director of Audit and accepted by the Government of the Hong Kong Special Administrative Region.

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ASSESSMENT AND COLLECTION OF PROPERTY TAX

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PART 1: INTRODUCTION

1.1 This PART describes the background to the audit and outlines its objectives and scope.

Background

1.2 Property tax is charged under the Inland Revenue Ordinance (Cap. 112) on property owners at the standard rate (Note 1) on the net assessable value of the rented property. Table 1 shows the computation formula of net assessable value.

Table 1
Computation formula of net assessable value

	(\$)
Rental income	A
Less: <u>Deductions</u>	
Rates paid by owner	(B)
Irrecoverable rent	(C)
	<hr/>
	D
Less: Allowance for repairs and outgoings (20% on D)	(E)
	<hr/>
Net assessable value	F <hr/> <hr/>

Source: Inland Revenue Ordinance

1.3 In practice, mainly property owners who are individuals pay property tax. This is because a corporation can apply for exemption from property tax if the profits derived from its properties are subject to profits tax under the Inland Revenue Ordinance.

Note 1: *The standard rate is 16% from 2004-05 onwards. It was 15.5% for 2003-04 and 15% from 1989-90 to 2002-03.*

1.4 The Inland Revenue Department (IRD) is responsible for the assessment and collection of property tax. Table 2 shows the details of property tax assessed from 2000-01 to 2004-05.

Table 2
Property tax assessed

Year	Number of assessments made ('000)	Number of demand notes issued ('000)	Amount of tax assessed (\$ million)
2000-01	488	83	1,358
2001-02	472	82	1,305
2002-03	476	83	1,239
2003-04	471	84	1,213
2004-05	480	86	1,185

Source: IRD records

1.5 The IRD has estimated that in 2005-06 it will make 470,000 property tax assessments, involving a cost of \$65 million.

Audit review

1.6 The Audit Commission (Audit) has recently carried out a review of the IRD's property tax assessment and collection activities. The review has found that there is room for improvement in a number of areas.

Acknowledgement

1.7 Audit would like to acknowledge with gratitude the full cooperation of the staff of the IRD during the course of the audit review.

PART 2: ISSUE OF TAX RETURNS

2.1 This PART examines the IRD's procedures for issuing tax returns.

Provisions of the Inland Revenue Ordinance

2.2 The Inland Revenue Ordinance contains the following provisions regarding the issue of tax returns:

- (a) **Tax returns.** Section 51(1) states that the IRD may give notice to any person requiring him within a reasonable time to furnish any tax return specified by the Board of Inland Revenue (Note 2); and
- (b) **Notification of chargeability to tax.** Section 51(2) states that every person chargeable to tax for any year of assessment shall inform the IRD that he is so chargeable not later than four months after the end of the basis period for that year of assessment unless he has already been required to furnish a tax return.

IRD's procedures

2.3 **Identifying property owners.** The IRD maintains a computerised Property Tax Database to record ownership and other information about each property. The information is sourced mainly from stamped property transfer documents (Note 3). The IRD uses the Database to identify property owners who may be chargeable to property tax.

2.4 **Issuing tax returns.** In April/May each year, the IRD issues tax returns to property owners likely to be chargeable to tax as follows:

- (a) **Composite Tax Returns (CTRs).** These tax returns are issued to individuals possessing solely-owned properties. Each individual is required to report in his CTR the rental income from such properties, together with any employment income (subject to salaries tax) and business profits (subject to profits tax); and

Note 2: *The Board of Inland Revenue is constituted under section 3 of the Inland Revenue Ordinance. It comprises the Financial Secretary as the chairman, the Commissioner of Inland Revenue and three other appointed members. Its functions include specifying the forms of tax returns.*

Note 3: *Under the Stamp Duty Ordinance (Cap. 117), agreements for sale (in respect of residential properties) and assignments (in respect of residential and non-residential properties) are required to be stamped by the Stamp Office of the IRD.*

- (b) **Property Tax Returns (PTRs).** These tax returns are issued to owners of jointly-owned or co-owned properties (Note 4). For each property, the owners are required to submit a PTR reporting their rental income.

Forms of tax returns

2.5 Under the Inland Revenue Ordinance, property tax is computed in the same way for all property owners. However, the details required to be provided by joint owners or co-owners in PTRs are different from those required to be provided by sole owners in CTRs. Table 3 shows the differences between the two forms of tax returns.

Table 3
Differences between a CTR and a PTR

Type of data	Details required to be provided by property owners	
	CTR	PTR
Change in ownership	None	Date of cessation of ownership or change in ownership
Use of property	Period of letting	<ul style="list-style-type: none"> • Number of complete months the property was let • Whether the property was let at the end of the year of assessment
Rental income	Amount of rental income	<ul style="list-style-type: none"> • Amount of rental income • Period for which the rental income was received
Deductions	Total amount of deductions for rates and irrecoverable rent	<ul style="list-style-type: none"> • Amount of deduction for rates • Period for which the rates were paid • Amount of deduction for irrecoverable rent • Period for which the rent should have been received

Source: IRD records

Note 4: For a jointly-owned property, on the death of one joint owner, the interest of the deceased in the property passes to the other joint owners, and this process continues until there is but one survivor, who then holds the property as sole owner. The ownership of a joint owner cannot pass under a will or intestacy. For a co-owned property, upon the death of one owner in common, the interest of the deceased in the property passes under the will of the deceased or intestacy.

Audit observations

2.6 ***Need to review the data in CTRs.*** As shown in Table 3, the IRD requires joint owners and co-owners to provide more data in PTRs, as compared with the data provided by sole owners in CTRs. From the IRD's records, Audit could not find documented reasons for requiring sole owners to provide less data. Audit notes that the IRD has used the additional data in PTRs (e.g. the amount of deduction for irrecoverable rent) to set criteria for selecting higher-risk cases for desk audit (see para. 3.4). **The IRD may therefore need to consider requiring sole owners to provide similar additional data in CTRs to facilitate tax assessment.**

Audit recommendation

2.7 **Audit has recommended that the Commissioner of Inland Revenue should, in view of the usefulness of the additional data in PTRs for tax assessment purposes, conduct a review to determine whether sole owners should also be required to provide such data in CTRs.**

Response from the Administration

2.8 The **Commissioner of Inland Revenue** agrees to review the design of CTRs to see if more data should be provided by sole owners for property tax purposes. She has said that the existing data provided in CTRs are sufficient for the purpose of property tax desk audit selection because, for example, the total amount of deductions claimed by the taxpayers for rates and irrecoverable rent is required in CTRs. As and when required, additional information can be obtained in respect of selected cases.

Review of property owners' tax liabilities

2.9 For property owners meeting the IRD specified criteria, including new owners and those previously assessed as not liable to tax, the IRD periodically reviews their tax liabilities. If a property owner is assessed to be liable to tax in a review, the IRD updates his personal records to indicate that tax is likely to be chargeable. The IRD then issues tax returns to him annually using the procedures mentioned in paragraph 2.4.

Change in review procedures

2.10 ***Previous procedures.*** Before adopting the new procedures described in paragraph 2.11, the IRD conducted reviews of property owners' tax liabilities by issuing tax returns. Property owners were required to complete the tax returns and submit them to the

IRD regardless of the rental income amounts. For all tax returns, the IRD made assessments of the property owners' tax liabilities and issued notices of assessments to them.

2.11 ***New procedures.*** Commencing June 2003 for joint owners and co-owners, and commencing May 2005 for sole owners, the IRD reviews property owners' tax liabilities by issuing advice letters to them as follows:

- (a) ***Advice letters to sole owners.*** Each advice letter states a number of conditions that may render the individual concerned liable to tax (e.g. total income exceeding the basic allowance). **The individual is not required to return the letter if none of the conditions are satisfied.** If one or more of the conditions apply to him, he is required to return the letter to the IRD (Note 5). The IRD then issues a CTR for his completion; and

- (b) ***Advice letters to joint owners or co-owners.*** **The owners concerned are requested to ignore the advice letter if their property has not been let.** If they have let the property, they are required to inform the IRD of the commencement date of the lease by returning the letter (Note 6). The IRD then issues a PTR for their completion.

According to the IRD, the issue of advice letters would save the resources used for assessing those cases in which the property owners are not liable to tax.

Audit observations

2.12 ***Need to review the effectiveness of advice letters.*** Audit notes that, using the new procedures, the IRD generally will not issue to property owners tax returns until they have returned the advice letters to the IRD. As no review of the effectiveness of the new procedures has been carried out, it is not known whether there are property owners who may evade tax by ignoring the advice letters. **Audit considers that the IRD needs to conduct a review of the effectiveness of using advice letters for ascertaining property owners' tax liabilities at an appropriate time.**

Note 5: *The advice letter also reminds the individual that he should notify the IRD if he is liable to tax for any other year(s) of assessment within the past six years or in the future.*

Note 6: *The advice letter also reminds the owners concerned that they should notify the IRD when the property is subsequently let.*

2.13 ***Need to warn owners about penalties.*** Audit notes that the CTRs, the PTRs and the advice letters issued to joint owners or co-owners all include a warning message reminding them that there are heavy penalties for non-compliance with the provisions of the Inland Revenue Ordinance. However, no such warning message is included in the advice letters issued to sole owners. **In Audit's view, the IRD needs to include a similar warning message in the advice letters issued to sole owners.**

Audit recommendations

- 2.14 **Audit has recommended that the Commissioner of Inland Revenue should:**
- (a) **review the effectiveness of using advice letters for ascertaining property owners' tax liabilities at an appropriate time; and**
 - (b) **include a warning message about the heavy penalties for non-compliance with the provisions of the Inland Revenue Ordinance in the advice letters issued to sole owners.**

Response from the Administration

2.15 The **Commissioner of Inland Revenue** accepts the audit recommendations. She has said that:

- (a) ***Effectiveness review.*** The IRD will conduct a post-implementation review at an appropriate time to assess the effectiveness of using advice letters to ascertain property owners' tax liabilities; and
- (b) ***Warning message.*** The IRD will include a warning message about the penalties for non-compliance in the advice letters issued to sole owners. At present, the envelopes of the advice letters carry a warning message about the penalty for failure to notify tax chargeability in time.

PART 3: ASSESSMENT OF PROPERTY TAX

3.1 This PART examines the IRD's procedures for assessing property tax.

Provisions of the Inland Revenue Ordinance

3.2 The Inland Revenue Ordinance contains the following provisions regarding the assessment of tax:

- (a) **Assessments.** Section 59(2) states that, where a person has furnished a tax return, the IRD may:
 - (i) accept the tax return and make an assessment accordingly; or
 - (ii) if it does not accept the tax return, estimate the sum in respect of which such person is chargeable to tax and make an assessment accordingly;
- (b) **Additional assessments.** Section 60(1) states that, where for any year of assessment any person chargeable with tax has not been assessed or has been assessed at less than the proper amount, the IRD may, within the year of assessment or within six years after the expiration thereof, assess such person at the amount or additional amount at which such person ought to have been assessed; and
- (c) **Penalties.** Section 80(2) states that any person who without reasonable excuse makes an incorrect tax return or fails to notify the IRD of his chargeability to tax shall be guilty of an offence. The penalty is a fine of \$10,000 and a further fine of three times the amount of tax undercharged.

IRD's procedures

3.3 **Assessing tax after examining tax returns.** The IRD uses a computerised Assess First Audit Later (AFAL) System to record and analyse the data in tax returns. Based on the IRD's pre-set criteria, the AFAL System screens out higher-risk tax returns for examination by assessing officers before they make assessments. For doubtful cases, assessing officers issue queries to the taxpayers, asking them to submit documentary evidence and/or further information.

3.4 **Assessing tax first and conducting desk audit later.** Tax returns not screened out for examination by assessing officers are accepted in good faith in the first instance. The tax assessments are made by the AFAL System automatically. Some of these tax

returns are later selected for desk audit by assessing officers. For cases selected at random, assessing officers examine the whole tax return and issue queries on doubtful areas. For cases selected according to the IRD's pre-set criteria in specific risk areas (e.g. deduction for irrecoverable rent), assessing officers issue queries on the risk areas concerned. For all cases, assessing officers make additional assessments if they find that the taxpayers have been undercharged.

Deduction for interest payments

3.5 ***Provisions of the Inland Revenue Ordinance.*** For property tax purposes, a property owner is not allowed to claim deduction for any interest payments. However, an eligible individual deriving rental income from a property may elect Personal Assessment (Note 7) and claim deduction for interest payments in respect of a loan obtained for the purpose of acquiring the property, provided that:

- (a) the deduction cannot exceed the net assessable value of the property; and
- (b) interest payments relating to periods when the property is not let (e.g. vacant) are not deductible.

3.6 ***IRD's procedures.*** A taxpayer electing Personal Assessment and claiming deduction for interest payments is required to provide in his CTR the details about each property owned, including:

- (a) the location of property and the taxpayer's share of ownership;
- (b) the taxpayer's share of interest payments; and
- (c) if a re-mortgage loan is involved, the balance and date of redemption of the previous mortgage loan, the interest paid for the previous mortgage loan, the amount of the re-mortgage loan and the interest paid for the re-mortgage loan.

In checking deduction for interest payments, assessing officers are required to ascertain the purpose of the loan. For a re-mortgage loan the amount of which was greater than the outstanding principal of the previous mortgage loan, assessing officers are required to ascertain the purpose of the additional sum borrowed to determine whether the additional interest expenses are deductible.

Note 7: *Under Personal Assessment, the taxpayer and his wife's incomes from all sources (i.e. rental income, employment income and business profits) are aggregated to compute tax liability.*

Audit observations

3.7 ***Need to improve procedures for checking deduction for interest payments.*** In examining Case C1 (see para. 5.22), Audit noted that the taxpayer and his wife obtained in September 1996 a re-mortgage loan on a jointly-owned property (Property A). They used the loan proceeds to jointly purchase Property B in November 1996 and Property C in December 1997. In December 1998, they sold Property B. (Appendix A shows the details.) The audit findings are summarised below:

- (a) ***Interest was allowed although Property B had been sold.*** Since part of the re-mortgage loan on Property A was used to purchase Properties B and C, the re-mortgage interest on Properties B and C should be deductible only when rental income was derived from them. However, Audit noted that, although Property B was sold in December 1998, the assessing officer had allowed the taxpayer and his wife to claim the full amount of re-mortgage interest from December 1998 to March 2004, totalling \$1 million. **In Audit's view, the assessing officer should have disallowed the re-mortgage interest related to Property B after it had been sold;** and
- (b) ***Interest was allowed although Property C was not let.*** The taxpayer and his wife reported in their PTR that Property C was not let in 2003-04. However, the assessing officer allowed their claim for deduction for interest payments in 2003-04 for Property C, including interest of \$45,000 on the mortgage loan on Property C and the relevant part of interest on the re-mortgage loan on Property A. **In Audit's view, the assessing officer should have disallowed such interest payments since no rental income was derived from Property C in 2003-04.**

Audit considers that the IRD needs to investigate this case to identify any deficiencies in the procedures for checking deduction for interest payments with a view to making improvements.

Audit recommendations

3.8 **Audit has recommended that the Commissioner of Inland Revenue should:**

- (a) **investigate Case C1 to identify any deficiencies in the procedures for checking deduction for interest payments;**
- (b) **based on the results of the investigation, improve the procedures for checking deduction for interest payments to ensure that:**

- (i) **deduction for interest payments on a re-mortgage loan the proceeds of which are used for acquiring another property is allowed only when rental income is derived from that property; and**
- (ii) **deduction for interest payments is not allowed for any period during which the property concerned is not let; and**
- (c) **consider issuing additional assessments for Case C1 to demand the undercharged tax.**

Response from the Administration

3.9 The **Commissioner of Inland Revenue** accepts the audit recommendations. She has said that:

- (a) ***Identifying deficiencies.*** The IRD has investigated Case C1. It was found that the officer concerned had not properly followed the assessing guidelines and procedures in computing the allowable interest payment deductions. This was an isolated case. The officer was cautioned to be more careful in handling such cases in future;
- (b) ***Improving procedures.*** It is the IRD's existing practice to regularly review the assessing guidelines and procedures. The IRD will strengthen the assessing guidelines and procedures with regard to the checking of deduction for interest payments; and
- (c) ***Issuing additional assessments.*** The IRD has raised additional assessments on the taxpayer concerned to assess the amount of interest payments deduction erroneously allowed in the previous assessments.

Audit examination of 20 assessment cases

3.10 Audit examined 20 property tax assessment cases (Cases A1 to A20) for 2003-04 to ascertain whether there is room for improvement in the assessment procedures. The 20 cases included 10 cases which had been examined by assessing officers prior to tax assessment (see para. 3.3), and 10 cases desk audited by assessing officers (see para. 3.4). Half of the 20 cases involved CTRs and the other half involved PTRs. In examining the rental and rates information reported by taxpayers in their tax returns, Audit made use of the database maintained by the Rating and Valuation Department (RVD – see para. 3.11). The audit examination has highlighted some areas requiring the IRD's attention (see paras. 3.12 to 3.14).

3.11 **RVD database.** The RVD maintains a computerised database to record the rental information obtained for rating and valuation purposes. Audit notes that:

- (a) in 2004-05, the RVD obtained up-to-date rental information for about 200,000 tenements;
- (b) the RVD obtains rental information mainly by issuing requisition forms to owners or occupiers under the Rating Ordinance (Cap. 116) and the Government Rent (Assessment and Collection) Ordinance (Cap. 515). The owners or occupiers are required to furnish up-to-date tenancy particulars of specified tenements, including the tenancy period, the rent per month, the rates per month and whether the tenant or the landlord is responsible for paying rates (Note 8). In addition, landlords are required to report the particulars of a new letting or lease renewal of domestic property to the RVD under the Landlord and Tenant (Consolidation) Ordinance (Cap. 7);
- (c) following the IRD's launching of an electronic stamping service of tenancy agreements in August 2004 (see para. 5.2(a)), owners or occupiers may, after completing the electronic stamping procedures, choose to be linked to the RVD's web page to report the rental particulars to the RVD electronically; and
- (d) the RVD obtains rental information from civil servants applying for private tenancy allowances to rent properties. Such civil servants are required to provide the RVD with the terms of the tenancy agreements for assessing whether they are acceptable.

Audit observations

3.12 **Need to enhance the assessment procedures.** In examining a CTR, assessing officers are generally not required to:

- (a) compare the number of properties solely owned by the taxpayer (as recorded in the IRD's Property Tax Database) and the number of such properties reported in the CTR as having been let; and
- (b) issue queries on the usage of properties not reported in the CTR.

Note 8: *According to the RVD records, about 88% of the requisition forms issued to owners or occupiers in 2004-05 were returned to the RVD. In Chapter 2 of the Director of Audit's Report No. 40 of March 2003, Audit recommended that the RVD should remind owners or occupiers of the statutory requirement of properly completing the requisition forms and returning them to the RVD within the specified time, and consider taking enforcement actions to ensure that they comply with the statutory requirements.*

Audit noted that in Cases A1 to A7 the number of properties reported in the CTR was less than the number of properties owned by the taxpayers. Audit checked to the RVD database and found that the taxpayers in Cases A1, A2 and A6 had not reported the letting of some of their properties (see Appendix B for details). Since the assessing officers in these three cases focused on checking the reported rental income, they could not identify the unreported rental income. **Audit considers that the IRD needs to enhance the assessment procedures to detect unreported rental income more effectively. In particular, the IRD should require assessing officers to check, where appropriate, properties owned by taxpayers but not reported as having been let.**

3.13 ***Need to make use of the RVD database.*** As exemplified by Cases A1, A2 and A6 mentioned above, the RVD database is useful for checking the rental income reported in tax returns. Audit notes that the RVD database also records the amounts of rates and whether the tenant or the landlord was responsible for paying rates (see para. 3.11(b)). Such information should be useful for checking the claims for deduction for rates in tax returns. For example, in Cases A8 and A9, the IRD required the taxpayers to submit copies of tenancy agreements and rates demand notes for desk auditing the taxpayers' claims for deduction for rates. In both cases, the IRD disallowed the claims because it found that the tenants were responsible for paying rates. Audit checked the two cases to the RVD database and found the same information. **In Audit's view, the IRD should, in consultation with the RVD, examine how to make the best use of the RVD database to further enhance the cost-effectiveness of its property tax assessment procedures (see also para. 5.7).**

3.14 ***Need to remind assessing officers to be vigilant.*** In Case A10, the taxpayer reported in his CTR that:

- (a) he and his wife wished to elect Personal Assessment because they had rental income from a jointly-owned property;
- (b) his employer (Company A) had provided him with a property as his place of residence; and
- (c) he was a director of Company A.

The taxpayer later claimed deduction under Personal Assessment for mortgage loan interest against his rental income. Audit noted that the address of the property jointly owned by the taxpayer and his wife was the same as that of the property provided to the taxpayer by Company A as his place of residence. According to the IRD's staff handbook, assessing officers should use a specified IRD form to submit such cases to supervisors for instruction because unacceptable tax avoidance arrangements may be involved. From the IRD's records, Audit could not find documentation indicating that the possible tax avoidance

arrangements had been detected and properly dealt with. **Audit considers that the IRD needs to remind assessing officers to be vigilant of cases involving possible tax avoidance arrangements and to follow the requirements stated in the IRD's staff handbook in dealing with such cases.**

Audit recommendations

- 3.15 **Audit has recommended that the Commissioner of Inland Revenue should:**
- (a) **enhance the property tax assessment procedures to detect unreported rental income more effectively. In particular, the Commissioner should require assessing officers to check, where appropriate, properties owned by taxpayers but not reported as having been let;**
 - (b) **in consultation with the RVD, examine how to make the best use of the RVD database to further enhance the cost-effectiveness of the IRD's property tax assessment procedures;**
 - (c) **remind assessing officers to be vigilant of cases involving possible tax avoidance arrangements and to follow the requirements stated in the IRD's staff handbook in dealing with such cases; and**
 - (d) **investigate the cases involving unreported rental income or possible tax avoidance arrangements as identified by Audit and, where appropriate, assess back tax and impose penalties on the taxpayers concerned.**

Response from the Administration

3.16 The **Commissioner of Inland Revenue** accepts the audit recommendations. She has said that:

- (a) ***Enhancing assessment procedures.*** It is quite common for the number of properties owned by a taxpayer not to be exactly the same as the number of let properties as reported in his tax return. This is because some properties may be occupied by the owner himself or his relatives (e.g. parents) and therefore not reported as let properties. Furthermore, some properties may be used as business premises or vacant and therefore not reported as let properties. Given such a common phenomenon, it is not practicable to check every case where there is a discrepancy in the number of properties owned and the number of properties let as reported in the tax return. However, this is a risk area that the IRD will look into and explore a more cost-effective way to detect unreported rental income;

- (b) **Using RVD database.** The IRD will consult the RVD in exploring ways to make use of the RVD database to improve the property tax assessment procedures in a cost-effective manner;
- (c) **Reminding assessing officers.** The IRD has always impressed upon the assessing officers that they must be vigilant of cases involving tax avoidance arrangements. There are already assessing guidelines to alert assessing officers to such need. The IRD has reminded them of the relevant procedures that have been laid down and to be more vigilant in identifying and attacking tax avoidance arrangements; and
- (d) **Following up cases.** The IRD has raised enquiries on all the taxpayers concerned. Depending on the outcome of the enquiries, additional assessments will be issued to recover the back tax and penalties will also be imposed, where appropriate.

3.17 The **Commissioner of Rating and Valuation** has said that he is happy to share the RVD database with the IRD. He hopes that the IRD would reciprocate to facilitate the RVD's assessment of rates and Government rent.

PART 4: COLLECTION OF PROPERTY TAX

4.1 This PART examines the IRD's procedures for collecting property tax.

Provisions of the Inland Revenue Ordinance

4.2 The Inland Revenue Ordinance contains the following provisions regarding the collection of tax:

- (a) **Payment of tax.** Section 71(1) states that tax shall be paid on or before the due date specified in the IRD's notice of assessment. Any tax not so paid shall be deemed to be in default;
- (b) **5% surcharge.** Section 71(5) states that, where any tax is in default, the IRD may order that a sum not exceeding 5% in all of the amount in default shall be added to the tax and recovered therewith;
- (c) **10% surcharge.** Section 71(5A) states that, where on the expiry of six months from the due date there remains unpaid any amount of the aggregate of the tax in default and any sum added thereto under section 71(5), the IRD may order that a sum not exceeding 10% in all of the unpaid amount shall be added to the unpaid amount and recovered therewith;
- (d) **Recovery proceedings.** Section 75(2) states that whenever any person makes default in payment of tax the IRD may recover the same by action in the District Court (Note 9);
- (e) **Recovery notices.** Section 76(1) states that, where tax payable by a person is in default and any third party owes money to or holds money for such person, the IRD may give the third party notice requiring him to pay such moneys not exceeding the amount of tax in default to the IRD; and
- (f) **Departure prevention directions.** Section 77(1) states that if the IRD satisfies a District Judge that a person has not paid all tax assessed upon him and there are reasonable grounds for believing that the person intends to depart, or has departed, from Hong Kong to reside elsewhere, the District Judge shall issue a

Note 9: *Upon entry of judgement, a defaulting taxpayer becomes liable to legal costs and interest on judgement debt from the date of commencement of proceedings to the date of full settlement in addition to the outstanding tax. If the judgement debt is not settled, the IRD may apply to the District Court to levy execution against the movable property and/or impose a charge on the immovable property belonging to the taxpayer.*

direction to prevent the person from departing from Hong Kong without paying such tax.

IRD's procedures

4.3 **Recovering tax in default.** Where tax is in default, the IRD generally imposes a late payment surcharge of 5%. When the tax has been outstanding for more than six months, the IRD may impose a further surcharge of 10%. If the tax remains unsettled, the IRD normally issues recovery notices to third parties (e.g. employers and banks) and institutes recovery proceedings in the District Court. In warranted cases, the IRD applies to the District Court for departure prevention directions to prevent defaulting taxpayers from leaving Hong Kong.

4.4 **Writing off irrecoverable tax.** Where all recovery actions have proved fruitless, the outstanding tax is written off. The IRD must make applications for write-off to the Secretary for Financial Services and the Treasury in respect of the following cases:

- (a) cases involving fraud or negligence on the part of a public officer, irrespective of the amount of loss;
- (b) cases involving theft or suspected theft of an amount exceeding \$50,000; and
- (c) cases involving other losses of an amount exceeding \$500,000.

Authorised IRD officers may approve other write-off cases. However, the IRD is required to submit a half-yearly return of such cases to the Secretary for Financial Services and the Treasury stating briefly the recovery actions taken.

4.5 **Reopening write-off cases.** The IRD maintains the collection files and records of all write-off cases. It will commence recovery actions if recovery of the tax in any write-off case appears possible at a later date.

Write-offs of property tax

4.6 Table 4 shows the write-offs of property tax from 2000-01 to 2004-05.

Table 4
Write-offs of property tax

Year	Number of cases	Amount of tax written off (\$ million)
2000-01	447	7.5
2001-02	470	11.5
2002-03	563	12.1
2003-04	802	14.5
2004-05	650	14.6

Source: IRD records

Note: From 2000-01 to 2004-05, the IRD, on average, recovered \$2.2 million property tax a year from reopened write-off cases (see para. 4.5).

Outstanding property tax

4.7 Table 5 shows an ageing analysis of the outstanding property tax as at 31 March 2005.

Table 5
Ageing analysis of outstanding property tax
(31 March 2005)

Number of years past due date	Number of demand notes (Note)	Amount of tax outstanding (\$ million)
1 or less	4,163	72.7
Over 1 to 2	1,221	22.9
Over 2 to 5	2,012	44.1
Over 5	859	22.2
Total	8,255	161.9

Source: IRD records

Note: A taxpayer may have more than one demand note outstanding.

Audit examination of 20 collection cases

4.8 Audit examined 20 collection cases (Cases B1 to B20) to ascertain whether there are areas for further improvement. The 20 cases included 10 cases in which the property tax was written off in 2004-05 and 10 cases in which the property tax had been outstanding for over five years as at 31 March 2005. The results indicate that there is scope for further improvement in a number of areas (see paras. 4.9 to 4.12).

Audit observations

4.9 ***Need to promptly obtain charging orders on taxpayers' properties.*** Of the 20 cases, in 11 cases, the IRD obtained judgement in the District Court for the unpaid property tax. In five cases, the IRD obtained the District Court's charging orders on the

taxpayers' properties (Note 10). In the other six cases, the IRD did not obtain charging orders on all or some of the taxpayers' properties. The audit findings on these six cases are summarised below:

- (a) **Properties sold before judgement was obtained.** In two cases, a charge could not be placed on the taxpayers' properties because they had been sold before the IRD obtained the judgement; and
- (b) **Properties sold after judgement was obtained.** In the remaining four cases, the taxpayers sold all or some of their properties after the IRD obtained the judgement, because the IRD did not obtain charging orders before the sales. These four cases included Cases B1 (see para. 4.10) and B2 (see para. 4.11). **Had charging orders been promptly obtained on the properties concerned, the defaulting taxpayers would not have been able to sell them.**

Audit also found that, of the nine cases in which the IRD had not obtained judgement in the District Court, in seven cases the taxpayers had sold all their properties. **Audit considers that placing a charge on the taxpayers' properties is an effective tax recovery measure. Where appropriate, the IRD needs to consider taking this measure promptly to recover outstanding tax.**

4.10 **Need to improve procedures for recovering tax from property sale proceeds.** In Case B1, due to deficiencies in issuing recovery notices, the IRD could not recover the property tax of \$112,000 charged to the taxpayer and his wife on their rental income from a jointly-owned non-residential property (see Appendix C for case details). The audit findings are summarised below:

- (a) **Recovery notices not issued promptly.** On 25 November 1996, the IRD stamped the agreement for sale of a residential property owned by the taxpayer. On 17 December 1996 (i.e. 22 days later), the IRD issued recovery notices to the purchaser and his solicitors. However, it could not recover any outstanding tax from the sale proceeds of \$4 million because the sale was completed on 3 December 1996 (i.e. 14 days before it issued the recovery notices). **Had the recovery notices been issued promptly, the outstanding property tax could have been recovered;** and

Note 10: *Under section 52A of the District Court Ordinance (Cap. 336), the District Court may by order impose a charge on a judgement debtor's property for securing the payment of any money due, or to become due, under a judgement of the Court.*

- (b) ***Recovery notices not covering all outstanding taxes.*** On 10 July 1998, the IRD stamped the agreement for sale of another residential property owned by the taxpayer's wife. On 22 July 1998 (i.e. 12 days later), the IRD issued recovery notices to the purchaser and his solicitors. However, the recovery notices only covered the salaries tax of \$39,000 due from the taxpayer's wife, but not the property tax due from him and his wife. As a result, the IRD only recovered the salaries tax amount from the sale proceeds of \$2.3 million. **Had the recovery notices covered the outstanding property tax, the IRD could have recovered the tax.**

Audit considers that the IRD needs to review and improve the procedures for recovering tax from property sale proceeds to ensure that recovery notices are issued promptly and all outstanding taxes are covered in the recovery notices.

4.11 ***Need to review procedures for recovering tax from executors.*** In Case B2, the IRD wrote off the property tax of \$107,000 charged to the executor on the rental income from a non-residential property (see Appendix D for case details). In Case B3, the property tax of \$259,000 charged to the executor on the rental income from a residential property remained outstanding in July 2005 (see Appendix E for case details). The audit findings are summarised below:

- (a) ***Recovery notices might have been misinterpreted by a bank.*** In Case B2, in August 2003 and again in November 2003, the IRD issued recovery notices to a bank requiring it to pay to the IRD moneys deposited in the name of "Mr X, Executor of the estate of the late Mr Y". The IRD, before issuing the recovery notices, had ascertained from the bank that the executor had deposits exceeding the amount of outstanding tax in his personal name. On both occasions the bank did not pay any money to the IRD;
- (b) ***Recovery notices not issued when property was sold.*** In Case B3, the executor sold the residential property for \$4.5 million in January 1999. The property transfer documents presented for stamping showed the executor (as identified by his identity card number) as the vendor. Since the IRD's computer system recorded the deceased (as identified by the deceased's identity card number), instead of the executor, as the tax defaulter, the property transfer documents had not been screened out for the purpose of issuing recovery notices to the purchaser and his solicitors. **Had the vendor been identified as the executor in this default case, the outstanding property tax could have been recovered from the sale proceeds; and**

- (c) **Recovery actions not vigorously taken.** In both cases, the executors, who were also the beneficiaries of the estates, were personally liable to the property tax. According to the IRD records, both executors owned a property and had employment and/or rental income. The IRD could take recovery actions against them (e.g. issuing recovery notices to their employers). However, in Case B2, after instituting recovery proceedings in the District Court and issuing recovery notices to a bank, the IRD wrote off the tax without taking further recovery actions. In Case B3, the IRD had only issued reminders and warning letters so far.

Audit considers that the IRD needs to review the procedures for recovering tax from executors. In particular, in Case B2 it needs to ascertain from the bank reasons for non-compliance with the two recovery notices. It should also take additional measures to facilitate screening out property transfer documents relating to the sale of properties of deceased persons. For Cases B2 and B3, the IRD needs to consider taking further recovery actions to recover the unpaid property tax.

4.12 **Compliance checks not timely completed.** In Cases B4 and B5, the IRD wrote off property tax totalling \$541,000 (see Appendices F and G for case details). Audit found that:

- (a) in both cases, the taxpayers had not reported their rental income. The IRD identified them when conducting property tax compliance checks (see para. 5.3);
- (b) in Case B4, the tenancy agreement indicated that the taxpayer started receiving rental income in June 1998. The IRD completed the compliance check in March 2003 (i.e. about five years later). The IRD issued assessments in June 2003. In the same month, the taxpayer was adjudicated bankrupt; and
- (c) in Case B5, the tenant's tax return indicated that the taxpayer started receiving rental income in April 1993. The IRD completed the compliance check in February 2000 (i.e. about seven years later). When it issued assessments in March 2000, the taxpayer was untraceable.

In summary, the belated completion of compliance checks in Cases B4 and B5 had prevented the IRD from issuing timely assessments and taking timely recovery actions (see para. 5.24 for further audit observations and para. 5.26(b) for the audit recommendation).

Audit recommendations

- 4.13 **Audit has recommended that the Commissioner of Inland Revenue should:**
- (a) **promptly apply to the District Court for charging orders on the taxpayers' properties in appropriate cases to facilitate recovery of outstanding tax;**
 - (b) **review and improve the procedures for recovering tax from property sale proceeds to ensure that recovery notices are issued promptly and all outstanding taxes are covered in such notices;**
 - (c) **review the procedures for recovering tax from executors and, in particular:**
 - (i) **ascertain from the bank in Case B2 why it had not complied with the two recovery notices and take appropriate follow-up action; and**
 - (ii) **take additional measures to facilitate screening out property transfer documents relating to the sale of properties of deceased persons for issuing recovery notices to the purchasers and their solicitors; and**
 - (d) **consider taking further recovery actions against the executors in Cases B2 and B3 to recover the unpaid property tax.**

Response from the Administration

4.14 The **Commissioner of Inland Revenue** accepts the audit recommendations. She has said that:

- (a) ***Obtaining charging orders.*** Before making an application to the District Court for charging orders on the taxpayers' properties, the IRD has to assess whether it is cost-effective to do so. Normally this involves seeking a valuation of the properties concerned and raising enquiries to ascertain the amount of any outstanding mortgage. If the outstanding mortgage loan exceeds the value of the property, it may not be cost-effective to apply for a charging order. The IRD however recognises the importance of prompt action and will review the existing procedures with a view to speeding up the application process;
- (b) ***Recovering tax from property sale proceeds.*** Normally, the time between the stamping of the property transfer document and the release of sale proceeds to the vendor is very short. The IRD will review its existing procedures with a view to speeding up the issue of recovery notices to the purchasers and their

solicitors. To facilitate the inclusion of all outstanding taxes in the recovery notices, the IRD enhanced its computer system in 2002. The enhanced system provides officers with details of a taxpayer's outstanding taxes, including taxes charged on the taxpayer himself, in name of his partnership businesses and in respect of his jointly-owned properties;

- (c) **Recovering tax from executors.** The IRD has sought clarification from the bank in Case B2 and will take appropriate follow-up action upon receipt of the reply. The IRD will also explore ways to help screen out property transfer documents relating to the sale of properties of deceased taxpayers for issuing recovery notices. One of the measures being considered is to capture the information of the executors in the IRD's computer system; and
- (d) **Following up cases.** The IRD is seeking legal advice and will take appropriate follow-up action on Cases B2 and B3 to recover the unpaid tax.

PART 5: PROPERTY TAX COMPLIANCE CHECKS

5.1 This PART examines the IRD's procedures for conducting compliance checks on property owners.

Sources of rental information

5.2 The Field Audit and Investigation Unit (FAIU) of the IRD is mainly responsible for conducting field audits and investigations on businesses and individuals with a view to combating tax evasion and tax avoidance. In addition, the FAIU uses rental information from internal sources to conduct compliance checks on property owners. The sources of rental information are as follows:

- (a) **Tenancy agreements.** Under the Stamp Duty Ordinance, executed tenancy agreements are required to be stamped. Prior to August 2004, stamping had to be done by presenting the original tenancy agreement to the Stamp Office of the IRD. After implementation of the IRD's computerised Property Stamping System in August 2004, stamping may also be done electronically by sending the details of the tenancy agreement to the IRD via the Internet (Note 11); and
- (b) **Tenants' tax returns.** Under the Inland Revenue Ordinance, where an individual has been provided with a place of residence by his employer, the individual is required to report in his tax return the address of the property concerned, the period in which the property was provided and the rent paid to the property owner (Note 12).

Procedures for conducting compliance checks

5.3 The FAIU conducts compliance checks on property owners in accordance with the following procedures:

- (a) **Selecting cases.** The FAIU selects cases from both tenancy agreements and tenants' tax returns as follows:

Note 11: *In June 2005, about 4% of the tenancy agreements were stamped electronically.*

Note 12: *In this PART, for simplicity the tax returns submitted by such individuals are referred to as tenants' tax returns, regardless of whether they or their employers are the tenants.*

- (i) **Selecting tenancy agreements.** After stamping, the Stamp Office normally returns the tenancy agreements to the stamp duty applicants without making copies. However, at the FAIU's request, each day during a specified two-hour period, the Stamp Office makes photocopies of tenancy agreements involving individuals as owners and annual rental exceeding a specified amount, before returning them to the stamp duty applicants (Note 13). The FAIU uses the photocopies of tenancy agreements to conduct compliance checks one or two years after the expiration of the tenancy period; and
 - (ii) **Selecting tenants' tax returns.** The FAIU classifies tenants (excluding civil servants – Note 14) into eleven groups based on their identity card numbers. Each year, it chooses one or two groups and uses a computer program to extract a list of tax returns submitted two years ago by tenants in those groups. It then selects the required number of tax returns from the list to conduct compliance checks (Note 15);
- (b) **Identifying owners.** The FAIU identifies the owner in each case as follows:
- (i) **Cases selected from tenancy agreements.** The FAIU cross-checks the owner details in the tenancy agreement against those in the IRD's Property Tax Database; and
 - (ii) **Cases selected from tenants' tax returns.** The FAIU retrieves the tax return to ascertain the property address before checking to the Property Tax Database to obtain the owner details. In the process, it will stop taking further action on the case if it finds that the annual rental did not exceed a specified amount or the property was owned by a corporation;
- (c) **Checking owners' tax returns.** For each case, the FAIU compares the rental information in the tenancy agreement or the tenant's tax return with that reported in the owner's tax return. It will follow up with the owner if there are discrepancies or the owner has submitted neither a tax return nor a notification of his chargeability to tax; and

Note 13: *From 1998-99 to 2004-05, each year the Stamp Office stamped about 187,000 original tenancy agreements and made photocopies of about 1,000 agreements.*

Note 14: *The civil servants concerned include mainly those provided with government-owned quarters and those receiving private tenancy allowances (see para. 3.11(d)). In 2004-05, about 700 civil servants received private tenancy allowances.*

Note 15: *As shown in Table 6 in paragraph 5.4, the FAIU completed 4,600 cases a year. Since the Stamp Office made photocopies of around 1,000 tenancy agreements for checking by the FAIU, the FAIU selected more than 3,000 cases from tenants' tax returns.*

- (d) ***Issuing additional assessments.*** When the follow-up action has confirmed that the owner had not reported or had understated rental income, the FAIU refers the case to an assessing section for issuing additional assessments and imposing penalties where appropriate. If the amount of unreported or understated rental income is substantial, it will refer the case to a field audit/investigation section for detailed investigation and taking penal action, including the institution of prosecution proceedings.

Results of compliance checks

5.4 Table 6 shows the results of compliance checks completed by the FAIU from 2000-01 to 2004-05.

Table 6
Results of FAIU's property tax compliance checks

Year	Cases completed		Cases of unreported or understated rental income		
	Source of rental information	Number of cases	Number of cases	Total amount of back tax assessed (\$'000)	Average amount of back tax assessed (\$'000)
2000-01	Tenancy agreements	770	144	6,500	45.1
	Tenants' tax returns	3,830	419	17,900	42.7
	Total	4,600	563	24,400	43.3
2001-02	Tenancy agreements	1,139	159	11,600	73.0
	Tenants' tax returns	3,461	388	11,500	29.6
	Total	4,600	547	23,100	42.2
2002-03	Tenancy agreements	994	132	9,000	68.2
	Tenants' tax returns	3,606	380	14,200	37.4
	Total	4,600	512	23,200	45.3
2003-04	Tenancy agreements	950	157	8,800	56.1
	Tenants' tax returns	3,650	389	14,500	37.3
	Total	4,600	546	23,300	42.7
2004-05	Tenancy agreements	825	190	8,900	46.8
	Tenants' tax returns	3,775	390	14,300	36.7
	Total	4,600	580	23,200	40.0

Source: IRD records

Audit observations

5.5 **Compliance checks are useful. The FAIU's compliance checks are useful for detecting unreported or understated rental income.** For example, as shown in Table 6, in 2004-05, of the 4,600 cases, the FAIU identified 580 cases of unreported or understated rental income, involving back tax totalling \$23.2 million. This translates into a yield to cost ratio of 25.8, given the staff cost of \$0.9 million the FAIU spent on the compliance checks.

5.6 **Need to make use of the Property Stamping System.** The FAIU has conducted compliance checks by comparing manually the rental information in tenancy agreements or tenants' tax returns with that reported by property owners in their tax returns. Audit notes that, with effect from August 2004, the details of electronically stamped tenancy agreements are captured automatically in the IRD's Property Stamping System (see para. 5.2(a)). **Audit considers that the IRD should make effective use of the rental information in the Property Stamping System to cross-check the correctness of rental income reported by property owners.**

5.7 **Need to make use of the RVD database.** The FAIU has not used rental information from external sources to conduct compliance checks. As mentioned in paragraph 3.11, the RVD maintains a computerised database to record rental information for rating and valuation purposes. In this review, Audit made use of the RVD database in performing the following audit procedures:

- (a) examination of IRD assessment cases (see para. 3.12);
- (b) verification check of property owners (see para. 5.13); and
- (c) examination of IRD compliance check cases (see para. 5.23).

Audit found the RVD database useful for detecting unreported or understated rental income. **In Audit's view, the IRD should, in consultation with the RVD, examine how to make the best use of the RVD database to further enhance the cost-effectiveness of its property tax compliance check programme.**

Audit recommendations

5.8 **Audit has recommended that the Commissioner of Inland Revenue should:**

- (a) **make effective use of the rental information in the Property Stamping System to cross-check the correctness of rental income reported by property owners; and**

- (b) **in consultation with the RVD, examine how to make the best use of the RVD database to further enhance the cost-effectiveness of the IRD's property tax compliance check programme.**

Response from the Administration

5.9 The **Commissioner of Inland Revenue** accepts the audit recommendations. She has said that:

- (a) ***Using Property Stamping System.*** The IRD has already drawn up plans for improvement. At present, the property tax compliance check by the FAIU is basically a manual operation. The number of checks that can be done is therefore limited. In order to improve efficiency, it has been decided to develop a new computer program to replace the manual operation. The new program will automatically capture the rental information in the Property Stamping System for compliance check purposes. The new computer program will be ready by the end of 2005; and
- (b) ***Using RVD database.*** The IRD will consult the RVD in exploring ways to make use of the RVD database to further enhance the IRD's compliance check programme in a cost-effective way.

5.10 The **Commissioner of Rating and Valuation** has said that he is happy to share the RVD database with the IRD. He hopes that the IRD would reciprocate to facilitate the RVD's assessment of rates and Government rent.

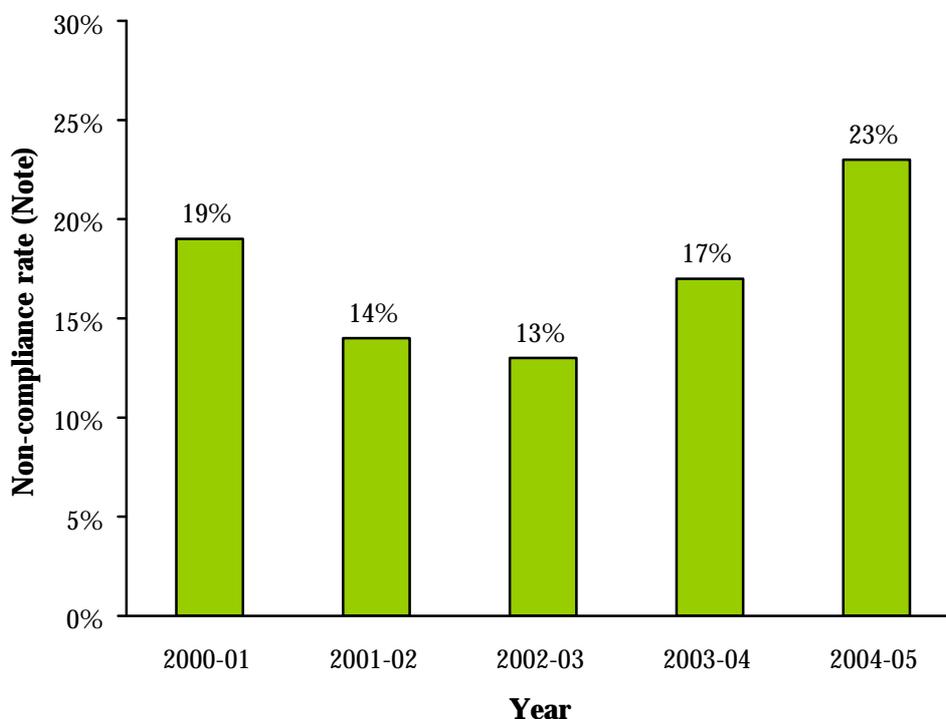
Non-compliance rate identified by IRD

5.11 Figure 1 shows the property tax non-compliance rates, as derived from the results of the FAIU's compliance checks on cases selected from tenancy agreements (involving annual rental exceeding a specified amount – Note 16).

Note 16: *For cases selected from tenants' tax returns, the number of cases completed by the FAIU included "no further action" cases involving annual rental not exceeding the specified amount or corporations as owners (see para. 5.3(b)(ii)). Since the number of such "no further action" cases has not been recorded, the actual number of cases checked cannot be readily ascertained for computing the non-compliance rates.*

Figure 1

Property tax non-compliance rates



Source: IRD records

Note: The non-compliance rate for a year in respect of tenancy agreement cases is computed as follows:

$$\frac{\text{Number of cases of unreported or understated rental income}}{\text{Number of cases checked by the FAIU}} \times 100\%$$

Audit verification check of rental income in 20 cases

5.12 Audit has used the RVD database to conduct a verification check of the rental income reported by property owners in their tax returns. The checked cases involved smaller rental amounts (as compared with cases selected by the FAIU from tenancy agreements) and included those involving civil servants as tenants (i.e. cases not selected by the FAIU from tenants' tax returns – see para. 5.3(a)(ii)). The audit procedures were as follows:

- (a) the name of ratepayer, the address and the rental information for 20 tenements with 2003-04 rental exceeding \$120,000 (but less than the specified amount for cases selected by the FAIU from tenancy agreements – see para. 5.3(a)(i)) were extracted from the RVD database. These 20 cases were selected as follows:

- (i) 10 cases were randomly selected from those with rental information obtained from the completed requisition forms issued by the RVD to owners or occupiers (see para. 3.11(b)); and
 - (ii) 10 cases were randomly selected from those with rental information obtained from private tenancy allowance application forms submitted to the RVD by the civil servants (see para. 3.11(d)); and
- (b) for each case, the owner details were ascertained from the IRD's Property Tax Database. The rental information for 2003-04 extracted from the RVD database was then compared with that reported in the owner's 2003-04 tax return.

5.13 Table 7 shows the results of the verification check conducted by Audit.

Table 7

Results of Audit verification check

Source of rental information	Number of cases checked	Cases of unreported rental income	
		Number	Percentage
RVD requisition forms returned by owners or occupiers	10	1 (Note 1)	10%
Private tenancy allowance application forms submitted by civil servants	10	2 (Note 2)	20%
Total	20	3 (Note 3)	15%

Source: IRD and RVD records

Note 1: The RVD database indicated that the owner had let his solely-owned property in 2003-04 for a monthly rent of \$12,000. However, the IRD did not issue a tax return to the owner, and he did not report to the IRD his chargeability to tax. Audit conducted further checks to the RVD database and found that the owner had let the property since acquiring it in September 2000. The total unreported rental income from September 2000 to March 2004 was \$492,000.

Note 2: The RVD database indicated that the owners had let their solely-owned properties to civil servants receiving private tenancy allowances. In both cases, the tenancy period was two years, from late 2002 to late 2004. The monthly rent was \$17,000 in one case and \$18,000 in the other. However, the owners in both cases did not report in their tax returns that they had let the properties. The unreported rental income for the two-year period totalled \$840,000. For both cases, Audit's further checks to the RVD database found no information indicating the use of the properties prior to their letting in late 2002.

Note 3: For the remaining 17 cases, there was no material difference between the rental income reported in the owners' tax returns and the amount recorded in the RVD database.

Audit observations

5.14 **High non-compliance rate.** The FAIU's compliance checks revealed that a high percentage of property owners had not reported or had understated their rental income (see Table 6 in para. 5.4). As shown in Figure 1 (para. 5.11), the non-compliance rate of cases selected from tenancy agreements in 2004-05 was 23%, up from an average of 16% for the previous four years. In addition, as shown in Table 7 (para. 5.13), Audit's verification check of 20 cases (involving smaller rental amounts) found three cases of unreported rental income. In one of the three cases (see Note 1 of Table 7), the owner had not reported his rental income for a number of years. **Audit is concerned that a high non-compliance rate will result in a large revenue loss unless the IRD takes effective measures to protect tax revenue.**

5.15 **Need to conduct more checks.** Audit notes that:

- (a) from 2000-01 to 2004-05, the IRD issued about 80,000 property tax demand notes a year (see Table 2 in para. 1.4); and
- (b) during the same period, the FAIU checked less than 4,600 cases a year (Note 17). On average, it found 550 cases of unreported or understated rental income a year and assessed back tax of \$23.4 million a year. The total back tax assessed from 2000-01 to 2004-05 amounted to \$117 million (see Table 6 in para. 5.4).

In view of the high non-compliance rate and to protect tax revenue, Audit considers that the IRD needs to conduct more compliance checks to identify non-compliance cases for assessing back tax. In this respect, Audit believes that the effective use of the rental information in the Property Stamping System and the RVD database (see paras. 5.6 and 5.7) should facilitate more compliance checks.

5.16 **Need to extend coverage.** Audit notes that the FAIU only checked cases involving annual rental not less than a specified amount. However, the results of Audit's verification check suggested that the non-compliance rate might also be high for cases involving smaller rental amounts. **Audit considers that the IRD needs to extend its compliance checks to provide a full coverage of cases involving different amounts of rental income. This would help the IRD to ascertain the non-compliance rates for the full spectrum of property owners with a view to identifying higher-risk groups requiring special attention.**

Note 17: *The FAIU completed 4,600 cases a year (see Table 6 in para. 5.4). The number of cases checked was less than 4,600 because the completed cases included "no further action" cases (see Note 16 to para. 5.11).*

5.17 ***Need to improve checking procedures.*** Audit notes that:

- (a) in selecting tenants' tax returns for conducting compliance checks, the FAIU excluded cases involving civil servants as tenants (see para. 5.3(a)(ii)). However, Audit's verification check of 10 cases involving civil servants receiving private tenancy allowances to rent properties found two cases of unreported rental income (see para. 5.13); and
- (b) the non-compliance rate for cases selected from tenants' tax returns cannot be computed because FAIU officers were not required to record the actual number of cases checked (see Note 16 to para. 5.11).

In Audit's view, the IRD needs to include cases involving civil servants receiving private tenancy allowances in selecting cases from tenants' tax returns, and improve the procedures for conducting compliance checks on such cases to facilitate computing the non-compliance rate.

5.18 ***Need to analyse non-compliance cases.*** Audit notes that the FAIU did not analyse the causes of non-compliance. Therefore, the FAIU could not evaluate the extent to which the high non-compliance rate was due to ignorance of the requirements of notification of chargeability to tax, unintentional errors in completing tax returns, evasion of tax or other reasons. **Audit considers that the IRD needs to analyse the non-compliance cases to ascertain the major causes of non-compliance. This would help the IRD to take appropriate measures (e.g. providing more extensive tax education and taxpayer services) to enhance compliance.**

5.19 ***Need to closely monitor non-compliance.*** Figure 1 (para. 5.11) shows that the non-compliance rate as derived from the results of the FAIU's compliance checks increased from 13% in 2002-03 to 17% in 2003-04, and then to 23% in 2004-05. **Audit considers that the IRD needs to closely monitor the non-compliance rate. This would help the IRD to evaluate the effectiveness of the measures taken for enhancing compliance and to assess whether additional measures are required to protect tax revenue.**

Audit recommendations

5.20 **Audit has recommended that the Commissioner of Inland Revenue should:**

- (a) **consider the need for conducting more compliance checks with a view to identifying more non-compliance cases for assessing back tax;**

- (b) **extend the compliance checks to provide a full coverage of cases involving different amounts of rental income and ascertain the non-compliance rates for the full spectrum of property owners with a view to identifying higher-risk groups requiring special attention;**
- (c) **include cases involving civil servants receiving private tenancy allowances in selecting cases from tenants' tax returns, and improve the procedures for conducting compliance checks on such cases to facilitate computation of the non-compliance rate;**
- (d) **establish the major causes of non-compliance with a view to making improvements in the compliance rate;**
- (e) **closely monitor the non-compliance rate to evaluate the effectiveness of the measures taken for enhancing compliance and to assess whether additional measures are required to protect tax revenue; and**
- (f) **investigate the three cases of unreported rental income as identified by Audit and, where appropriate, assess back tax and impose penalties on the property owners concerned.**

Response from the Administration

5.21 The **Commissioner of Inland Revenue** accepts the audit recommendations. She has said that:

- (a) ***Conducting more checks.*** The IRD agrees to conduct more compliance checks. At present, resource constraints dictate that only cases of higher risks are subject to compliance checks. Furthermore, as the existing operation relies heavily on manual effort, the number of compliance checks cannot be greatly increased. However, the situation should be improved when the new computer program mentioned in paragraph 5.9(a) is in place;
- (b) ***Extending coverage.*** Implementation of the new computer program will help release resources to conduct a full coverage compliance check on cases involving different amounts of rental income by phases. It will also permit the computation of the non-compliance rates for the full spectrum of property owners;
- (c) ***Improving checking procedures.*** The new computer program will also capture tenancy agreements involving civil servants;
- (d) ***Analysing non-compliance cases.*** The new computer program will include some functions to help analyse the non-compliance cases; and

- (e) **Following up cases.** The IRD has raised enquiries with the taxpayers concerned and has also taken appropriate follow-up actions on the three cases of unreported rental income as identified by Audit. Depending on the taxpayers' reply to the enquiries and the outcome of the follow-up actions, assessments will be issued to recover the back tax. Penalties will also be imposed on the taxpayers concerned, where appropriate.

Audit examination of 20 compliance check cases completed by FAIU

5.22 Audit also examined 20 compliance check cases (Cases C1 to C20) completed by the FAIU in 2003-04. The 20 cases, all involving unreported or understated rental income, included 10 cases selected from tenancy agreements and 10 cases selected from tenants' tax returns. The results indicate that there is room for improvement in the procedures for conducting compliance checks (see paras. 5.23 to 5.25).

Audit observations

5.23 **Need more extensive checks in non-compliance cases.** Audit notes that in each of the 20 cases the FAIU found that the taxpayer had not reported, or had understated the rental income for the period covered by the tenancy agreement or the tenant's tax return. However, the FAIU did not perform additional work (e.g. issuing queries) to ascertain whether the taxpayer also had unreported or understated rental income for other periods or from other properties. For example, using a tenancy agreement covering the period from December 1998 to December 2000, the FAIU found that the taxpayer in Case C2 had understated his 1998-99 rental income from a property purchased in October 1996 by \$71,000 (see Appendix H for case details). Audit checked to the RVD database and had the following additional findings:

- (a) **Understated rental income for a prior period.** The RVD database indicated that in 1997-98 the property was let at a monthly rent of \$65,000. In the 1997-98 tax return, the taxpayer understated his rental income from the property by \$197,000;
- (b) **Understated rental income for a subsequent period.** The RVD database indicated that in 2001-02 the property was let at a monthly rent of \$50,000. In the 2001-02 tax return, the taxpayer understated his rental income from the property by \$84,000; and
- (c) **Understated rental income from other properties.** The RVD database indicated that from 1997-98 to 2001-02 the taxpayer let six other properties. In the tax returns for these years, the taxpayer understated the rental income from these six properties by a total of \$3.3 million.

In Audit's view, the IRD should treat taxpayers in non-compliance cases as higher-risk taxpayers and perform more extensive checks on them.

5.24 ***Need to conduct timely checks.*** Audit notes that for the 10 cases selected from tenancy agreements, the FAIU on average completed the compliance check 4.9 years after the expiration of the year in which the tenancy agreement commenced. For the 10 cases selected from tenants' tax returns, the FAIU on average completed the compliance check 3.1 years after the expiration of the year for which the tenant's tax return was submitted. The belated completion of compliance checks, particularly for cases selected from tenancy agreements, would increase the assessment and collection risks as follows:

- (a) ***Assessment risks.*** The long time taken by the FAIU to complete a case implies that, even if the FAIU had performed additional work and found that the owner had also not reported or had understated the rental income for years earlier than those under investigation, the assessing section might not have been able to issue additional assessments for all such years. This is because, as mentioned in paragraph 3.2(b), the Inland Revenue Ordinance provides that additional assessments for a year can only be made within six years after the expiration of the year; and
- (b) ***Collection risks.*** The long time taken by the FAIU to complete a case also implies that additional assessments would be issued a long period after the taxpayer received the rental income. The IRD would face greater risks in collecting the back tax because events occurring during the intervening period could render the recovery actions ineffective and the back tax uncollectible. Cases B4 and B5 mentioned in paragraph 4.12 were examples of cases in which delays in completing compliance checks had resulted in write-off of property tax.

In Audit's view, the FAIU should conduct compliance checks on a timely basis to enable additional assessments for all relevant years to be promptly issued within the time limits specified in the Inland Revenue Ordinance.

5.25 ***Need to review penalty guidelines.*** Audit notes that in 14 of the 20 cases, the assessing officers acted in accordance with the IRD's guidelines and did not impose penalties (see para. 3.2(c)) on the property owners. The reasons for not taking penal action in these 14 cases included the following:

- (a) the amount of tax undercharged was less than the amount specified in the IRD's guidelines as requiring penal action; and
- (b) the taxpayer had passed away.

In view of the high non-compliance rate, Audit considers that the IRD needs to conduct a review to determine whether the penalty guidelines should be tightened to enable assessing officers to take more penal action to deter non-compliance.

Audit recommendations

- 5.26 **Audit has recommended that the Commissioner of Inland Revenue should:**
- (a) **for property owners found to have unreported or understated rental income from a property for a particular period, perform more extensive compliance checks to ascertain whether they also have unreported or understated rental income for other periods or from other properties;**
 - (b) **conduct compliance checks on a timely basis to enable additional assessments for all relevant years to be promptly issued within the time limits specified in the Inland Revenue Ordinance;**
 - (c) **conduct a review to determine whether the penalty guidelines should be tightened to enable assessing officers to take more penal action to deter non-compliance; and**
 - (d) **investigate Case C2 and, where appropriate, assess back tax and impose penalties on the taxpayer concerned.**

Response from the Administration

5.27 The **Commissioner of Inland Revenue** accepts the audit recommendations. She has said that:

- (a) ***More extensive checks.*** In handling non-compliance cases, professional officers of the IRD are always required to exercise their professional knowledge and judgement. In appropriate cases, they should extend the compliance check to ascertain whether the taxpayers also have unreported or understated rental income for other periods or from other properties. The IRD has issued an internal guideline to this effect and professional officers have been reminded of this again;
- (b) ***Conducting timely checks.*** The IRD recognises the importance of conducting timely checks. Under the existing manual system, compliance checks are conducted only after the tenancy periods as shown on the tenancy agreements expire. It has been decided that when the new computer program mentioned in paragraph 5.9(a) is in operation, compliance checks will be conducted annually

during the tenancy periods. This new practice will help early detection of non-compliance cases;

- (c) **Reviewing penalty guidelines.** The IRD agrees to review the penalty guidelines with a view to strengthening the deterrent effects. The IRD will also consider providing more publicity and taxpayer education to boost voluntary compliance; and
- (d) **Following up Case C2.** The IRD has issued enquiries to the taxpayer concerned for a full review of the letting information of all the properties owned by him for all relevant years. Depending on the outcome of the enquiries, additional assessments will be issued to recover the back tax. Penalties will also be imposed on the taxpayer concerned, where appropriate.

Appendix A
(para. 3.7 refers)

Chronology of key events relating to the use of a re-mortgage loan in Case C1

Item	Date	Event
(a)	September 1990	The taxpayer and his wife jointly purchased Property A.
(b)	September 1996	<p>The taxpayer and his wife obtained a re-mortgage loan of \$4.5 million on Property A. Of the \$4.5 million:</p> <ul style="list-style-type: none"> • \$1.2 million was used for repaying the balance of the previous mortgage loan; • \$1.9 million was used for purchasing Property B (see item (c)); and • \$1.2 million was used for purchasing Property C (see item (d)).
(c)	November 1996	<p>The taxpayer and his wife jointly purchased Property B. Of the purchase price of \$6.2 million:</p> <ul style="list-style-type: none"> • \$4 million was settled by obtaining a mortgage loan; and • \$1.9 million was settled by using part of the re-mortgage loan proceeds on Property A (see item (b)).
(d)	December 1997	<p>The taxpayer and his wife jointly purchased Property C. Of the purchase price of \$4.2 million:</p> <ul style="list-style-type: none"> • \$3 million was settled by obtaining a mortgage loan; and • \$1.2 million was settled by using part of the re-mortgage loan proceeds on Property A (see item (b)).
(e)	December 1998	The taxpayer and his wife sold Property B for \$5.2 million. They did not use the sale proceeds to repay the re-mortgage loan on Property A.

Source: IRD records

Appendix B
(para. 3.12 refers)

**Difference between the number of properties owned
and the number of properties let in Cases A1 to A7**

Case	Number of properties solely owned (Note 1)	Number of solely-owned properties let (Note 2)	Difference	Results of Audit's check to RVD database
	(a)	(b)	(a) - (b)	
A1	60	34	26	Three of the 26 properties were let for five to eight months during 2003-04. The unreported rental income for 2003-04 was \$103,000.
A2	22	21	1	The property was let throughout 2003-04. The unreported rental income for 2003-04 was \$72,000.
A3	19	15	4	The RVD database did not have rental information on the 4 properties.
A4	17	15	2	The RVD database did not have rental information on the 2 properties.
A5	16	11	5	The RVD database did not have rental information on the 5 properties.
A6	15	11	4	One of the 4 properties was let throughout 2003-04. The unreported rental income for 2003-04 was \$386,000.
A7	7	2	5	The RVD database did not have rental information on the 5 properties.

Source: IRD and RVD records

Note 1: This number is obtained from the IRD's Property Tax Database.

Note 2: This is the number of solely-owned properties reported in the taxpayer's CTR as having been let.

Appendix C
(para. 4.10 refers)

Chronology of key events leading to the write-off of property tax in Case B1

Item	Date	Event
(a)	February, October and November 1995	Following an investigation of the tax affairs of the taxpayer, the IRD issued additional property tax assessments for 1991-92 to 1994-95 on the taxpayer and his wife's rental income from a jointly-owned non-residential property.
(b)	December 1995	The IRD issued a recovery notice to a bank and recovered \$25,000.
(c)	May 1996	The taxpayer and his wife sold the non-residential property for \$5.3 million (Note).
(d)	November 1996	The IRD obtained judgement in the District Court for the unpaid property tax for 1991-92 to 1994-95.
(e)	4 November 1996	The taxpayer entered into an agreement for sale of a residential property owned by him for \$4 million.
(f)	25 November 1996	The IRD stamped the agreement in item (e).
(g)	17 December 1996	The IRD issued recovery notices to the purchaser and his solicitors. However, it could not recover any outstanding tax because the sale was completed on 3 December 1996.
(h)	24 June 1998	The taxpayer's wife entered into an agreement for sale of another residential property owned by her for \$2.3 million.
(i)	10 July 1998	The IRD stamped the agreement in item (h).
(j)	22 July 1998	The IRD issued recovery notices to the purchaser and his solicitors. However, the recovery notices only covered the salaries tax of \$39,000 due from the taxpayer's wife, but not the property tax due from the taxpayer and his wife. As a result, the IRD only recovered the salaries tax.
(k)	January 2000	The taxpayer's wife was adjudicated bankrupt.

Appendix C
(Cont'd)
(para. 4.10 refers)

Item	Date	Event
(l)	February 2000	The taxpayer was adjudicated bankrupt.
(m)	February 2005	After noting that no dividend would be paid, the IRD wrote off the property tax and surcharges totalling \$112,000.

Source: IRD records

Note: Since the agreement for sale of a non-residential property was not required to be stamped, the solicitors only presented the assignment to the IRD for stamping after completion of the sale. As a result, the IRD did not issue any recovery notices.

Appendix D
(para. 4.11 refers)

Chronology of key events leading to the write-off of property tax in Case B2

Item	Date	Event
(a)	September 1994	A person (Mr Y) who had owned a non-residential property passed away.
(b)	July 1997	The Probate Registry issued a probate to the executor (Mr X), who was also one of the beneficiaries.
(c)	July 2001	The IRD obtained judgement in the District Court for the property tax for 1995-96 to 1997-98 charged to the executor on the rental income from the property.
(d)	October 2002	The executor sold the property for \$3.8 million.
(e)	April 2003	The IRD required a bank to supply information about any deposits placed by the executor in his personal name. The bank replied that the executor had deposits totalling \$138,000 in his personal name.
(f)	August 2003	The IRD issued a recovery notice to the bank requiring the bank to pay to the IRD moneys deposited in the name of "Mr X, Executor of the estate of the late Mr Y". The bank did not pay any money to the IRD.
(g)	October 2003	The IRD again required the bank to supply information about any deposits placed by the executor in his personal name. The bank replied that the executor had deposits totalling \$307,000 in his personal name.
(h)	November 2003	The IRD issued a recovery notice to the bank requiring the bank to pay to the IRD moneys deposited in the name of "Mr X, Executor of the estate of the late Mr Y". The bank again did not pay any money to the IRD.
(i)	September 2004	The IRD wrote off the property tax and surcharges totalling \$107,000.

Source: IRD records

Appendix E
(para. 4.11 refers)

Chronology of key events relating to the outstanding property tax in Case B3

Item	Date	Event
(a)	February 1993	A person who had owned a residential property passed away.
(b)	March 1996	The Probate Registry issued letters of administration to the executor, who was the deceased's son.
(c)	January 1999	The executor sold the property for \$4.5 million.
(d)	August 2000 to April 2005	The IRD issued two reminders and 14 warning letters urging the executor to settle the property tax for 1993-94 to 1998-99 charged to the executor on the rental income from the property.
(e)	July 2005	Property tax and surcharges totalling \$259,000 remained outstanding.

Source: IRD records

Appendix F
(para. 4.12 refers)

Chronology of key events leading to the write-off of property tax in Case B4

Item	Date	Event
(a)	June 1998	The FAIU obtained from the Stamp Office a photocopy of a tenancy agreement covering the period from June 1998 to May 2000. The monthly rent was \$96,000.
(b)	December 2001	The taxpayer's property was sold by a bank for \$21 million in exercising the power of sale in the mortgage loan agreement.
(c)	October 2002	The FAIU commenced to conduct a compliance check on the taxpayer and found that he had not reported the rental income to the IRD.
(d)	March 2003	The FAIU completed the case and referred it to an assessing section for issuing additional property tax assessments for 1998-99 to 2000-01.
(e)	June 2003	The assessing section issued the additional assessments.
(f)	June 2003	The taxpayer was adjudicated bankrupt.
(g)	May 2004	After noting that no dividend would be paid, the IRD wrote off the property tax and surcharges totalling \$290,000.

Source: IRD records

Chronology of key events leading to the write-off of property tax in Case B5

Item	Date	Event
(a)	April 1997	The taxpayer sold a property for \$10.3 million.
(b)	August 1999	The FAIU commenced to conduct a compliance check on the taxpayer. It found from the tax returns submitted by an individual that his employer had paid rent for 1993-94 to 1995-96 in providing the property as his quarters. However, the taxpayer had not reported the rental income to the IRD.
(c)	February 2000	The FAIU completed the case and referred it to an assessing section for issuing additional property tax assessments.
(d)	March 2000	The assessing section issued additional assessments for 1993-94 to 1995-96 based on the FAIU's findings. It also issued an estimated assessment for 1996-97. However, the taxpayer was untraceable.
(e)	April 2000, February and August 2001, June 2002 and April 2003	The IRD issued recovery notices to banks and recovered \$43,000.
(f)	May 2004	Since the taxpayer had been untraceable and there were no assets or income for recovery, the IRD wrote off the property tax and surcharges totalling \$251,000.

Source: IRD records

Appendix H
(para. 5.23 refers)

Chronology of key events relating to the FAIU compliance check on Case C2

Item	Date	Event
(a)	October 1996	The taxpayer purchased a property.
(b)	December 1998	The FAIU obtained from the Stamp Office a photocopy of a tenancy agreement covering the period from December 1998 to December 2000. The monthly rent was \$43,000.
(c)	June 2002	The FAIU commenced to conduct a compliance check on the taxpayer. It found that, in the 1998-99 CTR, the taxpayer had understated the rental income from the property by \$71,000.
(d)	March 2004	The FAIU completed the case and referred it to an assessing section for issuing an additional property tax assessment for 1998-99.
(e)	April 2004	The taxpayer paid the back tax for 1998-99.

Source: IRD records

Appendix I

Acronyms and abbreviations

AFAL	Assess First Audit Later
Audit	Audit Commission
CTR	Composite Tax Return
FAIU	Field Audit and Investigation Unit
IRD	Inland Revenue Department
PTR	Property Tax Return
RVD	Rating and Valuation Department