

CHAPTER 1

Inland Revenue Department

Assessment and collection of estate duty

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ASSESSMENT AND COLLECTION OF ESTATE DUTY

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ASSESSMENT AND COLLECTION OF ESTATE DUTY

Summary

1. Estate duty is charged under the Estate Duty Ordinance on the principal value of all property passing on the death of a person, including property owned by him, his share of property jointly owned with others and property which he gave away during the three years before his death. The Estate Duty Office (EDO) of the Inland Revenue Department (IRD) is responsible for the assessment and collection of estate duty. Before applying for probate or letters of administration, which is a prerequisite for administering a deceased's estate, an executor must obtain estate duty clearance papers from the EDO (paras. 1.2, 1.3 and 2.3).

AUDIT FINDINGS

2. **The limit for small estates.** Section 14A of the Estate Duty Ordinance allows the executors of small estates to obtain certificates of exemption from estate duty by following a simplified procedure. The processing of such cases by the EDO also follows a simplified procedure. However, since 1981, the limit for small estates has remained unchanged at \$400,000 while the estate duty exemption limit has been raised from \$1 million to \$7.5 million. In 2002-03, only 7,317 or 49% of the 15,047 exempt cases were classified as small estates and processed using the simplified procedure. In Audit's view, the EDO should consider raising the limit for small estates to enable more exempt cases to be processed more cost-effectively using the simplified procedure (paras. 2.8 and 2.9).

3. **Procedures for assessing estate duty.** Audit found that there was scope for improvement in the following areas:

- (a) **Guidelines on the valuation of unincorporated businesses and unlisted shares.** EDO officers valued the deceased's unincorporated businesses or unlisted shares in accordance with the EDO's guidelines and spent much time and effort in obtaining agreement on the valuation with the executor. The EDO could

promulgate the guidelines to assist the general public (paras. 3.8 and 3.9);

- (b) **Submission of notifications of the deceased's bank balances by banks.** The EDO did not take any penalty action against banks which failed to submit notifications of the deceased's bank balances, contrary to the Estate Duty Ordinance. The EDO needs to routinely remind all banks of their obligations under the Estate Duty Ordinance and instigate penalty action in cases warranting it (paras. 3.10 and 3.11);
- (c) **Checking of undisclosed cash gifts.** The EDO's procedures for checking withdrawals in the selected cases provide a reasonable assurance that all undisclosed cash gifts exceeding \$200,000 are investigated. However, in other cases, due to the reduced scope of checking, some dutiable cash gifts may not be detected. The EDO needs to review its procedures to determine whether the scope of checking should be increased (paras. 3.12 and 3.13);
- (d) **Inclusion of bonus shares for estate duty assessment.** In one case, contrary to the Estate Duty Ordinance, bonus shares subsequently issued were not treated as part of the gift for estate duty assessment. The amount of under-assessed estate duty in this case was about \$300,000. The EDO needs to ensure that its officers take bonus shares into account when making estate duty assessments (paras. 3.14 and 3.15); and
- (e) **Action to finalise estate duty assessments.** In some cases, the assessment of estate duty has not yet been finalised, despite the estate duty affidavit or account having been received over 10 years ago. In long outstanding cases like this, where no further information could be provided by the executor, the EDO should consider issuing an estimated assessment under section 14(15) of the Estate Duty Ordinance (paras. 3.16 and 3.17).

4. **Procedures for recovering estate duty.** Audit noted that, as at 31 March 2003, there were 124 outstanding estate duty cases. These included 17 cases in which a total of \$26 million of estate duty and interest were outstanding. In each of these 17 cases, the EDO had received the estate duty affidavit over 10 to 30 years ago. Audit found that:

- (a) in 3 of these 17 long outstanding cases, although the executors had been issued with probate or letters of administration by the Probate Registry, they had not paid any estate duty or had paid only part of the estate duty; and
- (b) in 9 out of the 17 cases, as the “intended executors” had not been issued with probate or letters of administration by the Probate Registry, they could not be held accountable for the estate duty. The EDO could not, therefore, institute recovery proceedings against them to recover the estate duty.

The EDO needs to find ways to take effective recovery actions in such cases (paras. 4.5 to 4.13).

5. **Procedures for recovering earnings and profits tax from the estates of deceased taxpayers.** As at 31 March 2003, the outstanding earnings and profits tax due from deceased taxpayers was \$117 million. To recover outstanding tax from a deceased’s estate, the Collection Enforcement Section (CES) of the IRD requests the EDO to provide information about the deceased’s estate. The CES conducts searches at the Probate Registry to ascertain whether the executor has been issued with probate or letters of administration. However, Audit found that:

- (a) the EDO had not provided the CES with accurate or timely information about the deceased’s estate (e.g. the status of the deceased’s bank accounts);
- (b) the CES had conducted fruitless searches at the Probate Registry before the EDO had issued estate duty clearance papers; and
- (c) the CES had written off the outstanding tax and discontinued searches at the Probate Registry before the Probate Registry had issued probate or letters of administration.

The IRD needs to improve the procedures for recovering earnings and profits tax from the estates of deceased taxpayers, and to explore the feasibility of enhancing efficiency and effectiveness of internal communications between the CES and the EDO by using improved information technology procedures (paras. 5.4 to 5.19).

6. **Estate duty avoidance schemes.** Audit noted that, in cases involving the use of certain types of estate duty avoidance schemes, the EDO had been unable to charge estate duty because the Estate Duty Ordinance does not have anti-avoidance provisions which could counteract such schemes. In July 2000, the EDO lost a Court of Final Appeal case in which the EDO attempted to invoke the common law fiscal nullity doctrine to challenge the avoidance scheme concerned. According to the EDO, unless counteracting legislative amendments are enacted, revenue loss could be very substantial. In March 2001, the IRD submitted to the Financial Services and the Treasury Bureau (FSTB) an amendment proposal to strengthen the anti-avoidance provisions in the Estate Duty Ordinance. In July 2003, the IRD was preparing a consultation paper for consulting the parties concerned. In Audit's view, in order to protect the revenue, the IRD and the FSTB need to expedite action on the issue (paras. 6.4 to 6.9).

AUDIT RECOMMENDATIONS

7. The Commissioner of Inland Revenue should:

Granting of certificates of exemption from estate duty

- (a) review the procedures for the granting of certificates of exemption from estate duty to determine whether the present limit of \$400,000 for small estates should be raised. This would enable more cases for which no estate duty is payable to be processed more cost-effectively using the EDO's simplified procedure (para. 2.10(a));

Assessment of estate duty

- (b) consider promulgating the EDO's guidelines on the valuation of unincorporated businesses and unlisted shares (para. 3.18(a));
- (c) regularly remind all banks of their obligations under section 25(1) of the Estate Duty Ordinance, and instigate penalty action in cases warranting it to ensure that banks promptly submit to the EDO notifications of the bank balances of the deceased (para. 3.18(b));

- (d) review the procedures for checking undisclosed cash gifts to determine whether the scope of checks should be increased (para. 3.18(c));
- (e) issue instructions to EDO officers to ensure that bonus issues arising from shares given away by the deceased are treated as a gift *inter vivos* (para. 3.18(d));
- (f) in those long outstanding cases where no further information could be provided by the executor, consider issuing an estimated assessment under section 14(15) of the Estate Duty Ordinance (para. 3.18(g));

Collection of estate duty

- (g) take rigorous recovery actions on all long outstanding cases, especially those cases in which estate duty has remained outstanding for more than 10 years (para. 4.16(a));
- (h) consult with the Department of Justice to find ways that will enable the EDO to recover estate duty in cases which do not have an executor who is accountable for the estate duty. In doing so, the Commissioner should consider the option of seeking the assistance of the Official Administrator in cases that warrant it (para. 4.16(b));

Recovery of earnings and profits tax from the estates of deceased taxpayers

- (i) improve coordination between the EDO and the CES in the recovery of earnings and profits tax from the estates of deceased taxpayers, and conduct a review to determine whether the EDO should promptly input key estate information into the IRD's computerised database (para. 5.20(a) and (b));
- (j) streamline the CES's procedures for conducting searches at the Probate Registry (para. 5.20(d));



- (k) consult with the Department of Justice to find ways that will enable the IRD to take effective action to recover earnings and profits tax from the deceased taxpayer's estate in cases in which probate or letters of administration has or have not been issued by the Probate Registry. The option of seeking the assistance of the Official Administrator should be considered in cases that warrant it (para. 5.20(f)); and

Estate duty avoidance schemes

- (l) in conjunction with the Secretary for Financial Services and the Treasury, expedite action to introduce a bill into the Legislative Council to strengthen the anti-avoidance provisions in the Estate Duty Ordinance in order to protect the revenue (para. 6.12(a)).

Response from the Administration

- 8. The Administration generally agrees with the audit recommendations.

PART 1: INTRODUCTION

1.1 This PART describes the background to the audit on the assessment and collection of estate duty.

Background

1.2 Estate duty is charged under the Estate Duty Ordinance (Cap. 111) on the principal value of all property passing on the death of a person, including:

- (a) property owned by the deceased;
- (b) the deceased's share of property jointly owned with others; and
- (c) property which the deceased gave away during the three years before his death.

However, property situated *outside* Hong Kong and certain property, including the matrimonial home of the deceased and his spouse, are exempted. For determining the rate of estate duty to be paid on any property passing on the death of the deceased, all property so passing is aggregated to form one estate. For persons who died on or after 1 April 1998, no estate duty is payable for estates not exceeding \$7.5 million. The estate duty rate is 5% for estates exceeding \$7.5 million but not exceeding \$9 million, 10% for estates exceeding \$9 million but not exceeding \$10.5 million, and 15% for estates exceeding \$10.5 million.

1.3 The Estate Duty Office (EDO) of the Inland Revenue Department (IRD) is responsible for the assessment and collection of estate duty. The Commissioner of Inland Revenue, being the Controlling Officer of the IRD, is also the Commissioner of Estate Duty for the purpose of the Estate Duty Ordinance. The estate duty assessed by the EDO during the period 1998-99 to 2002-03 is shown in Table 1.

Table 1
Estate duty assessed by the
EDO during the period 1998-99 to 2002-03

Year	Amount of estate duty assessed (\$ million)
1998-99	1,168
1999-2000	1,359
2000-01	1,081
2001-02	1,250
2002-03	1,896

Source: IRD's records

1.4 The estate duty assessment and collection activities are carried out by the EDO's assessing officers with the support of taxation officers and common/general grade staff. The IRD has estimated that in 2003-04, some 15,000 estate duty cases will be processed, involving 49 man-years of work at a cost of \$19 million.

Audit review

1.5 Audit has recently conducted a review of the EDO's estate duty assessment and collection activities to ascertain if there is room for improvement. Audit has found that there are areas where improvements can be made and has made a number of recommendations to address the issues.

PART 2: GRANTING OF CERTIFICATES OF EXEMPTION FROM ESTATE DUTY

2.1 This PART examines the EDO's procedures for the granting of certificates of exemption from estate duty to executors in respect of estates not exceeding \$7.5 million.

EDO's procedures for issuing estate duty clearance papers

2.2 Section 15(1) of the Estate Duty Ordinance states that no probate or letters of administration shall be issued by the High Court until the Commissioner of Estate Duty shall have certified in writing that the estate duty payable by the executor (Note 1) upon the estate in respect of which probate or letters of administration is sought has been paid or the Commissioner has allowed payment thereof to be postponed.

2.3 A **grant of representation** is a legal document issued, on application, by the High Court to at least one and not more than four persons authorising them to administer a deceased's estate (Note 2). A grant of representation enables organisations holding property in the deceased's name to identify to whom the property should be paid or transferred. There are three main types of grant of representation, as follows:

- (a) **Probate.** This grant is issued to the executor named in the deceased's will;
- (b) **Letters of Administration (with Will).** This grant is issued to the lawful attorney of the executor named in the will or to the beneficiaries under the will; and

Note 1: *As stated in section 3 of the Estate Duty Ordinance and when referred to hereinafter, "executor" means the executor or administrator of a deceased person.*

Note 2: *As far as a grant of representation is concerned, a deceased's estate comprises all property owned by him, excluding property jointly owned with others because his interest in such property passes, on his death, to the surviving joint owners. If the whole of the estate does not exceed \$150,000 and consists of money (e.g. bank deposits), the Official Administrator may be requested to administer the estate in a summary manner without a grant of representation. In these cases, the Registrar of the High Court is the Official Administrator, ex officio. A statutory commission is chargeable on the gross value of an estate dealt with by the Official Administrator in a summary manner.*

- (c) **Letters of Administration.** This grant is issued to persons entitled to the administration of the estate, when the deceased has not made a will or when any will made is not valid.

The Probate Registry is the office of the High Court that issues probates or letters of administration. Rule 43 of the Non-contentious Probate Rules (Cap. 10A) states that every application for a grant of probate or letters of administration shall be supported by such documents as may be required under the Estate Duty Ordinance. **Accordingly, the Probate Registry requires the executor to obtain estate duty clearance papers from the EDO before applying for probate or letters of administration.**

2.4 For an executor to obtain estate duty clearance papers from the EDO, the procedures are as follows:

- (a) **Estates exceeding \$400,000.** In accordance with section 14(6) of the Estate Duty Ordinance, the executor submits an estate duty affidavit in the prescribed form disclosing all property passing on the death of the deceased. The EDO examines the affidavit before assessing the amount of estate duty payable, if any. The EDO then issues estate duty clearance papers, as follows:
- (i) **Dutiable cases.** Once the assessed estate duty has been paid, the EDO issues to the executor a certificate of receipt of estate duty and a schedule of property showing all property passing on the death of the deceased; and
- (ii) **Exempt cases.** The EDO issues to the executor a certificate of exemption from estate duty and a schedule of property; and
- (b) **Small estates not exceeding \$400,000.** In accordance with section 14A of the Estate Duty Ordinance and provided that the specified conditions are met (Note 3), the executor is exempted from submitting an estate duty affidavit.

Note 3: *The conditions specified by the EDO are that the deceased did not own landed property, a business or a share of business, or shares in a company not listed on The Stock Exchange of Hong Kong Limited, and that no litigation is contemplated. If these conditions are not met, the executor is required to submit an estate duty affidavit in accordance with section 14(6) of the Estate Duty Ordinance (see para. 2.4(a)).*

The executor follows a simplified procedure by submitting a Statement in lieu of Affidavit disclosing all property passing on the death of the deceased. After checking the Statement in lieu of Affidavit, the EDO issues to the executor a certificate of exemption (Note 4) and the processed Statement in lieu of Affidavit.

2.5 In all cases, the estate duty clearance papers issued by the EDO are annexed to the probate or letters of administration issued by the Probate Registry. According to section 23 of the Estate Duty Ordinance, any person who, without lawful authority or reasonable excuse, in any way deals with any property of the deceased which is not set out in the EDO's estate duty clearance papers shall be liable to a penalty of \$10,000 or three times the amount of the estate duty payable upon the estate so dealt with, at the election of the Commissioner of Estate Duty.

2.6 In cases where the assessment of estate duty cannot be finalised within a reasonable period of time after the executor's submission of an estate duty affidavit or a Statement in lieu of Affidavit, the executor can apply to the EDO for provisional estate duty clearance papers to enable him to apply to the Probate Registry for probate or letters of administration. Before providing the executor with provisional estate duty clearance papers, the EDO may require him to produce a satisfactory guarantee for payment of the estate duty.

Audit observations

2.7 Audit noted that, in about 98% of the estate duty cases processed by the EDO during the period 1998-99 to 2002-03, no estate duty was payable because the estate did not exceed the estate duty exemption limit of \$7.5 million. Details are shown in Table 2.

Note 4: *A certificate of exemption is evidence that the executor has been exempted from submitting an estate duty affidavit and that no estate duty is payable on the deceased's estate. For simplicity, such certificates and the certificates of exemption from estate duty (see para. 2.4(a)) are hereinafter collectively referred to as certificates of exemption from estate duty.*

Table 2

**Estate duty cases processed by the
EDO during the period 1998-99 to 2002-03**

Year	Total number of cases	Number of exempt cases	Number of dutiabale cases
1998-99	13,832	13,506 (97.6%)	326 (2.4%)
1999-2000	14,243	13,889 (97.5%)	354 (2.5%)
2000-01	13,564	13,246 (97.7%)	318 (2.3%)
2001-02	14,701	14,399 (97.9%)	302 (2.1%)
2002-03	15,345	15,047 (98.1%)	298 (1.9%)

Source: IRD's records

2.8 In all the exempt cases, the EDO provided the executor with a certificate of exemption from estate duty. However, as mentioned in paragraph 2.4(b), for exempt cases in which the deceased's estate did not exceed \$400,000 and provided that the specified conditions were met, the executor was allowed, under section 14A of the Estate Duty Ordinance, to follow a simplified procedure by submitting a Statement in lieu of Affidavit. Processing of Statements in lieu of Affidavits by the EDO also followed a simplified procedure. For the remaining exempt cases, the executor had to comply with the formal requirement of submitting an estate duty affidavit. In 2002-03, Statements in lieu of Affidavits were submitted in 7,317 or 49% of the 15,047 exempt cases.

2.9 Audit noted that:

- (a) section 14A of the Estate Duty Ordinance was enacted in 1972 to enable the executors of small estates to obtain certificates of exemption from estate duty with a minimum of formalities. The limit for small estates was set at \$100,000 in 1972 when the estate duty exemption limit was set at \$200,000;

- (b) in 1981, section 14A was amended to raise the limit for small estates to \$400,000 when the estate duty exemption limit was increased to \$1 million; and
- (c) since 1981, the limit for small estates had remained unchanged at \$400,000. The estate duty exemption limit had been raised on eight occasions, from \$1 million to \$7.5 million.

Audit could not find, from the EDO's records, documented reasons for maintaining the limit for small estates at \$400,000. **Audit considers that, relative to the present estate duty exemption limit of \$7.5 million, the limit of \$400,000 for small estates is low. The EDO should consider raising the limit for small estates. This would enable more cases for which no estate duty is payable to be processed more cost-effectively using the simplified procedure mentioned in paragraph 2.4(b).**

Audit recommendations

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

- (a) **review the procedures for the granting of certificates of exemption from estate duty to determine whether the present limit of \$400,000 for small estates should be raised. This would enable more cases for which no estate duty is payable to be processed more cost-effectively using the EDO's simplified procedure (see para. 2.4(b)); and**
- (b) **if raising the limit is found to be desirable, take action to revise the limit for small estates specified in section 14A of the Estate Duty Ordinance.**

Response from the Administration

2.11 The **Commissioner of Inland Revenue** has said that she will monitor the appropriateness of the limit for small estates continually. She has reviewed the procedures for the granting of certificates of exemption from estate duty. She considers that the present limit of \$400,000 for small estates is appropriate and does not propose to amend it. She has also said that:

Granting of certificates of exemption from estate duty

- (a) there is not much difference in the time and effort taken to process a simple estate duty affidavit and a Statement in lieu of Affidavit;
- (b) record shows that the total number of estates with value between \$400,000 and \$1 million that met the conditions for filing a Statement in lieu of Affidavit was small, being 388 and 404 for 2001-02 and 2002-03 respectively; and
- (c) under the existing provisions of the Inland Revenue Ordinance (Cap. 112), the filing of an affidavit enables tax assessments which would otherwise have been time-barred to be issued within one year of the date of filing (see Note 12 to para. 5.2). The filing of a Statement in lieu of Affidavit has no such effect.

2.12 The **Secretary for Financial Services and the Treasury** agrees with the Commissioner of Inland Revenue's observations and supports the follow-up actions proposed by the Commissioner.

PART 3: ASSESSMENT OF ESTATE DUTY

3.1 This PART examines the EDO's procedures for assessing estate duty to ascertain whether there is room for improvement.

EDO's procedures for assessing estate duty

3.2 Under the Estate Duty Ordinance, in cases where property passes on the death of a person, the persons accountable for estate duty and the information required to be submitted to the EDO are as follows:

- (a) **Property owned by the deceased.** Section 14(6) provides that the executor shall be accountable for the estate duty in respect of all property of which the deceased was competent to dispose at his death. The executor shall submit to the EDO an estate duty affidavit disclosing all property passing on the death of the deceased;
- (b) **Property jointly owned by the deceased with others.** Section 14(7A) provides that, notwithstanding section 14(6), where a beneficial interest in property vested in the deceased and another person jointly passes by survivorship on the death of the deceased, the executor and the person to whom the beneficial interest so passes (i.e. the surviving joint owner) shall be accountable for the estate duty in respect of the deceased's share of such property, and shall deliver to the EDO an account specifying the property in question (Note 5);
- (c) **Gifts made by the deceased before his death.** Section 14(7) provides that the donee of a gift made by the deceased during the three years before his death shall be accountable for the estate duty in respect of the gifted property. The donee shall deliver to the EDO an account specifying the property in question; and

Note 5: *If the executor discloses the jointly owned property in the estate duty affidavit and pays the estate duty in respect of the property, the surviving joint owners may not need to submit a separate account to the EDO.*

- (d) **Notification of interest of the deceased in a bank.** Section 25(1) provides that, where the deceased had at the date of his death any interest (whether as depositor or creditor) in any bank within Hong Kong, the bank shall, within one month from the date of first receiving information of either the death of such deceased person or his interest in the bank, whichever shall be the later, notify the EDO of such death and of the extent of the interest of the deceased in the bank.

3.3 Section 14(15) of the Estate Duty Ordinance provides that the Commissioner of Estate Duty may assess the amount of estate duty payable according to the best of the Commissioner's judgement if:

- (a) the Commissioner is not satisfied with the affidavit or account delivered by any person; or
- (b) the person has not delivered an affidavit or account within six months after the death of the deceased and the Commissioner is of the opinion that such person is accountable for estate duty.

3.4 Section 16(1) of the Estate Duty Ordinance provides that, where an affidavit or account is delivered after the lapse of 12 months from the death of the deceased, the estate duty shall be charged at twice the applicable rate, unless the person accountable for the estate duty satisfies the Commissioner of Estate Duty that there is a reasonable excuse for the delay in the delivery of the affidavit or account. The Commissioner has the discretion to remit or reduce such additional duty.

3.5 The EDO examines each estate duty affidavit or account before assessing estate duty. To determine whether property passing on the death of the deceased has been fully disclosed and properly valued, the EDO performs some basic procedures in every case. These basic procedures include referral of landed properties to the Rating and Valuation Department for valuation, checking of withdrawals to identify undisclosed gifts made by the deceased and examination of financial statements to assess the value of unlisted shares. In addition, the EDO selects cases meeting certain pre-set criteria for additional or in-depth examination. The EDO has stated in the IRD's annual estimates that it aims, for 80% of the dutiable or complicated cases, to assess estate duty within two years of receipt of the estate duty affidavit or account.

Audit observations

Audit's examination of 20 estate duty cases

3.6 From 2000-01 to 2002-03, there were on average 7,606 new estate duty cases each year in which an estate duty affidavit or account was delivered to the EDO for assessment of estate duty (i.e. excluding the cases in which a Statement in lieu of Affidavit was submitted). The number of estate duty cases assessed by the EDO, including dutiable and exempt cases, was 7,368 in 2000-01, 7,637 in 2001-02 and 8,028 in 2002-03. As at 31 March 2003, there were 1,275 outstanding cases for which assessment of estate duty had not yet been issued. An ageing analysis of these cases is shown in Table 3.

Table 3

Ageing analysis of outstanding cases not yet assessed for estate duty (31 March 2003)

Number of years since the receipt of estate duty affidavit or account	Number of cases
1 or less	801
Over 1 to 2	182
Over 2 to 3	88
Over 3 to 4	66
Over 4 to 5	46
Over 5 to 7	53
Over 7 to 10	34
Over 10 to 15	5
Total	<u>1,275</u>

Source: IRD's records

3.7 To ascertain whether there is room for improvement in the procedures for assessing estate duty, Audit selected for in-depth review a sample of 15 cases (hereinafter referred to as Cases A1 to A15 — Note 6) in which estate duty had been assessed during the period 2000-01 to 2002-03. Audit also examined the 5 cases (hereinafter referred to as Cases A16 to A20) in which the estate duty affidavit or account had been received over 10 years ago but for which estate duty had not yet been assessed as at 31 March 2003. The audit findings are given in paragraphs 3.8 to 3.17.

***Guidelines on the valuation of
unincorporated businesses and unlisted shares***

3.8 In Cases A1 to A15, the executors had appointed solicitors to act for them in estate duty matters, including the submission of estate duty affidavits and the handling of enquiries from the EDO. In 12 cases (Cases A4 to A15), the deceased's estate included unincorporated businesses or unlisted shares. Audit found that:

- (a) in 6 cases (Cases A4 to A9), the EDO accepted the value of the unincorporated businesses or unlisted shares as stated in the estate duty affidavits; and
- (b) in the other 6 cases (Cases A10 to A15), EDO officers valued the unincorporated businesses or unlisted shares in accordance with the EDO's guidelines, and subsequently spent much time and effort in obtaining, through the solicitors, the executors' agreement to this valuation. Of these 6 cases:
 - (i) in 2 cases (Cases A10 and A11) the unincorporated businesses or unlisted shares had been included in the estate duty affidavits, but their values had not been stated; and
 - (ii) in 4 cases (Cases A12 to A15) the EDO had not accepted the value of the unincorporated businesses or unlisted shares stated in the estate duty affidavits.

Note 6: Cases A8 and A15 were two major cases identified by the EDO as involving estate duty avoidance schemes (see para. 6.6). The other 13 cases were selected randomly by Audit.

3.9 In Audit's view, the EDO needs to consider whether the EDO's guidelines mentioned in paragraph 3.8(b) could be promulgated to the general public. This would help all parties concerned with the valuation of unincorporated businesses and unlisted shares.

Need to ensure banks submit notifications of the deceased's bank balances to the EDO

3.10 Section 25(1) of the Estate Duty Ordinance requires a bank to notify the EDO of the death of any customer and of the balances in that customer's accounts with the bank. Audit's examination of Cases A1 to A15 revealed that, in all these cases, some banks failed to submit such notification. In particular, Audit found 4 cases (Cases A4, A6, A9 and A10) where the banks concerned were aware of the death of the deceased. For illustration, details of Case A10 are given below:

Case A10

- In May 2000, Bank A submitted to the EDO notification of the death of the deceased and the balances in his accounts.
- In October 2000, the executor submitted to the EDO an estate duty affidavit which showed that the deceased had accounts with four other banks, in addition to Bank A. The documents attached to the affidavit indicated that the death of the deceased had been notified to all five banks and, during the period April 2000 to July 2000, these banks provided the executor with information on the deceased's accounts.
- However, the other four banks did not submit to the EDO any notification.
- Up to July 2003, the EDO had not taken any penalty action (Note 7) against the four banks for non-compliance with the requirements of section 25(1).

Note 7: Section 25(1) of the Estate Duty Ordinance states that, in default of the notification, a penalty of \$5,000 shall be recoverable from the bank.

3.11 From the EDO's records, Audit could not find documented reasons for not taking action against the banks which had failed to comply with the notification requirements under section 25(1) of the Estate Duty Ordinance. Audit considers that notification from a bank of the deceased's bank balances provides useful information to the EDO for verifying the bank balances disclosed in the estate duty affidavit or account. Such notifications also help detect any undisclosed bank balances, in particular those bank accounts jointly owned by the deceased with others (Note 8). **In Audit's view, in order to ensure that banks comply with the notification requirements under section 25(1) of the Estate Duty Ordinance and to create a deterrent effect, the EDO needs to routinely remind all banks of their obligations under the Estate Duty Ordinance and instigate penalty action in cases that warrant it.**

Inadequate checking by EDO of withdrawals from bank accounts to identify undisclosed cash gifts

3.12 In Cases A1 to A15, the EDO had checked the withdrawals made by the deceased during the three years before his death, as follows:

- (a) ***Selected cases.*** For cases selected by the EDO for additional or in-depth examination (see para. 3.5), any withdrawal exceeding a predetermined amount was checked; and
- (b) ***Other cases.*** Any withdrawal exceeding a predetermined amount greater than the predetermined amount for the selected cases was checked.

In 4 cases (Cases A4, A5, A10 and A11), the EDO identified that some withdrawals were cash gifts made by the deceased which had not been disclosed by the donees. After enquiring of the donees, the EDO assessed the estate duty payable by them.

3.13 Section 6(1)(c) of the Estate Duty Ordinance states that gifts made by the deceased during the three years before his death are dutiable (if the value of the whole estate exceeds the estate duty exemption limit of \$7.5 million — see para. 1.2), unless the gifts:

Note 8: *Jointly owned bank accounts carry a higher risk of non-disclosure by the surviving joint owners. This is because the deceased's interest in such accounts passes to the joint owners, without the need for them to obtain the estate duty clearance papers for applying for probate or letters of administration (see para. 3.2(b)).*

- (a) are made in consideration of marriage;
- (b) are proved to the satisfaction of the Commissioner of Estate Duty to have been part of the normal expenditure of the deceased, and to have been reasonable having regard to the amount of his income or to the circumstances; or
- (c) in the case of any donee, do not exceed in the aggregate \$200,000 in value or amount.

Audit notes that the EDO's procedures for checking withdrawals in the selected cases (see para. 3.12(a)) provide a reasonable assurance that all undisclosed cash gifts exceeding \$200,000 are investigated. However, for cases not selected by the EDO for additional or in-depth examination, due to the reduced scope of checking, some dutiable cash gifts may not be detected. In Audit's view, the EDO needs to review its procedures to determine whether it should increase the scope of checks made for undisclosed cash gifts.

Bonus shares not treated as a gift

3.14 In Case A5, Audit noted that the estate duty had not been properly assessed. Details of Case A5 are as follows:

Case A5

- About two years before his death, the deceased gave the donees a gift comprising 2,600 shares of Company A.
- About one year before the deceased's death, Company A announced a bonus issue. As a result, 3,800 bonus shares were issued to the donees.
- The EDO, in assessing the estate duty, agreed with the donees that the principal value of the gift was the value of the original 2,600 shares as at the time of death of the deceased.

3.15 Section 9(1) of the Estate Duty Ordinance states that, where any shares in a company are comprised in a gift *inter vivos* and the donee is, as the holder of those shares, issued with shares in the company, the shares so issued shall be treated as having been comprised in the gift. Therefore, Audit considers that in Case A5:

- (a) the bonus shares should have been treated as part of the gift; and
- (b) the principal value of the gift should have been assessed on 6,400 (i.e. 2,600+3,800) shares of Company A.

Audit estimated that the amount of under-assessed estate duty in Case A5 was about \$300,000. In Audit's view, the EDO needs to issue instructions to EDO officers to ensure that bonus shares are treated as part of the gift in accordance with the Estate Duty Ordinance. The EDO should also consider reopening Case A5 to demand the estate duty under-assessed.

Delay in finalising estate duty assessments

3.16 Audit's examination of Cases A16 to A20 (i.e. the 5 cases in which the estate duty affidavit or account had been received over 10 years ago but for which estate duty had not yet been assessed as at 31 March 2003) revealed that the main reasons for the delay in finalising the estate duty assessments were as follows:

- (a) ***Dispute over ownership of assets.*** In Cases A16, A17 and A20, there were disputes between the EDO and the executor over the ownership of certain assets. The executors claimed that:
 - (i) some assets were not owned by the deceased but were held in trust for others;
 - (ii) the deceased in fact had no interest in some assets treated by the EDO as jointly owned by the deceased with others; and
 - (iii) some payments made by the deceased to his relatives were not gifts as presumed by the EDO.

However, the EDO considered that the executors had provided insufficient information to support their claims. In addition, the executors could not provide information about some unincorporated businesses or unlisted shares for valuation purposes. As at 31 July 2003, the disputes remained unresolved;

- (b) ***In-depth enquiries into a potential avoidance scheme.*** In Case A18, the EDO suspected that a scheme had been used for avoiding estate duty and made in-depth enquiries into the transactions involved. As at 31 July 2003, the enquiries were still in progress; and
- (c) ***Dispute over valuation of landed properties.*** In Case A19, the deceased owned some 50 landed properties. The EDO referred all the landed properties to the Rating and Valuation Department for valuation. As at 31 July 2003, the executor had not yet agreed on the valuation of some 30 landed properties.

3.17 Audit is concerned that, in Cases A16 to A20, the assessment of estate duty has not yet been finalised although the estate duty affidavit or account was received over 10 years ago. **Audit considers that the EDO needs to review each case to determine what actions should be taken to finalise the assessment of estate duty. In cases where no further information could be provided by the executor, the EDO should consider issuing an estimated assessment under section 14(15) of the Estate Duty Ordinance (see para. 3.3).**

Audit recommendations

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

Guidelines on the valuation of unincorporated businesses

- (a) **consider promulgating the EDO's guidelines on the valuation of unincorporated businesses and unlisted shares. This would help all parties concerned with the valuation of unincorporated businesses and unlisted shares (see para. 3.9);**

Bank notification of the deceased's bank balances

- (b) **regularly remind all banks of their obligations under section 25(1) of the Estate Duty Ordinance, and instigate penalty action in cases warranting it to ensure that banks promptly submit to the EDO notifications of the bank balances of the deceased (see para. 3.11);**

Checking of undisclosed cash gifts

- (c) **review the procedures for checking undisclosed cash gifts to determine whether the scope of checks should be increased (see para. 3.13);**

Bonus shares

- (d) **issue instructions to EDO officers to ensure that bonus issues arising from shares given away by the deceased are treated as a gift *inter vivos* (see para. 3.15);**
- (e) **consider reopening Case A5 (see para. 3.15) to demand the estate duty under-assessed, and identify any similar cases of under-assessment;**

Delay in finalising estate duty assessments

- (f) **review those cases in which the assessment of estate duty has still not been finalised after a long period of time to determine what actions should be taken to finalise the assessment (see para. 3.17); and**
- (g) **in those long outstanding cases where no further information could be provided by the executor, consider issuing an estimated assessment under section 14(15) of the Estate Duty Ordinance (see para. 3.17).**

Response from the Administration

3.19 The **Commissioner of Inland Revenue** accepts the audit recommendations mentioned in paragraph 3.18(a), (b) and (d) to (g). In response to the audit recommendation mentioned in paragraph 3.18(c), she has reviewed the procedures for checking undisclosed cash gifts. She considers the present scope of checking is

adequate and strikes a balance between revenue protection and resource management. She has also said that:

Guidelines on the valuation of unincorporated businesses

- (a) as a taxpayer's service, she agrees to issue guidelines on the valuation of unincorporated businesses and unlisted shares. She intends to publish these guidelines in the form of a leaflet, which will also be uploaded to the IRD's website;

Bank notification of the deceased's bank balances

- (b) a reminder letter will be issued to the Hong Kong Association of Banks for circulation among its members periodically;

Bonus shares

- (c) she agrees to draw staff's attention specifically to the issue of bonus shares so as to avoid recurrence of similar omission. Case A5 mentioned in paragraph 3.15 is an isolated case. The relevant instruction has already been included in the EDO's staff handbook;
- (d) instruction has been given to reopen Case A5 to assess the undercharged duty. EDO officers have also been reminded to exercise greater care in view of this incident. Similar cases will be reopened once identified; and

Delay in finalising estate duty assessments

- (e) as there is standing instruction that old cases should be accorded with priority by EDO officers, she has directed the Assistant Commissioner to monitor the review more closely with a view to finalising the old cases as soon as practicable. If warranted, assessments under section 14(15) of the Estate Duty Ordinance will be issued.

3.20 The **Secretary for Financial Services and the Treasury** agrees with the Commissioner of Inland Revenue's observations and supports the follow-up actions proposed by the Commissioner.

PART 4: COLLECTION OF ESTATE DUTY

4.1 This PART examines the EDO's procedures for collecting estate duty to determine whether there is room for improvement.

Requirements for the payment of estate duty

4.2 Section 12 of the Estate Duty Ordinance provides that:

- (a) estate duty shall be due for payment by the accountable person (see para. 3.2) on the delivery of an estate duty affidavit or account, or on the expiration of six months from the death of the deceased, whichever first happens; and
- (b) in addition to any estate duty payable, interest shall accrue and be payable on such duty while it remains unpaid, at the rate of 4% per annum from the date of death of the deceased until the expiration of six months from that date, and at the rate of 8% per annum thereafter.

Where the EDO has assessed the estate duty and the duty already paid exceeds the assessed amount, the excess amount will be refunded to the accountable person. Otherwise, the accountable person will be required to settle the unpaid amount.

4.3 In cases where the Commissioner of Estate Duty has assessed the estate duty under section 14(15) of the Estate Duty Ordinance (see para. 3.3), section 14(15A) provides that the estate duty shall be paid within one month after the giving of notice of assessment.

EDO's procedures for recovering estate duty

4.4 The EDO may take the following actions to recover estate duty:

- (a) ***Institute recovery proceedings in the District Court.*** Section 14(1) of the Estate Duty Ordinance provides that estate duty shall be recoverable by the Commissioner of Estate Duty by action in the District Court. Section 14(5) states that, in any proceedings for the recovery of estate duty, the court shall

have jurisdiction to appoint a receiver of the property and to order a sale of the property; and

- (b) ***Charge estate duty on property.*** Section 18 provides that a rateable part of the estate duty on an estate, in proportion to the value of any property which does not pass to the executor as such (e.g. gifted property), shall be a first charge on the property in respect of which estate duty is leviable. Notice of any such charge on any leasehold property may be given by the Commissioner registering a memorial in the Land Registry against the property affected thereby.

When all possible recovery actions have proved fruitless, the irrecoverable amount of estate duty is written off.

Audit observations

Many long outstanding estate duty cases

4.5 From 2000-01 to 2002-03, there was only one estate duty write-off case, in which estate duty of \$0.4 million in respect of a gift made by the deceased was deemed irrecoverable because the donee was untraceable. However, as at 31 March 2003, there were 124 cases involving \$261.11 million of outstanding estate duty and interest. Details are shown in Table 4.

Table 4
Cases involving outstanding estate duty and interest
(31 March 2003)

Number of years since the receipt of estate duty affidavit or account	Number of cases	Amount of outstanding estate duty and interest (\$ million)
1 or less	8	2.11
Over 1 to 2	9	11.30
Over 2 to 5	30	96.04
Over 5 to 10	60	126.09
Over 10 to 15	13	22.32
Over 15 to 20	2	1.87
Over 20 to 25	1	1.37
Over 25 to 30	1	0.01
	} 17	} 25.57
Total	<u>124</u>	<u>261.11</u>

Source: IRD's records

***Audit's examination of 13 cases where estate
duty affidavit was received over 10 to 25 years ago***

4.6 Table 4 shows that there were 17 cases involving \$25.57 million of estate duty and interest for which the EDO received the estate duty affidavit or account over 10 to 30 years ago. Audit examined 13 cases (Note 9) and found that in each case the EDO had received an estate duty affidavit from the person applying for estate duty clearance papers. Details of these 13 cases are given in Appendix A. The amount of outstanding estate duty and interest in each case is shown in Table 5. The audit findings (up to 31 July 2003, which was the date audit field work was completed) are given in paragraphs 4.7 to 4.15.

Note 9: *Of the other 4 cases, there were 3 cases in which the amount of the outstanding estate duty and interest was relatively small (between \$8,000 and \$32,000). In the remaining case, the outstanding estate duty and interest were fully settled in May 2003.*

Table 5

**13 cases in which estate duty affidavit was received
over 10 to 25 years ago but estate duty and interest were still outstanding
(31 March 2003)**

Case	Number of years past estate duty due date (Note)	Amount of outstanding estate duty and interest (\$ million)
<i>Affidavit received over 10 to 15 years ago</i>		
B1	10	6.78
B2	11	0.24
B3	11	0.42
B4	11	5.48
B5	11	0.11
B6	12	0.73
B7	12	4.02
B8	4	1.70
B9	9	0.67
B10	17	0.55
<i>Affidavit received over 15 to 20 years ago</i>		
B11	20	0.62
B12	16	1.25
<i>Affidavit received over 20 to 25 years ago</i>		
B13	22	1.37

Source: IRD's records

Note: *In Cases B8, B9 and B12, as the estate duty was assessed under section 14(15) of the Estate Duty Ordinance, the due date was one month after the giving of notice of assessment. In other cases, the due date was the date of delivery of the affidavit or six months from the death of the deceased, whichever first happened. In all cases, interest accrued from the date of death of the deceased (see paras. 4.2 and 4.3).*

Deceased's estate not used by executor for paying estate duty

4.7 In Case B1, the executor did not pay any estate duty although he had sold some landed properties owned by the deceased. Details are as follows:

Case B1

- In June 2000, the EDO issued provisional estate duty clearance papers to the executor after receiving an equitable charge executed by him on a landed property owned by the deceased (Note 10).
- In October 2000, the Probate Registry issued letters of administration to the executor.
- In April 2001, the EDO noted that the executor had sold some of the deceased's other landed properties. The EDO asked the executor to explain why the sale proceeds had not been used to pay the estate duty. The executor indicated that he had financial difficulties and asked the EDO to remit the interest and part of the outstanding estate duty.
- During the period June 2001 to October 2002, the EDO sent two letters and four reminders asking the executor to submit documents to support his application for remission of the interest on the outstanding estate duty. However, the executor did not respond to the EDO's request.

Audit noted that, without the payment of estate duty, the EDO had the legal right to enforce the equitable charge. **In Audit's view, in Case B1, the EDO should have taken more rigorous actions (e.g. by enforcing the equitable charge) to recover the estate duty.**

Note 10: *The equitable charge was executed by depositing the title deeds with the EDO as security for the payment of estate duty. The executor irrevocably designated the Commissioner of Estate Duty to be his attorney to execute, if and when the Commissioner considered necessary, a legal charge or an assignment of the property to the Government for the payment of estate duty.*

Payment of estate duty by instalments

4.8 In Cases B2 and B11, the executors, upon the issue of probate or letters of administration by the Probate Registry, paid part of the estate duty by instalments. In Case B2, estate duty of \$1.23 million had been paid. However, \$0.24 million remained outstanding as at 31 March 2003. Details of Case B11 are as follows:

Case B11

- In August 1997, following the settlement of litigation between the beneficiaries, the EDO issued provisional estate duty clearance papers to the executor after receiving an equitable charge executed by him on a landed property owned by the deceased.
- In March 1999, the Probate Registry issued letters of administration to the executor.
- In April 2000, the EDO urged the executor to pay the estate duty when the letters of administration were returned to him, following his withdrawal of an application to amend the annexed schedule of property.
- During the period June 2001 to December 2002, the executor indicated that he had financial difficulties. However, he made three payments totalling \$0.45 million as partial settlement of the estate duty.
- In June 2003, the executor told the EDO that he was making arrangements to pay the outstanding estate duty in one lump sum.

Audit noted that the estate duty in Cases B2 and B11 had remained outstanding for 11 years and 20 years respectively. **Audit considers that the EDO needs to closely monitor these two cases and take rigorous recovery actions if the estate duty remains outstanding. In Case B11, the EDO should consider enforcing the equitable charge on the landed property.**

***Difficulties encountered in recovering estate duty
for cases without probate or letters of administration***

4.9 Audit noted that:

- (a) in 7 cases (Cases B3, B5, B6, B9, B10, B12 and B13), the EDO had not issued estate duty clearance papers to the intended executor (Note 11) as the assessed estate duty had not been fully paid. The intended executors in these cases could not apply to the Probate Registry for probate or letters of administration; and
- (b) in 2 cases (Cases B4 and B7), the EDO had issued provisional estate duty clearance papers to the intended executors. However, the intended executors had not obtained probate or letters of administration from the Probate Registry.

In all 9 cases, the EDO had encountered difficulties in recovering the estate duty from the deceased's estate. Details are given in paragraphs 4.10 to 4.12.

4.10 ***Recovery proceedings could not be instituted against an intended executor.***

Section 14(1) of the Estate Duty Ordinance provides that estate duty shall be recoverable by action in the District Court (see para. 4.4(a)). However, in all 9 cases, recovery proceedings could not be instituted as the intended executor was not accountable for the estate duty. For illustration, details of Case B13 are given below:

Note 11: *In this PART, "intended executor" means the person who had submitted an estate duty affidavit to the EDO stating that he intended to apply for probate or letters of administration, but had not been issued with such probate or letters of administration by the Probate Registry.*

Case B13

- In March 1987, the EDO asked the Department of Justice (DOJ) to assist in recovering the outstanding estate duty.
- In November 1988, the DOJ adjourned recovery actions in the District Court as the DOJ needed time to consider whether the intended executor was accountable for the estate duty.
- In June 1992, the DOJ advised the EDO that:
 - (i) under the Estate Duty Ordinance, an executor shall pay the estate duty in respect of all property of which the deceased was competent to dispose at his death; and
 - (ii) it did not seem that an “intended executor” was covered by the Ordinance.
- During the period November 1991 to July 1993, the intended executor made offers to settle the estate duty. The EDO did not accept the offered amounts because they were less than the amount of the outstanding estate duty.
- In July 1998, in response to the EDO’s enquiries, the DOJ advised the EDO that:
 - (i) a person was accountable to pay estate duty upon the grant of probate or letters of administration to him; and
 - (ii) as the intended executor had not obtained probate or letters of administration, he was not an executor in law and should not be made accountable for the estate duty.

4.11 ***Bank refused to release balances in the deceased’s bank accounts.*** In Case B9, the deceased had bank accounts with balances greater than the outstanding estate duty. Details are given below:

Case B9

- In December 1998, after the intended executor had become untraceable, the EDO wrote to the bank stating that:
 - (i) the EDO intended to recover the outstanding estate duty from the balances in the deceased's accounts; and
 - (ii) the EDO would provide the bank with a letter of indemnity whereby the EDO undertook to keep the bank indemnified against all actions which might be brought against the bank in connection with the release of the balances to the EDO.
- However, the bank did not agree to release the balances to the EDO to pay the estate duty.

4.12 ***Equitable charge executed by an intended executor could not be enforced.***
In Cases B4 and B7, the EDO could not enforce the equitable charge on the landed properties executed and lodged by the intended executors as guarantee for payment of the estate duty. For illustration, details of Case B7 are given below:

Case B7

- In December 1995, the EDO issued provisional estate duty clearance papers to the intended executor after receiving an equitable charge executed by him on a landed property owned by the deceased.
- In January 1996, the intended executor applied to the Probate Registry for letters of administration. However, the application was held over pending the outcome of litigation between the beneficiaries.
- In August 1997, the EDO requested the DOJ to assist in recovering the outstanding estate duty.
- In March 2002, the DOJ advised the EDO that:
 - (i) the equitable charge executed by the intended executor merely provided security on title deeds of the property and could not be enforced by way of sale of the property;
 - (ii) a legal charge in favour of the Commissioner of Estate Duty, executed pursuant to the equitable charge, could be enforced by way of sale of the property; and
 - (iii) however, as the intended executor had not been granted letters of administration, he was not an “executor in law” and had no power to create a legal charge on the property in favour of the Commissioner of Estate Duty.

4.13 **In summary, in these 9 cases (i.e. Cases B3 to B7, B9, B10, B12 and B13), due to the absence of an executor who is accountable for the estate duty, the EDO has been unable to recover the long outstanding estate duty (i.e. these are cases where the Probate Registry has not issued probate or letters of administration). Audit considers that the EDO needs to find ways to take effective recovery actions in such cases.** In this connection, Audit notes that section 16 of the Probate and Administration Ordinance (Cap. 10) provides that, on application made by the Official Administrator, the High Court shall, unless it sees good reason to the contrary, grant to him administration in cases where a deceased person has left property situated in Hong Kong and no person has, within 12 months after the death of such person, obtained administration of his estate. **The EDO needs to explore the option of**

asking the Official Administrator to apply for a grant of administration in cases that warrant it.

Outstanding estate duty involving gifted property

4.14 In Case B8, the outstanding estate duty was due from donees to whom a gift had been made by the deceased during the three years before his death. As in the estate duty write-off case mentioned in paragraph 4.5, these donees had become untraceable. According to the information available to the EDO, these individuals had departed from Hong Kong to reside elsewhere.

4.15 Audit notes that section 77 of the Inland Revenue Ordinance provides that, if the IRD applies to a District Judge and satisfies him that there are reasonable grounds for believing that an individual intends to depart, or has departed, from Hong Kong to reside elsewhere without paying all the tax due from him, the District Judge shall issue a departure prevention direction to stop the individual from leaving Hong Kong. However, the Estate Duty Ordinance does not contain a similar provision for recovery of estate duty from individuals departing from Hong Kong to reside elsewhere. **The EDO needs to review the effectiveness of its recovery actions in cases involving individuals departing from Hong Kong to reside elsewhere (including Case B8 and the write-off case mentioned in paragraph 4.5) to determine whether, to protect the revenue, legislation similar to section 77 of the Inland Revenue Ordinance should be enacted in the Estate Duty Ordinance.**

Audit recommendations

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

- (a) **take rigorous recovery actions on all long outstanding cases, especially those cases in which estate duty has remained outstanding for more than 10 years (see paras. 4.7 and 4.8);**
- (b) **consult with the DOJ to find ways that will enable the EDO to recover estate duty in cases which do not have an executor who is accountable for the estate duty. In doing so, the Commissioner should consider the option of seeking the assistance of the Official Administrator in cases that warrant it (see para. 4.13); and**

- (c) **review the effectiveness of the actions taken by the EDO to recover estate duty in cases involving individuals departing from Hong Kong to reside elsewhere to determine whether, to protect the revenue, legislation similar to section 77 of the Inland Revenue Ordinance should be enacted in the Estate Duty Ordinance (see para. 4.15).**

Response from the Administration

4.17 The **Commissioner of Inland Revenue** has said that:

Recovery of estate duty

- (a) the EDO will monitor the long outstanding cases more closely and take appropriate recovery actions. Assistance from the DOJ will be enlisted, if warranted;
- (b) she will seek advice from the DOJ to find ways that will enable the EDO to recover estate duty in cases which do not have an executor who is accountable for the estate duty. She will also consider any views from the Official Administrator; and

Departure prevention directions

- (c) she has reservations on the effectiveness of and justification for enacting under the Estate Duty Ordinance a provision similar to section 77 of the Inland Revenue Ordinance because application for departure prevention directions is generally restricted to cases involving gifts *inter vivos* or joint bank accounts and the number of default cases is small. Of the 124 cases with outstanding estate duty and interest as at 31 March 2003, it is estimated that not more than 15% involve donees or joint account holders.

4.18 The **Secretary for Financial Services and the Treasury** agrees with the Commissioner of Inland Revenue's observations and supports the follow-up actions proposed by the Commissioner.

4.19 The **Judiciary Administrator** has said that he and the **Official Administrator** would be pleased to discuss with the Commissioner of Inland Revenue measures to address the audit recommendation mentioned in paragraph 4.16(b). They have to ensure that any measures would not impair, or be seen as impairing, the independence of the Judiciary.

PART 5: RECOVERY OF EARNINGS AND PROFITS TAX FROM THE ESTATES OF DECEASED TAXPAYERS

5.1 This PART examines the IRD's procedures for recovering earnings and profits tax from the estates of deceased taxpayers including, in particular, the procedures used by the EDO for supplying estate information to the Collection Enforcement Section (CES) of the IRD.

IRD's procedures for recovering earnings and profits tax from the estates of deceased taxpayers

5.2 Unit 2 of the IRD assesses an individual's earnings and profits tax (i.e. profits tax, salaries tax, property tax and tax charged under personal assessment). Tax not paid by an individual on or before the due date specified in the IRD's tax demand note is deemed to be in default. The CES is responsible for recovering any tax in default. The CES may take various recovery actions, including the institution of recovery proceedings in the District Court and the issue of a recovery notice to any third party (e.g. a bank) who owes or holds moneys for the defaulting individual, requiring the third party to pay such moneys to the IRD. **In cases where there is outstanding tax due from a deceased person, the CES identifies the executor as a first step in recovering the outstanding tax from the deceased's estate (Note 12).** If necessary, the CES sends tax inspectors to conduct searches at the Probate Registry to find out the name and address of the executor. If the outstanding tax or any part of it cannot be recovered, the irrecoverable amount is written off.

Procedures used by the EDO to supply estate information to the CES

5.3 Information on the death of a taxpayer may be input into the IRD's computerised database by Unit 2 or the CES when such information is received in the normal course of their work. In addition, the Immigration Department provides the IRD with monthly information on registered deaths in the form of a computer file for direct uploading to the IRD's computerised database. In all cases, when information on

Note 12: *Under section 54 of the Inland Revenue Ordinance, the executor of a deceased person shall be chargeable with the earnings and profits tax for all periods prior to the date of such person's death with which the said person would be chargeable if he were alive, and shall be liable to do all such acts, matters or things as the deceased person if he were alive would be liable to do, provided that no assessment or additional assessment in respect of a period prior to the date of such person's death shall be made after the expiry of 1 year from such date of death, or 1 year from the date of filing of the estate duty affidavit, whichever is the later.*

the death of a taxpayer is updated to the IRD's computerised database, the CES is notified of the death of the taxpayer by means of an advisory slip generated by the IRD's computer system. In August 1985, to assist the CES in taking timely actions to recover earnings and profits tax from the estates of deceased taxpayers, the EDO and the CES agreed to a set of procedures by which the EDO supplies estate information to the CES. These procedures are as follows:

- (a) the CES sends a standard enquiry form to the EDO giving the name and identity card number of a deceased taxpayer who has unpaid earnings and profits tax;
- (b) in response, the EDO furnishes the CES with the following information on the form:
 - (i) the reference number of the EDO's file for the case;
 - (ii) the date of issue of the estate duty clearance papers;
 - (iii) the name and address of the intended executor;
 - (iv) the name and address of the authorised representative (e.g. solicitors); and
 - (v) particulars of the bank accounts of the deceased, including the bank names, account numbers and account balances;
- (c) if the estate duty clearance papers have **not** yet been issued, the EDO also returns a note saying that the EDO will duly inform the CES of the date of issue of the estate duty clearance papers once they have been issued; and
- (d) if the EDO does not have a file for the case, it simply returns the uncompleted enquiry form to the CES. The EDO is not required to take any follow-up action.

Audit observations

Write-offs of earnings and profits tax due from deceased taxpayers

5.4 The write-offs of earnings and profits tax due from deceased taxpayers amounted to \$10.2 million in 2000-01, \$9.9 million in 2001-02 and \$15.4 million in 2002-03. An analysis of the write-offs in 2002-03 is shown in Table 6.

Table 6

Write-offs of earnings and profits tax due from deceased taxpayers in 2002-03

Type of tax	Number of cases	Total amount	Average amount per case
	(a)	(b)	(c) = $\frac{(b)}{(a)}$
		(\$'000)	(\$'000)
Profits tax	43	9,877	230
Salaries tax	199	3,956	20
Property tax	89	1,351	15
Personal assessment	15	203	14
Total	<u>346</u>	<u>15,387</u>	44

Source: IRD's records

According to the IRD's records, in most write-off cases the deceased did not leave any assets that would enable recovery of tax.

Outstanding earnings and profits tax due from deceased taxpayers

5.5 An analysis of the outstanding earnings and profits tax due from deceased taxpayers as at 31 March 2003 is shown in Table 7.

Table 7

**Outstanding earnings and profits tax
due from deceased taxpayers as at 31 March 2003**

	Number of cases	Total amount of outstanding earnings and profits tax	Average amount per case
	(a)	(b)	(c) = $\frac{(b)}{(a)}$
		(\$'000)	(\$'000)
Cases in which the executors had applied for estate duty clearance papers, but such papers had not been issued by the EDO	86	50,032	582
Other cases (Note)	965	66,804	69
Total	<u>1,051</u>	<u>116,836</u>	111

Source: IRD's records

Note: These were mainly cases in which no executor had applied for estate duty clearance papers or such papers had already been issued by the EDO. There is no readily available information indicating the number of cases in these two categories or the number of cases with probate or letters of administration already issued by the Probate Registry.

Audit's examination of 20 cases with tax written off or outstanding

5.6 To ascertain if there is room for improvement in the procedures for recovering earnings and profits tax from the estates of deceased taxpayers, Audit examined a random sample of 20 cases (hereinafter referred to as Cases C1 to C20). In each of these 20 cases, more than \$100,000 of tax was written off during the period 2000-01 to 2002-03 or remained outstanding as at 31 March 2003. Details of these 20 cases are given in Appendix B. The audit findings are given in paragraphs 5.7 to 5.19.

Estate information not provided to the CES in an accurate or timely manner

5.7 Audit noted that in all 20 cases, because the deceased taxpayers had outstanding earnings and profits tax, the CES requested the EDO to supply information about the estate in accordance with the agreed procedures (see para. 5.3). However, Audit's examination revealed cases in which the EDO had not supplied the requested information in an accurate or timely manner. Details are given in paragraphs 5.8 to 5.12.

5.8 ***The EDO incorrectly informed the CES about jointly owned bank accounts.*** Because a deceased's interest in jointly owned property passes, on his death, to the surviving joint owners, the IRD has no legal authority to recover any outstanding tax owed by the deceased from jointly owned bank accounts. According to the IRD, however, information on jointly owned bank accounts may be useful for other tax purposes. Cases C8, C9 and C20 all involved bank accounts jointly owned by the deceased with another person. In Cases C8 and C20, the EDO did not disclose the jointly owned accounts. In Case C9, the EDO disclosed incorrectly to the CES the jointly owned accounts in the enquiry form as the bank accounts of the deceased. **In Audit's view, in Cases C8, C9 and C20, the EDO should have disclosed the bank accounts to the CES with a clear indication that these were jointly owned accounts. This would avoid a situation where the CES may take unwarranted collection action.**

5.9 ***Bank accounts of the deceased not disclosed to the CES.*** In Case C19, in February 1998 the executor submitted an estate duty affidavit showing bank balances of \$158,000 owned by the deceased. However, in April 1998, the EDO omitted to disclose the bank accounts to the CES (Note 13). **In Audit's view, the EDO should have ensured that complete and accurate information on the bank accounts of the deceased was supplied to the CES.**

5.10 ***Information submitted by the executor not disclosed to the CES.*** In Case C11, due to incorrect information supplied by the EDO, the CES could not initiate action to recover outstanding tax from the deceased's estate. Details are as follows:

Note 13: *The EDO later disclosed the bank accounts to the CES in a follow-up enquiry form in March 2000 and in another follow-up enquiry form in August 2002.*

Case C11

- On 8 December 2000, the executor submitted a Statement in lieu of Affidavit to the EDO showing assets of \$137,000 owned by the deceased.
- On 14 December 2000, the EDO returned to the CES an uncompleted enquiry form, which indicated incorrectly that no estate information was available.
- In June 2001, the CES wrote off the outstanding tax of \$153,000 on the basis that the deceased had left no assets for recovery of tax.

In Audit's view, the EDO should have always ensured that correct and accurate information was supplied to the CES.

5.11 ***The CES not informed of issue of estate duty clearance papers.*** In Cases C10 and C20, after it had issued the estate duty clearance papers, the EDO did not subsequently inform the CES (see para. 5.3(c)). For illustration, details of Case C10 are given below:

Case C10

- In May 2000, when the CES sent an enquiry form to the EDO, the latter was not able to supply the name and address of the executor. The information only became available in June 2000 when the executor's application for estate duty clearance papers was received.
- In August 2000, the EDO issued the estate duty clearance papers, which showed assets of \$167,000 owned by the deceased.
- The EDO did not inform the CES that the papers had been issued.
- In January 2001, the CES wrote off the outstanding tax of \$191,000 on the basis that no executor particulars were available from the EDO's records and that no property in the name of the deceased was found in the IRD's computerised database.

In Audit's view, in Cases C10 and C20, the EDO should have informed the CES when it issued the estate duty clearance papers.

5.12 ***Information only supplied to the CES after the CES issued follow-up enquiries.*** In 4 cases (Cases C13, C14, C17 and C19), the EDO did not inform the CES that it had issued the estate duty clearance papers at the time of issue. The EDO only did so several months afterwards in response to follow-up enquiries from the CES. For illustration, details of Cases C14 and C17 are given below:

Case C14

- The estate duty clearance papers had not been issued when the EDO returned three (including two follow-up) enquiry forms to the CES during the period from October 1998 to June 2000.
- The estate duty clearance papers were issued later in June 2000.
- The EDO only informed the CES about this in November 2000, in response to another follow-up enquiry form.

Case C17

- In April 2000, the EDO returned the enquiry form to the CES stating that the estate duty clearance papers had not yet been issued.
- **In May 2000, the EDO issued the estate duty clearance papers showing assets of \$7.8 million in the deceased's estate, including bank balances of \$1.6 million and landed properties valued at \$4.8 million net of outstanding mortgage loans.**
- In June 2000, the Probate Registry issued letters of administration to the executor.
- In November 2000, in response to a follow-up enquiry form, the EDO advised the CES that in May 2000 the estate duty clearance papers had been issued.
- **In June 2002 (i.e. 19 months later), the CES issued recovery notices to banks and recovered only about \$130.**
- **As at 31 March 2003, tax of \$2.5 million remained outstanding.** According to the executor, he was unable to pay the tax because the bank balances in the deceased's estate had been used for various purposes and the market value of the landed properties in the deceased's estate had dropped considerably.

The audit findings in these 4 cases (i.e. Cases C13, C14, C17 and C19) indicate that the EDO should have immediately informed the CES when it issued the estate duty clearance papers. In Case C17, the CES should, based on the estate information provided by the EDO, have taken immediate action to recover the outstanding tax from the deceased's estate.

***Need to review the procedures for
supplying estate information to the CES***

5.13 The existing procedures for supplying estate information in paper form by the EDO to the CES were established in August 1985. **In line with the IRD's objective of enhancing efficiency and effectiveness through computerisation, Audit considers that the IRD needs to review these procedures to determine whether it is more cost-effective for the EDO to promptly input all key estate information (e.g.**

date of issue of estate duty clearance papers) into the IRD's computerised database and simultaneously alert the CES by electronic mail or other means. This would enable the CES to receive timely and updated estate information and to have on-line access to such information in the IRD's computerised database.

Need to conduct searches at the Probate Registry more cost-effectively

5.14 As mentioned in paragraph 2.3, the Probate Registry requires the executor to obtain estate duty clearance papers from the EDO *before* applying for probate or letters of administration. Therefore, in cases where no executor has submitted an application for estate duty clearance papers or where the EDO is processing such an application, searches conducted at the Probate Registry will produce no results as the probate or letters of administration could not have been issued. However, Audit's examination revealed cases in which the CES had conducted such searches. Details are as follows:

- (a) ***Searches conducted in cases where no executor had submitted an application for estate duty clearance papers.*** In Cases C1 to C9, no executor had submitted an application for estate duty clearance papers to the EDO. In Cases C2 and C7, the CES did not conduct searches at the Probate Registry before writing off the outstanding tax. However, in the remaining 7 cases (i.e. Cases C1, C3 to C6, C8 and C9), the CES sent tax inspectors to the Probate Registry to conduct one to three searches. In each search, it was found that the Probate Registry had not issued the probate or letters of administration; and
- (b) ***Searches conducted when the EDO was processing the application for estate duty clearance papers.*** In Case C14, while the EDO was processing the application for estate duty clearance papers, the CES conducted three searches at the Probate Registry and found that no probate or letters of administration had been issued. In Case C16, the CES conducted one search at the Probate Registry, but without results.

In Audit's view, the CES should not send tax inspectors to conduct searches at the Probate Registry before the EDO has issued estate duty clearance papers.

Recovery of outstanding tax from estates of deceased taxpayers

5.15 As shown in Appendix B, in Cases C10 to C15 the deceased taxpayer had left an estate. However, the CES had written off all the outstanding tax for the following reasons:

- (a) **Deceased left no estate.** In Cases C10 (see para. 5.11) and C11 (see para. 5.10), based on the incorrect or preliminary information supplied by the EDO, the CES incorrectly concluded that the deceased left no estate for recovery of tax;

- (b) **No executor could be found.** In Cases C12 to C14, although the EDO had issued the estate duty clearance papers, the CES could not find the probate or letters of administration at the Probate Registry; and

- (b) **The executor claimed that the deceased left no estate.** In Case C15, in response to the IRD's demand for tax, the executor said that the deceased had left no assets but debts.

5.16 On 21 July 2003, Audit conducted searches at the Probate Registry to obtain updated information on the granting of probate or letters of administration in Cases C10 to C15. The results are shown in Table 8.

Table 8

**Status of granting of probate or letters of administration in Cases C10 to C15
(21 July 2003)**

Case	Estate duty clearance papers issued by EDO on	Date of last search conducted by CES at Probate Registry	Result of Audit's search at Probate Registry on 21 July 2003
C10	21 Aug. 2000	13 Oct. 2000	Application for letters of administration withdrawn on 21 Aug. 2002
C11	15 Dec. 2000	8 Jan. 2001	Letters of administration issued on 6 Mar. 2001
C12	20 Nov. 2001	22 Jan. 2003	No application submitted
C13	13 Nov. 2001	18 Jan. 2002	No application submitted
C14	26 Jun. 2000	15 Dec. 2000	Probate issued on 5 Jun. 2001
C15	12 Jun. 2001	No search conducted	Probate issued on 5 Feb. 2002

Source: IRD's records and searches conducted by Audit at the Probate Registry

As shown in Table 8, in Cases C11, C14 and C15, if the CES had conducted further searches at the Probate Registry, it would have found that the Probate Registry had issued the probate or letters of administration to the executor. In Audit's view, after the issue of the estate duty clearance papers, searches should be conducted at appropriate intervals (say not less than quarterly) to obtain updated information on the issue of the probate or letters of administration. This will enable the CES to follow up with the executor on outstanding tax matters in a timely manner.

5.17 Under section 62 of the Probate and Administration Ordinance, the executor shall administer a deceased's estate by paying the funeral, testamentary and administration expenses and the debts of the deceased, and distributing the residue of

the deceased's estate to the beneficiaries. Under Part I of Schedule 1 of the Ordinance, where an estate is insolvent, the funeral, testamentary and administration expenses have priority over the debts of the deceased, and in general statutory debts such as tax debts shall be paid in priority to other debts. Accordingly, in Cases C11, C14 and C15, the executor should (after paying the funeral, testamentary and administration expenses if the estate was insolvent) have first used the deceased's estate to pay the outstanding tax. **In Audit's view, the CES should consider reopening these three write-off cases with a view to taking action against the executors for recovering the tax written off.**

5.18 Audit also found that the probate or letters of administration had not been applied for in Cases C12 and C13 and that the application had been withdrawn in Case C10 (Note 14). **As with the recovery of estate duty (see para. 4.13), the IRD needs to consult with the DOJ to find ways that will enable the IRD to take effective action to recover tax from the deceased's estate in such cases. In particular, the IRD needs to consider the option of asking the Official Administrator to apply for a grant of administration in cases that warrant it.**

Obtaining information on probates and letters of administration by electronic means

5.19 Under existing arrangements, the Immigration Department provides the IRD with monthly information on registered deaths in the form of a computer file for direct uploading to the IRD's computerised database (see para. 5.3). A similar arrangement, however, has not been made with the Probate Registry for supplying the IRD with information on the issue of probate and letters of administration. **Audit considers that the IRD needs to explore with the Probate Registry the feasibility of regularly supplying the IRD with information by electronic means in the longer term. This would provide the IRD with information on the issue of probate and letters of administration in a more timely and cost-effective way.** In this connection, Audit notes that some information on the issue of probate and letters of administration by the

Note 14: *In Cases C10 and C12, the EDO's estate duty clearance papers showed that the value of the property passing on the deceased's death was less than the debts incurred by the deceased (i.e. the deceased's estate might be insolvent).*

Probate Registry has been provided quarterly to the EDO in paper form since October 2002 (Note 15).

Audit recommendations

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

Coordination between the EDO and the CES

- (a) **improve coordination between the EDO and the CES in the recovery of earnings and profits tax from the estates of deceased taxpayers. In particular, the Commissioner should take additional measures to ensure that:**
 - (i) **the EDO supplies the CES with accurate information on the bank accounts of deceased taxpayers and other information submitted by executors (see paras. 5.8 to 5.10); and**
 - (ii) **the EDO informs the CES immediately when estate duty clearance papers are issued (see paras. 5.11 and 5.12);**

Note 15: *With effect from October 2002, in response to the Independent Commission Against Corruption's recommendation on the work of the EDO, the EDO and the Probate Registry have implemented the following procedures for detecting forgery of estate duty clearance papers:*

- (a) *every quarter, the Probate Registry provides the EDO with a copy of the daily computer reports on probates and letters of administration issued to executors, showing for each case the name of the deceased and the issue date; and*
- (b) *the EDO sends a tax inspector to the Probate Registry to sample check whether the information contained in the Probate Registry's case files (e.g. the name of the executor and the value of the estate) agrees with the EDO's records.*

According to the EDO, it will consider the possibility of developing an electronic estate duty information system for the EDO and the Probate Registry in the long run.

Communication of information

- (b) **conduct a review to determine whether the EDO should promptly input key estate information (e.g. date of issue of estate duty clearance papers) into the IRD's computerised database, and whether the CES should be immediately made aware of such information by electronic mail, in order to enhance the efficiency and cost-effectiveness of tax recovery (see para. 5.13);**

Delay in taking action to recover tax

- (c) **ensure that there is no delay on the part of the CES in recovering earnings and profits tax from the estates of deceased taxpayers (see para. 5.12);**

Conducting searches at the Probate Registry

- (d) **streamline the CES's procedures for conducting searches at the Probate Registry so that searches are conducted at appropriate intervals after the issue of estate duty clearance papers by the EDO (see paras. 5.14 and 5.16);**

Write-off cases in respect of deceased taxpayers

- (e) **consider reopening the write-off cases in respect of deceased taxpayers with property passing on their death to ascertain whether action can be taken to recover the earnings and profits tax written off (see para. 5.17);**

Cases without probate or letters of administration issued

- (f) **consult with the DOJ to find ways that will enable the IRD to take effective action to recover earnings and profits tax from the deceased taxpayer's estate in cases in which probate or letters of administration has or have not been issued by the Probate Registry. The option of seeking the assistance of the Official Administrator should be considered in cases that warrant it (see para. 5.18); and**

Obtaining information on probate or letters of administration by electronic means

- (g) **in the longer term, explore with the Probate Registry the feasibility of regularly supplying the IRD with timely information by electronic means on the issue of probate and letters of administration for uploading into the IRD's computerised database (see para. 5.19).**

Response from the Administration

5.21 The **Commissioner of Inland Revenue** has said that:

Coordination between the EDO and the CES

- (a) she generally agrees with the recommendation to improve coordination between the EDO and the CES. The EDO will issue a circular reminding its staff of the requirement to supply the CES with accurate information on the bank accounts of deceased taxpayers and other information submitted by executors, and to inform the CES immediately when estate duty clearance papers are issued;

Communication of information

- (b) she agrees to conduct a review on the cost-effectiveness of developing and implementing computerised systems that would enable key estate information to be promptly input by the EDO into the IRD's computerised database and the CES to be immediately made aware of such information by electronic mail;

Delay in taking action to recover tax

- (c) the CES will review outstanding cases at regular intervals with a view to recovering earnings and profits tax soonest possible from the estate of the deceased;

Conducting searches at the Probate Registry

- (d) the CES will review its procedures and work plans to ensure that any search at the Probate Registry is conducted in a cost-effective manner;

Write-off cases in respect of deceased taxpayers

- (e) the CES will re-examine the write-off cases in respect of deceased taxpayers with property passing on their death, and take appropriate action to recover the earnings and profits tax written off;

Cases without probate or letters of administration issued

- (f) she will seek advice from the DOJ to identify effective ways of recovering earnings and profits tax from the deceased taxpayer's estate in cases in which probate or letters of administration has or have not been issued by the Probate Registry. She will liaise with the Official Administrator on the issue; and

Obtaining information on probate or letters of administration by electronic means

- (g) she will, in the longer term, consider exploring with the Probate Registry the feasibility of regularly supplying the IRD with timely information by electronic means on the issue of probate and letters of administration.

5.22 The **Secretary for Financial Services and the Treasury** agrees with the Commissioner of Inland Revenue's observations and supports the follow-up actions proposed by the Commissioner.

5.23 The **Judiciary Administrator** has said that he and the **Official Administrator** would be pleased to discuss with the Commissioner of Inland Revenue measures to address the audit recommendations mentioned in paragraph 5.20(f) and (g). They have to ensure that any measures would not impair, or be seen as impairing, the independence of the Judiciary.

PART 6: ESTATE DUTY AVOIDANCE SCHEMES

6.1 This PART examines the effectiveness of the EDO in tackling estate duty avoidance schemes.

Anti-avoidance provisions of the Estate Duty Ordinance

6.2 The Estate Duty Ordinance was first enacted in 1932 without any anti-avoidance provisions. In 1959, sections 34 to 45 of the Estate Duty Ordinance were enacted to counteract the avoidance of estate duty through the use of controlled companies. The main provisions are as follows:

- (a) **Definition of controlled company.** Under section 34, a controlled company is defined as any company which, at any relevant time, is deemed to have been under the control of not more than five persons not being a company which, at any such time, is deemed to have been either a subsidiary company or a company in which the public were substantially interested; and

- (b) **Charge on assets of controlled company.** Under section 35, where a person has made to a controlled company a transfer of any property and any benefits accruing to the deceased from the controlled company accrued to him in the three years ending with his death, the assets of the controlled company shall be deemed for the purposes of estate duty to be included in the property passing on his death to an extent determined by reference to the proportion that the aggregate amount of the benefits accruing to the deceased from the controlled company bore to the net profits of the controlled company.

Anti-avoidance rules of the common law

6.3 At common law, an anti-avoidance rule called the fiscal nullity doctrine (or the Ramsay principle) can be invoked to challenge certain estate duty avoidance schemes. In general, the doctrine applies to tax avoidance schemes involving:

- (a) a pre-ordained series of transactions or one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial end; and

- (b) steps inserted which have no commercial purpose apart from the avoidance of a liability to tax.

For such tax avoidance schemes, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied.

Audit observations

6.4 Following the enactment in 1959 of the anti-avoidance provisions on controlled companies in the Estate Duty Ordinance (see para. 6.2), it is difficult for an individual to avoid estate duty by transferring and holding assets through the use of controlled companies which would have perpetual existence, while continuing to enjoy income from these controlled companies during his lifetime. **However, Audit noted that the EDO had identified various types of estate duty avoidance schemes not involving the use of controlled companies. Most of these avoidance schemes involved the use of a series of highly artificial transactions to relocate offshore the Hong Kong property of the deceased shortly before his death. In the absence of anti-avoidance provisions in the Estate Duty Ordinance for counteracting these types of avoidance schemes, the EDO could not charge estate duty on such property relocated offshore. This is because property situated outside Hong Kong is exempted from estate duty (see para. 1.2).**

6.5 In July 2000, the EDO lost a Court of Final Appeal case in which the EDO attempted to invoke the fiscal nullity doctrine (see para. 6.3) to challenge an estate duty avoidance scheme. The Court of Final Appeal held that:

- (a) there was a pre-ordained series of transactions and the intermediate steps, particularly the arrangements to finance the asset purchases, were inserted purely for avoiding estate duty. Accordingly, the purpose test under the fiscal nullity doctrine (or the Ramsay principle) was satisfied; and
- (b) the fiscal nullity doctrine (or the Ramsay principle) did not permit the Commissioner of Estate Duty to reconstitute the relevant transactions by giving them a character different from their genuine character. *The end result in the case was that there was no transfer of property by way of gift of Hong Kong property which fell within the charge of the Estate Duty Ordinance.*

6.6 Following the Court of Final Appeal's decision, the EDO considered it necessary to enact legislation to prevent the use of similar avoidance schemes. **In November 2000, the EDO estimated that, if legislative amendments were not introduced to counteract this type of avoidance schemes, revenue loss would amount to \$760 million a year (Note 16). In this connection, Audit noted that in the two cases involving estate duty avoidance schemes (i.e. Cases A8 and A15 mentioned in para. 3.7 and Note 6), according to the EDO's estimate, the estate duty involved could amount to about \$120 million.**

6.7 In March 2001, the IRD submitted to the Financial Services and the Treasury Bureau (FSTB) of the Government Secretariat an amendment proposal to strengthen the anti-avoidance provisions in the Estate Duty Ordinance. The IRD considered that the proposal would enable the IRD to tackle estate duty avoidance schemes more effectively.

6.8 From the records of the IRD and the FSTB, Audit noted that:

- (a) **during the 20-month period from March 2001 to November 2002, little progress was made on the proposal to strengthen the anti-avoidance provisions in the Estate Duty Ordinance.** The proposal was put on hold pending a fundamental review of estate duty in the context of the annual Budget exercises led by the Financial Secretary (Note 17);
- (b) in November 2002, a decision was taken by the Financial Secretary in preparing for the 2003-04 Budget to resume the exercise of strengthening the anti-avoidance provisions in the Estate Duty Ordinance; and
- (c) in May 2003, as suggested by the FSTB, the IRD started to prepare a consultation paper for consulting the parties concerned before preparing the bill for introduction into the Legislative Council.

Note 16: *In August 2003, the EDO revised downwards its estimate of revenue loss to \$100 million to \$200 million a year.*

Note 17: *According to the FSTB, the intention was to take a holistic approach to look at the issue together with other tax collection work. The Administration considered it more appropriate to proceed with the proposal to strengthen the anti-avoidance provisions in the Estate Duty Ordinance only after the overall future of estate duty had become clearer.*

6.9 **Audit is concerned that delay in the strengthening of the anti-avoidance provisions in the Estate Duty Ordinance will result in substantial revenue loss, amounting to hundreds of millions of dollars a year. In order to protect the revenue, the IRD and the FSTB need to expedite action urgently on the issue.**

6.10 ***Interpretation and practice notes on estate duty avoidance.*** As and when required, the IRD issues interpretation and practice notes on specific tax matters setting out its interpretations of the statutory provisions and its assessment practices for the information and guidance of taxpayers. The EDO has issued interpretation and practice notes on the anti-avoidance provisions relating to controlled companies (see para. 6.2). **In view of the inherent wide scope of the *proposed* amendments to strengthen the anti-avoidance provisions, following their enactment in the Estate Duty Ordinance, Audit considers that the EDO needs to issue interpretation and practice notes to provide guidance to the general public.**

6.11 ***Prescribed form for estate duty affidavit.*** The EDO assesses estate duty based largely on the information submitted in estate duty affidavits or Statements in lieu of Affidavits. **In order to facilitate the identification of estate duty avoidance schemes against which the *proposed* anti-avoidance provisions can be invoked, Audit considers that the EDO should review the prescribed forms for estate duty affidavit and Statement in lieu of Affidavit to determine whether additional information should be required to be provided by executors.**

Audit recommendations

6.12 **Audit has *recommended* that the Commissioner of Inland Revenue should, in order to protect the revenue:**

- (a) **in conjunction with the Secretary for Financial Services and the Treasury, expedite action to introduce a bill into the Legislative Council to strengthen the anti-avoidance provisions in the Estate Duty Ordinance (see para. 6.9);**
- (b) **promptly issue interpretation and practice notes on the proposed anti-avoidance provisions after their enactment in the Estate Duty Ordinance (see para. 6.10); and**

- (c) **review the prescribed forms for estate duty affidavit and Statement in lieu of Affidavit to determine whether additional information should be submitted by executors to facilitate the identification of estate duty avoidance schemes (see para. 6.11).**

Response from the Administration

6.13 The **Commissioner of Inland Revenue** agrees with all the audit recommendations mentioned in paragraph 6.12.

6.14 The **Secretary for Financial Services and the Treasury** has said that:

- (a) it was a conscious decision at senior level of the Administration to temporarily withhold the exercise of preparing amendments to the Estate Duty Ordinance pending an overall review on the future of the estate duty tax; and
- (b) a decision has been taken in the context of preparing for the 2003-04 Budget to resume the exercise of strengthening the anti-avoidance provisions in the Estate Duty Ordinance. The IRD and the FSTB are therefore proceeding with the consultation exercise without further delay. The IRD and the FSTB are also preparing the necessary instructions and papers in order to move ahead with the amendment proposal to strengthen the anti-avoidance provisions in the Estate Duty Ordinance.

Appendix A
(para. 4.6 refers)

**13 cases in which estate duty affidavit was received over 10 to 25 years ago
but estate duty and interest were still outstanding as at 31 March 2003**

Case	The deceased passed away in	Affidavit received in	Estate duty assessed in	Number of years past estate duty due date (Note)	Amount of outstanding estate duty and interest (\$ million)
<i>Affidavit received over 10 to 15 years ago</i>					
B1	Mar. 1992	Mar. 1993	May 2000	10	6.78
B2	Nov. 1991	Jun. 1992	Aug. 1994	11	0.24
B3	Jun. 1991	Jun. 1992	Mar. 1995	11	0.42
B4	Jul. 1991	Apr. 1992	Feb. 2003	11	5.48
B5	Aug. 1991	Dec. 1991	Mar. 1995	11	0.11
B6	Oct. 1990	Sep. 1991	Feb. 2000	12	0.73
B7	Jun. 1990	Jun. 1991	Mar. 1994	12	4.02
B8	Feb. 1990	Nov. 1990	Aug. 1998	4	1.70
B9	Jan. 1990	Jul. 1990	May 1994	9	0.67
B10	Feb. 1986	Feb. 1989	Apr. 1997	17	0.55
<i>Affidavit received over 15 to 20 years ago</i>					
B11	Jan. 1983	Jan. 1984	Apr. 1986	20	0.62
B12	Oct. 1979	Jun. 1983	Jun. 1987	16	1.25
<i>Affidavit received over 20 to 25 years ago</i>					
B13	Apr. 1980	Nov. 1981	May 1986	22	1.37

Source: IRD's records

Note: *In Cases B8, B9 and B12, as the estate duty was assessed under section 14(15) of the Estate Duty Ordinance, the due date was one month after the giving of notice of assessment. In other cases, the due date was the date of delivery of the affidavit or six months from the death of the deceased, whichever first happened. In all cases, interest accrued from the date of death of the deceased (see paras. 4.2 and 4.3).*

**20 cases with earnings and profits tax written off
during the period 2000-01 to 2002-03 or outstanding as at 31 March 2003**

Case	Amount of tax written off or outstanding	Value of solely owned property passing on the death of the deceased taxpayer (Note 1)
	(\$'000)	(\$'000)
<i>Write-off cases without estate information received by the EDO (Note 2)</i>		
C1	371	Unknown
C2	191	Unknown
C3	169	Unknown
C4	166	Unknown
C5	165	Unknown
C6	162	Unknown
C7	138	Unknown
<i>Write-off cases with property passing on the death of the deceased taxpayer</i>		
C8 (Note 3)	483	Unknown
C9 (Note 3)	238	Unknown
C10	191	167
C11	153	137
C12	148	Unknown (Note 4)
C13	140	1,270
C14	121	1,758
C15	119	285

Case	Amount of tax written off or outstanding (\$'000)	Value of solely owned property passing on the death of the deceased taxpayer (Note 1) (\$'000)
Cases with outstanding tax due from the deceased taxpayer as at 31 March 2003		
C16	3,044	21,530
C17	2,487	7,753
C18	413	1,278
C19	357	5,413
C20	167	535

Source: IRD's records

Note 1: Information on the solely owned property passing on the death of the deceased taxpayer was extracted by Audit from the EDO's case files. The property represented unpledged assets shown at their principal values before deductions, if any, for debts incurred by the deceased (e.g. tax debts) and funeral expenses (as information on such expenses is not available). The status of granting of probate or letters of administration as at 21 July 2003 is given in Table 8 of paragraph 5.16 for Cases C10 to C15. The status of Cases C16 to C20 as at 21 July 2003 is as follows:

- (a) **Case C16.** The estate duty clearance papers had not been issued by the EDO as the assessed estate duty had not been paid;
- (b) **Cases C18 and C19.** The estate duty clearance papers had been issued but the executor had not been granted probate or letters of administration by the Probate Registry; and
- (c) **Cases C17 and C20.** The executor had been granted probate or letters of administration.

Note 2: In Cases C1 to C7, the EDO did not have a case file as apparently no application for estate duty clearance papers, or information from banks or other sources had been received.

Note 3: In Cases C8 and C9, information received by the EDO from banks indicated that the deceased had bank accounts jointly owned with another person.

Note 4: In Case C12, the property concerned represented compensation claims against the Government for resumption of the deceased's landed property. The provisional estate duty clearance papers issued by the EDO to the executor indicated that the principal value of the property had not yet been determined.

Appendix C

Acronyms and abbreviations

CES	Collection Enforcement Section
DOJ	Department of Justice
EDO	Estate Duty Office
FSTB	Financial Services and the Treasury Bureau
IRD	Inland Revenue Department