

# Report No. 45 of the Director of Audit — Chapter 2

## ASSESSMENT AND COLLECTION OF PROPERTY TAX

### Summary

1. Property tax is charged under the Inland Revenue Ordinance (Cap. 112) on owners of rented properties. In 2004-05, the property tax assessed by the Inland Revenue Department (IRD) was \$1.2 billion.

#### Issue of tax returns

2. *New procedures for reviewing owners' tax liabilities.* Commencing June 2003, the IRD reviews owners' tax liabilities by issuing advice letters. Owners are not required to return the advice letters if they are not liable to tax. As no review of the effectiveness of the new procedures has been carried out, it is not known whether there are owners who may evade tax by ignoring the advice letters. *The Audit Commission (Audit) has recommended that the Commissioner of Inland Revenue should review the effectiveness of using advice letters for ascertaining property owners' tax liabilities at an appropriate time.*

#### Assessment of property tax

3. *Deduction for interest payments.* In one case involving the use of a re-mortgage loan to purchase two properties, the assessing officer allowed deduction for interest payments for the two properties, although one property had already been sold and the other was not let. *Audit has recommended that the Commissioner of Inland Revenue should improve the procedures for checking deduction for interest payments.*

4. *Detection of unreported rental income.* In three cases, the assessing officers could not identify that the taxpayers had not reported the letting of some of their properties because the assessing officers focused on checking the reported rental income. Audit detected the unreported rental income by checking to the Rating and Valuation Department (RVD) database, which records rental information for rating and valuation purposes. *Audit has recommended that the Commissioner of Inland Revenue should enhance the assessment procedures and examine how to make the best use of the RVD database to further enhance the cost-effectiveness of the assessment procedures.*

## **Collection of property tax**

5. ***Obtaining charging orders.*** In four cases, the defaulting taxpayers were able to sell all or some of their properties because the IRD did not obtain charging orders before the sales. *Audit has recommended that the Commissioner of Inland Revenue should promptly apply for charging orders on the taxpayers' properties.*

6. ***Recovering tax from property sale proceeds.*** In one case, the IRD could not recover the property tax from the sale proceeds of the taxpayers' properties. This was because the recovery notices had not been issued promptly before the sale of a property, and the recovery notices issued for the sale of another property had not covered the outstanding property tax. *Audit has recommended that the Commissioner of Inland Revenue should review and improve the procedures for recovering tax from property sale proceeds.*

7. ***Recovering tax from executors.*** In one case involving outstanding property tax charged to the executor, the IRD did not ascertain from a bank its reasons for non-compliance with two recovery notices. In another case involving an executor, the IRD could not recover the outstanding tax from the sale proceeds of the deceased's property because the property transfer documents had not been screened out for issuing recovery notices. *Audit has recommended that the Commissioner of Inland Revenue should review the procedures for recovering tax from executors.*

## **Property tax compliance checks**

8. ***Need to make use of the Property Stamping System.*** With effect from August 2004, the details of electronically stamped tenancy agreements are captured automatically in the IRD's Property Stamping System. *Audit has recommended that the Commissioner of Inland Revenue should make effective use of the rental information in the Property Stamping System to cross-check the correctness of rental income reported by property owners.*

9. ***Need to make use of the RVD database.*** Audit made use of the RVD database in performing certain audit procedures and found it useful for detecting unreported or understated rental income. *Audit has recommended that the Commissioner of Inland Revenue should examine how to make the best use of the RVD database to further enhance the cost-effectiveness of the compliance check programme.*

10. ***Need to conduct more checks.*** From 2000-01 to 2004-05, the IRD issued about 80,000 property tax demand notes a year, and the Field Audit and Investigation Unit (FAIU) of the IRD checked less than 4,600 cases a year. On average, the FAIU found 550 cases of unreported or understated rental income a year and assessed back tax of \$23.4 million a year. *Audit has recommended that the Commissioner of Inland Revenue should consider the need for conducting more compliance checks.*

11. ***Need to extend coverage.*** The FAIU only checked cases involving annual rental not less than a specified amount. However, Audit's verification check of 20 cases involving rents smaller than the specified amount found three cases of unreported rental income. *Audit has recommended that the Commissioner of Inland Revenue should extend the compliance checks to provide a full coverage of cases and ascertain the non-compliance rates for the full spectrum of property owners.*

12. ***Need to improve checking procedures.*** In selecting tenants' tax returns for conducting compliance checks, the FAIU excluded cases involving civil servants as tenants. However, Audit's verification check of 10 cases involving civil servants receiving private tenancy allowances to rent properties found two cases where the owners had not reported the rental income. *Audit has recommended that the Commissioner of Inland Revenue should include cases involving civil servants in selecting cases from tenants' tax returns.*

13. ***Need to analyse non-compliance cases.*** The FAIU did not analyse the causes of non-compliance. *Audit has recommended that the Commissioner of Inland Revenue should establish the major causes of non-compliance with a view to improving the compliance rate.*

14. ***Need to closely monitor non-compliance.*** The non-compliance rate, as derived from the results of the FAIU's compliance checks, increased from 13% in 2002-03 to 17% in 2003-04, and then to 23% in 2004-05. *Audit has recommended that the Commissioner of Inland Revenue should closely monitor the non-compliance rate to evaluate the effectiveness of the measures taken for enhancing compliance and to assess whether additional measures are required.*

15. ***Need more extensive checks in non-compliance cases.*** In one case, after finding that the taxpayer had understated the rental income for the period covered by the tenancy agreement by \$71,000, the FAIU did not perform additional investigations. Therefore it failed to detect that the taxpayer had also understated the rental income for other periods and from other properties by a total of \$3.6 million. *Audit has recommended that the Commissioner of Inland Revenue should perform more extensive compliance checks in non-compliance cases.*

16. ***Need to conduct timely checks.*** For 10 cases selected from tenancy agreements, the FAIU on average completed the compliance check 4.9 years after the end of the year when the tenancy agreement commenced. *Audit has recommended that the Commissioner of Inland Revenue should conduct compliance checks on a timely basis to enable additional assessments for all relevant years to be promptly issued.*

17. ***Need to review penalty guidelines.*** In 14 cases involving unreported or understated rental income, the assessing officers acted in accordance with the IRD's guidelines and did not impose penalties on the owners. *Audit has recommended that the Commissioner of Inland Revenue should conduct a review to determine whether the penalty guidelines should be tightened.*

#### **Response from the Administration**

18. The Administration has accepted all the audit recommendations.

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