

## THE DEATH OF ESTATE DUTY? THE CASE FOR RETENTION AND REFORM<sup>1</sup>

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As prescribed by the Basic Law, Hong Kong is committed to promoting free trade and safeguarding the free movement of goods and capital.<sup>2</sup> Accordingly, the HKSAR Government emphasizes the guiding principle of 'market leads and government facilitates' in fostering economic development.<sup>3</sup> Turning specifically to the Government's fiscal policy, Hong Kong is proud of its low, simple and predictable tax regime which generally provides a level playing field in tax treatment for all types of investors.<sup>4</sup>

However, today's economic climate is becoming increasingly competitive. Hong Kong can see increasing competition for foreign investment within the region from, *inter alia*, Singapore, other major cities in the Mainland and Macau. How best can Hong Kong continue to attract foreign capital and investment in order to maintain its status as a leading international financial centre?

Given these commitments and challenges, it seems particularly appropriate to reflect upon the role of estate duty<sup>5</sup> in Hong Kong's overall system of taxation in light of the Government's recent Consultation Paper entitled 'Estate Duty Review' (hereinafter referred to as the 'Consultation Document'), the publication of which was foreshadowed in *The 2004/05 Budget Speech*.

Estate duty is a tax on property located in Hong Kong that passes upon death. It is Hong Kong's only direct tax on capital.<sup>6</sup> It could thus be argued that estate duty does act as a barrier to free trade, investment and movement of capital in Hong Kong. Indeed, it has long been contended that estate duty should be abolished.<sup>7</sup> The Consultation Document sets forth, in addition to posing the contention for complete abolition of estate duty, other proposals previously received by the Financial Services

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<sup>1</sup> The genesis for this article is attributable to Professor Halkyard's research for the Joint Liaison Committee on Taxation ('JLCT'), which in May 1992 commenced a study on the future of estate duty. The full fruits of that study are contained in Andrew Halkyard, 'Hong Kong Estate Duty: A Blueprint for Reform?' (2000) 30 *Hong Kong Law Journal* 47 – 73. This article is a condensed and updated version of that previous study.

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<sup>2</sup> See Article 115 of the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, hereinafter referred to as the 'Basic Law'.

<sup>3</sup> See *The 2004/05 Budget Speech*. Similar formulations, such as 'small government, big market', have appeared in previous Budget Speeches.

<sup>4</sup> Article 108 of the Basic Law requires the Hong Kong Special Administrative Region to decide on taxation matters by "taking the low tax policy previously pursued in Hong Kong as reference". See further, *The 2004/05 Budget Speech*, para 55 and, more recently, *Estate Duty Review: Consultation Document*, July 2004.

<sup>5</sup> See Estate Duty Ordinance (LHK, Cap 111), hereinafter referred to as 'the EDO'.

<sup>6</sup> With the possible exception of stamp duty, which is arguably only nominally a tax on instruments rather than on transactions: see Stamp Duty Ordinance (LHK, Cap 117).

<sup>7</sup> See, for example, the criticisms noted, but rejected, by the Financial Secretary in *The 1982/83 Budget Speech*, printed in *Hong Kong Hansard*, 24 February 1982, p 449.

and the Treasury Bureau. This article examines these contentions and proposals and concludes that abolition of estate duty is not justified at this time. It is, however, a tax in dire need of reform.

### Taxation policy

Before proceeding further, it is useful to recap the traditional requirements of Hong Kong's taxation policy. These were succinctly summarized by the late Sir Philip Haddon-Cave, in *The 1978-79 Budget Speech* as follows:

The *first* requirement is to generate sufficient recurrent revenue to finance a major part of a given level of total public expenditure ... and to maintain our fiscal reserves at a satisfactory level. The *second* requirement is that the tax system is as neutral as possible as regards the internal cost/price structure and investment decisions. The *third* is that the laws governing the tax system are adapted from time to time to make them consistent with changing commercial practices. The *fourth* requirement is that each and every levy – be it direct or indirect – is simple and easy (and, therefore, inexpensive) to administer and does not encourage evasion, for a low and narrowly based tax system cannot afford to finance costly overheads. The *fifth* requirement is that the tax system is equitable as between different classes of taxpayers or potential taxpayers and between different income groups (and this means, *inter alia*, setting relatively high thresholds for personal taxation and generally ensuring that the system rests as lightly as possible on those at the lower end of the income spectrum, or leaves them virtually untouched). Exceptionally, and this is the *sixth* requirement, the tax system must be capable of being used to achieve non-fiscal objectives when necessary.<sup>8</sup>

Enshrined in the Basic Law, Section 1 of Part V, in particular Articles 107 and 108, the above requirements have been repeatedly emphasized, although in different formulations and extent, in recent Budgets for the HKSAR.<sup>9</sup> It is against these broad criteria that we propose to consider and examine the various contentions posed by the Consultation Document.

### Abolition?

Common arguments for a total abolition of estate duty are summarized in the Consultation Document.<sup>10</sup> They are:

- Estate duty is a disincentive to invest or retain assets in Hong Kong.
- Estate duty is a complicated tax which is not cost-effective to administer.

<sup>8</sup> These requirements were consistently reiterated before the handover. The last major official public statement can be found in *The 1996-97 Budget Speech* (Hong Kong: Government Printer, 1996) para 47.

<sup>9</sup> For example, the traditionally prudent fiscal principles were referred to in *The 1998-99 Budget Speech*: para 30, and the anticipated outcomes of that Budget were summarized in this context: para 143. Most recently, see *The 2004-05 Budget Speech* para 55.

<sup>10</sup> Paras 14 and 15, Consultation Document. Amongst several opinions reported by the media after the release of the Consultation Document, Mr. Peter Wong Hong-yuen, Chairman of the Business and Professional Federation of Hong Kong, wrote a paper for and on behalf of the Federation, advocating the abolition of estate duty. The article was subsequently published in the South China Morning Post: see SCMP, September 3, 2004. It is also available at the Federation's website: [www.bpf.org.hk](http://www.bpf.org.hk).

- Estate duty is an unfair tax.
- Estate duty is a cause for delay in administering the deceased's estate.

### Estate duty: A disincentive to invest?

A Hong Kong estate typically includes the following assets: immovable property (including the matrimonial home), listed shares, other investment assets (including unlisted shares), bank deposits and other property (including life insurance policies and personal effects).<sup>11</sup> They are dutiable assets if they are located in Hong Kong at the time of the deceased's death<sup>12</sup> unless they are specifically exempted.<sup>13</sup> In the interest of attracting more foreign investment to Hong Kong, it could be argued that estate duty might create a disincentive. In reality however, what concrete evidence is available that Hong Kong estate duty has deterred persons from holding assets in Hong Kong?

#### *Local perspective*

While it makes sense to keep many items of movable property, including chattels, bank deposits and other choses in action, outside Hong Kong, the key assets in the Hong Kong context – local shares and immovable property – cannot be directly moved outside Hong Kong. Specifically, shares (and registered loan stock such as debentures) are located at the place where they can be dealt with. This is generally the place where the register is located.<sup>14</sup> For Hong Kong incorporated companies and offshore companies listed in Hong Kong, their share registers must be kept in Hong Kong.<sup>15</sup> Similarly, it is legally (and physically) impossible to move immovable property outside Hong Kong.

Experience tends to indicate that persons will not cease investing in Hong Kong listed shares, registered securities and land and buildings simply to avoid payment of estate duty. Further or alternatively, there does not appear to be any direct causal relationship between the risk of duty exposure and the market trend. During the property and share market boom immediately before and shortly after the handover, stamp duty collections relating to transactions in Hong Kong immovable property and Hong Kong stock amounted to a staggering 21.2% of total taxation revenue collected.<sup>16</sup> Turning to the subsequent downfall in stamp duty collection, it would surely be an overstatement to attribute our sluggish economic performance to the existence of estate duty. Equally true, it is not appealing to suggest that the recent

<sup>11</sup> Based on a letter, with detailed figures, dated 19 August 1992 from the Commissioner of Inland Revenue to Michael Olesnicky, Chair of JLCT, a copy of which Professor Halkyard has on file. The *Inland Revenue Department Annual Report* now printed by the Government Logistics Department contains similar data, though not as detailed. Reports of recent years are available at the website of the Inland Revenue Department: [www.ird.gov.hk](http://www.ird.gov.hk).

<sup>12</sup> EDO s 10(b) exempts from duty all property situated outside Hong Kong as at the date of death.

<sup>13</sup> Among these assets, one may be reminded of the specific exemptions for the matrimonial home of the deceased (EDO s 10A) and the benefits under a policy of insurance effected on the life of the deceased (EDO s 10(g)).

<sup>14</sup> See *Brassard v Smith* [1925] AC 371. See further, Peter Willoughby and Andrew Halkyard, *Encyclopaedia of Hong Kong Taxation: Estate Duty* (vol 2) (Singapore: Butterworths, 1993-) I [1652], point 14.

<sup>15</sup> See Companies Ordinance (LHK, Cap 32) s 95(2) and s 103(7) (for Hong Kong incorporated companies) and Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Ltd, r 19.05(3) and (4) (for offshore companies listed on the Main Board of Hong Kong Exchanges and Clearing Ltd; compare the equivalent provisions in the GEM Listing Rules: r 11.08(3) and (4)).

<sup>16</sup> See the *Inland Revenue Department Annual Report 1997-98* (Hong Kong: Printing Department, 1998).

revival of the property and share market has anything to do with the current estate duty review.

It is true that Hong Kong shares, loan capital and immovable property can be metaphorically shifted outside Hong Kong by holding such property through offshore companies and trusts. Without belaboring the point, it must follow that opportunities for the avoidance, or mitigation,<sup>17</sup> of estate duty are legion and the epithet describing estate duty as a 'voluntary tax' is well deserved. But all this seems to flow more from Hong Kong's adherence to a source-based principle of taxation,<sup>18</sup> which is, to say the least, porous. In the estate duty context this peculiar jurisdiction to tax does not encourage the movement of assets away from Hong Kong; rather, more systemically, it encourages the use of offshore structures to hold Hong Kong assets that would otherwise be potentially subject to duty.<sup>19</sup> In this latter regard, it should also be appreciated that the set-up and running costs relating to offshore asset holding structures are somewhat proportionate to the value of the assets and can be very substantial. Quite often, the objectives for moving assets out of Hong Kong are manifold, among which minimizing estate duty exposure may only be auxiliary or even incidental.<sup>20</sup>

In fact, the Estate Duty Office conducted an informal survey in late-1997 to assess whether estate duty encouraged the transfer of assets out of Hong Kong.<sup>21</sup> From the information obtained, the Estate Duty Office concluded that where funds were transferred outside Hong Kong in the deceased's own name this was generally on a temporary basis. Where funds were transferred offshore to relatives and third parties, the Estate Duty Office concluded this was generally for a specific purpose or in the nature of a gift. On this basis the Estate Duty Office considered that there was no indication that estate duty encouraged funds to be placed offshore, either permanently or for a long period of time. It would be useful for the Government to undertake an updated survey and to see whether this would produce different findings.

### *Comparative perspective*

It is noteworthy that, particularly before the advent of the new millennium, a vigorous debate took place in the United States upon the economic and social justifications for imposing taxes on wealth generally, and for continuing to impose estate tax specifically.<sup>22</sup> This has given rise to a very large body of literature, both theoretic and

<sup>17</sup> See the contrasting definitions of these terms adopted by the Privy Council in *CIR (NZ) v Challenge Corp Ltd* [1987] AC 155.

<sup>18</sup> This principle is reflected in the EDO by s 10(b) (see note 12 above)

<sup>19</sup> See *Shiu Wing Ltd v Commissioner of Estate Duty* [2000] 3 HKLRD 76 an estate duty avoidance case involving a complex offshore trust structure designed to hold Hong Kong assets, the first case of this kind to be considered by the Court of Final Appeal.

<sup>20</sup> For example, in *Shiu Wing Ltd v Commissioner of Estate Duty*, cited above, the trustees raised the objective of asset protection which the judge at first instance accepted as genuine: [1998] 3 HKC 44 at 53.

<sup>21</sup> About 46 active cases which comprised of dutiable estates that had not been finalized were selected at random. The results of the survey were communicated to JLCT in a letter dated 10 March 1998, a copy of which Professor Halkyard has on file. The then Commissioner stated anecdotally: 'We cannot subscribe to the view that estate duty has encouraged the transfer of assets out of Hong Kong, or at any rate, permanently and in large quantities.'

<sup>22</sup> See, for example, US Congress, *Present Law and Background Relating to Estate and Gift Taxes* (Washington: JCT, January 27, 1998), also cited in *Tax Notes* (February 9, 1998) p 706 (Doc. 98-4216) and Caron, McCouch and Burke, *Federal Wealth Transfer Tax Anthology* (Cincinnati: Anderson Publishing Co, 1998). These publications examine policy issues relating to the effect of wealth taxes on matters such as

policy oriented.<sup>23</sup> At the risk of over-simplification, the case in favour of abolishing estate tax, might be summarized as follows:<sup>24</sup>

... The estate tax is a bad tax. It raises little revenue. It does not redistribute wealth. It imposes large costs on the economy. And it is complicated and unfair. It should be abolished. In recent years a number of countries have done exactly that. The United States should join them.

In the event, amendments were passed in 2001 to phase out the US federal estate tax with complete repeal scheduled for 2010.<sup>25</sup> During the interim period, there will be a gradual reduction of the maximum estate tax rate from 50% to the now 48% and further to 45% by 2007.<sup>26</sup>

While the arguments sound strikingly similar, should the fate of Hong Kong estate duty be the same? In the US, it seems that the issues have been comprehensively studied and vigorously debated, both within and outside Congress, before the decision was made. The transition period will take another five years before federal estate tax is phased out. When it is eventually abolished, the gift tax, which is another form of capital tax, will remain but at a reduced rate with the unified credit against the tax returning to the 2001 level of US\$1 million.<sup>27</sup> Overall impact on the US fiscal situation and economy following abolition remains to be investigated. Thus, the question remains: is it the right time now to completely abolish estate duty in Hong Kong?

It may also be instructive to compare the experience of our regional neighbors and competitors.<sup>28</sup> Estate duty has been repealed in recent years in countries as diverse as Australia, India, Malaysia, New Zealand and Macau. There is no estate duty charged in Indonesia and Thailand, although it is levied in Singapore and Taiwan whereas South Korea and Japan impose inheritance tax. But these selective examples of repeal and non-taxation do not show the full picture. With the exception of Malaysia, in all these countries capital is taxed in other ways, either specifically under a capital gains tax regime (Australia, India, Indonesia, Japan and South Korea) or, and often in addition thereto, under a broadly-based system of indirect tax such as a Goods and Services Tax (Australia, Indonesia, New Zealand, Japan, Singapore, South Korea and Thailand). In many instances, these more modern taxes – that are not levied in Hong Kong – were introduced as part of a package to reduce other levels of taxation on income. If taxing on capital, in one form or another, is the norm, what should be the alternative in Hong Kong if estate duty is to be abolished?<sup>29</sup>

Considering the impact of estate duty on the future development of Hong Kong as an international financial and asset management centre, global experience again does not support the existence of any direct causal relationship. As pointed out in the Consultation Document, countries where such centres are situated including the UK,

saving, investment and labour supply. They also examine the feasibility of alternative methods to tax wealth, apart from estate tax.

<sup>23</sup> See generally, Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts* (vol 5, 2<sup>nd</sup> ed; 1999 Cumulative Supplement, No 2 Text) (Boston: Warren Gorham & Lamont) pp 120-2 and S120-1 and S120-2 and sources cited therein.

<sup>24</sup> Bartlett, 'The End of the Estate Tax?' *Tax Notes* (July 7, 1997) p 109.

<sup>25</sup> § 2210, US Internal Revenue Code, Title 26 as amended by Pub.L. 107-16, part V, § 501(a), June 7, 2001.

<sup>26</sup> § 2001, US Internal Revenue Code, Title 26 as amended by Pub.L. 107-16, part V, § 511(c), June 7, 2001.

<sup>27</sup> Pub.L. 107-16, part V, §§ 511(d) and 521(b)(2).

<sup>28</sup> For further details, see paras 6 and 7 of, together with the Annex to, the Consultation Document.

<sup>29</sup> See further the analysis in the following section.

the US, Japan, Switzerland, Luxemburg and Ireland have estate duty. In contrast, although estate duty is not levied in Indonesia or Thailand, neither of these countries has developed as an international financial centre as has Hong Kong. After all, tax exposure is a factor, and just a factor, to be considered in making a decision to invest.<sup>30</sup>

#### Estate duty: Complex and not cost-effective?

As in the United States, estate duty in Hong Kong raises relatively little revenue. However, it should be appreciated that the costs to Hong Kong of abolishing estate duty should not be under-estimated. Specifically, over the past four years estate duty represents approximately 1.6 per cent of total government tax revenue.<sup>31</sup> In light of Hong Kong's low direct costs of collecting taxation, estate duty is undoubtedly revenue productive.<sup>32</sup> It is also fair comment that estate duty yields will probably increase in real terms when those who have created and accumulated wealth in Hong Kong over the last 30 to 40 years die owning Hong Kong assets. In other words, it may be premature to argue at this time that estate duty should be abolished for failing to achieve its objective to 'enable the whole community to benefit upon the death of persons who had grown very rich partly through the appreciation in value of assets and the progress of Hong Kong to which the whole community contributed.'

It should also be appreciated that any abolition of estate duty may, as a practical matter, need to be revenue neutral. This means that, everything being equal,<sup>33</sup> it would need to be replaced by increases in other taxes. Possibilities include the introduction of dividend withholding tax and/or capital gains tax (like estate duty, these taxes would typically affect high net worth individuals) or an increase in the standard rate (currently 16% in the 2004-2005 year of assessment) for high-income earners. Doubtless, business interests would oppose the former; and the latter would find no favour with many influential individual taxpayers. How about the introduction of a sales tax? Although seemingly ultimately inevitable, it remains problematic whether it can be levied without incurring substantial administrative costs and whether it would receive a broad level of public and political acceptance without its perceived regressive nature being smoothed out.

It is also true, as in the United States, that estate duty in Hong Kong is unnecessarily complex and imposes economic costs on those who must comply with its statutory strictures, as well as on those who seek to avoid it. It is submitted that these matters are best countered by simplifying the charge to estate duty, rather than by abolishing it.

#### Estate Duty: An unfair tax?

One further argument raised by taxation policy theorists in the United States, and elsewhere, is that estate duty does virtually nothing to equalize the distribution of

<sup>30</sup> See Consultation Document para 24. In his letter, referred to in note 21 above, the then Commissioner stated: 'The relocation of funds is mainly determined by such factors as the economy, infrastructure, tax system [and] exchange controls of the place in question.' Also see note 20 above.

<sup>31</sup> See *Inland Revenue Department Annual Report 2002-03* (Hong Kong: Printing Department, 2003) Figure 1, p 10.

<sup>32</sup> *Ibid*, Figure 4, p 11 where it is stated that over the last four years the cost is less than one and a half cents per dollar of tax collected.

<sup>33</sup> The so-called positive 'knock-on' effect on other taxes, in particular stamp duty, argued to be brought by the abolition of estate duty remains questionable.

wealth.<sup>34</sup> This is largely because legal estate planning can virtually eliminate estate duty liability, even and usually for the largest estates since those are the ones who can afford to arrange their affairs properly during lifetime. The same conclusion seems valid in Hong Kong where, as noted above, estate duty is often dubbed a 'voluntary tax'. Tangentially, it should be noted that estate duty in Hong Kong only applies where a person dies with a net assessable estate of slightly less than US\$1 million.<sup>35</sup> At this level, comparatively few Hong Kong estates are dutiable.<sup>36</sup>

In the context of Hong Kong's political, economic and social conditions, it is rarely argued, and certainly not argued by the HKSAR Government, that taxation should be used as a primary tool to redistribute wealth. Any such policy might entail changes which would be unpopular and even diverge from Article 108 of the Basic Law that indicates Hong Kong should continue to practise a low tax policy. Instead, the Government has adopted such strategies as 'return wealth to the people' by way of less taxation on income and increasing public expenditure on social welfare.

It must also be acknowledged that Hong Kong's pursuit of simplicity and efficiency in levying taxation has meant that matters of principle are sometimes ignored thus leading to unfairness. It is in view of an overall preference for the simple, efficient and compliance friendly taxation system existing in Hong Kong that these unsatisfactory features are generally tolerated.

Tangentially, estate duty has a role to play in assisting the Investigations Unit of the Inland Revenue Department ('the IRD'),<sup>37</sup> whose function is to uncover cases of tax evasion. A deceased person owning a large amount of property, the accumulation of which cannot be explained by profits tax or other records of income held by the IRD, is a prime candidate for detailed investigation.<sup>38</sup> Estate duty thus has a positive impact upon overall tax collection by the IRD. Apparently, the extent of the impact may well be diminished in today's IRD audit based assessing environment, but so far no cogent evidence has been adduced to prove that it has gone completely.

#### Estate duty: Causing delay in obtaining probate?

Another common complaint against estate duty is that the assessing process, coupled with probate procedures, causes unduly long delays in the administration of estates and results in assets being tied up for inordinately long periods. It has been further contended that these delays are not restricted to dutiable estates because in many other cases the Commissioner must be satisfied that no liability exists, for example, where estates are just below the minimum threshold for duty.<sup>39</sup>

The issue of estate duty clearances is now covered by the IRD's performance pledges.<sup>40</sup> In 2003-04, 99.7% of the 8,212 simple and non-dutiable cases (not

<sup>34</sup> See sources cited in the publications referred to at notes 22-24 above.

<sup>35</sup> The current chargeable threshold is HK\$7,500,000. See EDO Part 24 of Schedule 1.

<sup>36</sup> See note 31 above, p 25 showing that of 14,701 and 15,345 cases finalized in 2001-02 and 2002-03, only 302 and 298 respectively were dutiable. Based on these figures the proportion of dutiable cases to total cases is about 2%.

<sup>37</sup> Before the audit based assessing environment, the IRD has once informed JLCT that approximately 10% of back duty cases arose from investigations commenced following enquiries raised during the assessment of estate duty liabilities on deceased estates.

<sup>38</sup> Understatements of profits and income by a taxpayer are often discovered when the executor files the Estate Duty Affidavit and the related accounts with the Estate Duty Office. See EDO s 14(6).

<sup>39</sup> See note 35 above.

<sup>40</sup> The estate duty performance pledges of the Inland Revenue Department for the year ending 31 March 2005 are set out in the departmental homepage at <http://www.ird.gov.hk/eng/pdf/pam32e/pdf> and are as follows:

involving valuations of land and private company shares) were finalized within six weeks. Out of the 6,497 simple and non-dutiable cases (involving valuations of land or private company shares), 98.4% of them were finalized within six months and the rest within the next six months. Of the remaining 938 complicated and dutiable cases, 81% were substantially finalized within two years.

It appears, therefore, fair to say that in the majority of cases, no undue delay occurs in the issue of estate duty clearances<sup>41</sup> provided that the performance pledges relied upon by the Commissioner are themselves fair and representative of good, speedy public service. In this regard, no criticism has apparently been directed at the utility and fairness of the pledges.

It should also be noted that where a case cannot be finalized within a reasonable period of time (a typical case may involve protracted negotiation on valuation of land or shares), the executor upon production of a satisfactory guarantee to settle any outstanding duty and interest can apply for provisional estate duty clearance to enable early administration of the estate.<sup>42</sup>

Therefore, in the absence of concrete evidence to the contrary, it can be concluded that the imposition of estate duty does not generally result in the assets of deceased estates being tied up for unreasonable periods of time.

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On the analysis above, it is submitted that the case has *not* been made that estate duty undermines Hong Kong's attractions as a place for investment and carrying on business or that the duty operates so unfairly or inappropriately that warrants its repeal at this juncture. It may also be argued that in view of the fiscal advantages referred to above, it seems undesirable for the Hong Kong Government to give up this source of revenue at this time.

### Selective repeal?

	Standard Response	Performance Target
Exempt and simple cases (neither requiring detailed investigation nor having a sworn value exceeding 60% of the exemption threshold)		
• Not involving landed properties, private company shares or interest in a business	Assessments or certificates of exemption issued within six weeks of receipt	First six weeks: 98%
• Involving landed properties, private company shares or interest in a business	Assessments or certificates of exemption issued within six weeks of receipt	First six months: 85% Next six months: 14%
Dutiable or complicated cases	Assessments or certificates of exemption issued within two years of receipt	First year: 55% Second year: 25% Third year: 10%

<sup>41</sup> See however, Fok, 'Wait Reduction' *Hong Kong Lawyer* (May 1998) p 16 who notes anecdotal evidence that estate duty clearance can be relatively time consuming.

<sup>42</sup> This is a non-statutory concession granted to facilitate earlier administration of estates. See the Specimen Form of Bank Guarantee for Payment of Estate Duty, reprinted in Willoughby and Halkyard, note 14 above, IV [23].



The Consultation Document lists two other proposals:

- Exemption for 'non-Hong Kong-domicile' or 'non-Hong Kong-resident' investors.
- Exemption for certain types of movable assets such as bank deposits, listed securities, interests in collective investment schemes.

Under the current regime, any individual, resident or non-resident in Hong Kong, who holds Hong Kong movable properties, for example, money in a Hong Kong bank account (whether in Hong Kong dollars or foreign currency) will have the account frozen on death and the estate must pay any estate duty chargeable. Even if estate duty is not chargeable because the deceased's Hong Kong assets do not exceed the estate duty threshold,<sup>43</sup> banks will invariably require probate procedures to be followed.<sup>44</sup> In the event, it could be argued that the burden of estate duty is a disincentive to invest in Hong Kong and therefore an exemption should be enacted for non-residents who hold certain or all bank deposits in Hong Kong, mirroring exemptions enacted in the United Kingdom<sup>45</sup> and Singapore.<sup>46</sup>

However, no empirical evidence so far has been produced, either locally or in either case of the United Kingdom or Singapore, to show the extent to which such an exemption may benefit the economy. On the contrary, there are two obvious reasons to reject such proposals in a Hong Kong context. First, it would discriminate against other assets held by both residents and non-residents and thus erode the source-based system of taxation operating in Hong Kong. Secondly, it would differentiate between Hong Kong domiciled/resident and non-domiciled/non-resident investors, which diverges from the principle of maintaining neutrality in our tax system.

An informal study conducted by the Hong Kong Association of Banks during the last decade<sup>47</sup> indicated that estate duty was not a major disincentive for depositors to hold deposits with financial institutions in Hong Kong. This would especially be the case in relation to Hong Kong dollar denominated deposits. Although any reduction or abolition of estate duty might cause an increase in Hong Kong dollar deposits, the study concluded that the overall effect on Hong Kong's banking system should be neutral because the relevant funds are returned to Hong Kong after being booked offshore. On the other hand, an exemption from estate duty for Hong Kong deposits denominated in foreign currency and held by non-residents may have a positive impact on the ability of banks to attract offshore deposits. But, even in this latter regard, the study produced no empirical evidence to show the extent to which an exemption from estate duty would benefit the Hong Kong economy.

Without the benefit of an updated study, it can only be concluded that even the limited case for partial exemption has not been made.

### Extended?

<sup>43</sup> See note 35 above.

<sup>44</sup> See EDO s 25, a provision requiring a bank to report to the Commissioner once it becomes aware of the death of a depositor. See further, Willoughby and Halkyard, note 14 above, I [3004].

<sup>45</sup> See Inheritance Tax Act 1984, s 157 which, subject to certain conditions, exempts from inheritance tax foreign currency accounts held in the United Kingdom by non-residents.

<sup>46</sup> See Estate Duty Act (Cap 96, 1997 Ed), s 11(1A) which exempts, as from 1 January 2002 onwards, all movables held by a deceased who is not domiciled in Singapore.

<sup>47</sup> Letters dated 26 October 1992 and 29 July 1997 from the Hong Kong Association of Bank's representative to Michael Olesnick, Chair of JLCT, copies of which Professor Halkyard has on file.

### Extending the jurisdiction to tax?

On the basis that estate duty is often referred to as a 'voluntary tax', could it be contended that if estate duty were to continue it should ideally apply to those in similar economic circumstances?

Hong Kong's adherence to a source-based system of taxation, rather than one based upon residence, makes extending the jurisdiction to tax difficult, if not impossible. To reiterate, where, as under current law, Hong Kong assets can be held through offshore entities free of estate duty, it seems unreal to speak of extending the tax base without changing the very basis of Hong Kong's taxation system.

### Anti-avoidance

Unlike the legislation governing income taxes, there is no general anti-avoidance provision in the EDO.<sup>48</sup> What can be, and has been, done by the IRD in relation to those increasingly sophisticated 'duty planning' products and schemes?

#### *Life insurance policies*

Benefits payable on death of a life insured under an insurance policy are exempt from duty.<sup>49</sup> This exemption applies to deaths on or after 1 April 1999 and generally covers life policies which are 'investment-linked'.

Some of these policies involve the life insured contributing his or her existing investment portfolio (including Hong Kong assets) as premium and require the insurance company paying back the investment together with interest at the rate of just 1% at the time of maturity. There is minimal commercial risk on the part of the insurance company while the policyholder makes use of the policy as a vehicle with a view to exempting the Hong Kong assets which are otherwise dutiable. It is understood that the Commissioner is considering to disqualify the benefits from the exemption.<sup>50</sup> However, such action would be controversial and undoubtedly subject to challenge in light of the provision which provides the exemption.

#### *'Controlled company' provisions*

Among the few specific anti-avoidance provisions in the EDO, the so-called 'controlled company' provisions have often been brought under the spotlight. The provisions are drawn in wide and broad (and perhaps unnecessarily complex) terms. However, concessions in practice<sup>51</sup> have (arguably) been said to cause unnecessary confusion and even erode the overall effectiveness of the provisions. For instance, in relation to a transfer of property to the controlled company which is the 'trigger' to activate the charging provision (section 35), the transfer can be made by any person and of any value. By concession, however, the provision will not be invoked if the transfer was not made by the deceased and the deceased never had any beneficial

<sup>48</sup> See Inland Revenue Ordinance (Cap 112, LHK), ss 61 and 61A.

<sup>49</sup> EDO s 10(ga).

<sup>50</sup> The Deputy Commissioner of Estate Duty indicated this possibility at a seminar entitled 'Clearance, Grant and Distribution - Tips for Estate Administration' organized by Courses & Seminars Ltd held on 4 September 2004.

<sup>51</sup> See generally Estate Duty Office Departmental Interpretation and Practice Notes No 1 (December, 2000).

interest in the property transferred.<sup>52</sup> The same concession will be given even if the transfer was made by the deceased provided that the transfer of property was a genuine arm's length transaction for full consideration in money.<sup>53</sup>

While the deceased's shares in a Hong Kong controlled company remain dutiable, and in such circumstances worldwide assets of the company are included for assessment, the provision will only be applied in the case of an offshore company if there exists a paramount intention to avoid tax.<sup>54</sup> In fact, the charging provision has rarely been invoked.<sup>55</sup> Despite the wide definition of 'benefits' which is relevant to determining both liability and quantum of duty,<sup>56</sup> it can be argued that the whole design while perhaps not a 'paper tiger' is, at least, a sleeping tiger. If the offshore vehicle is a trust, the 'controlled company' provisions are totally irrelevant.

\* \* \*

In the above instances, in the absence of any general or specific anti-avoidance provision, the Commissioner will need to base her claim on the *Ramsay* principle.<sup>57</sup> Despite the defeat in *Shiu Wing Ltd v Commissioner of Estate Duty*,<sup>58</sup> her pursuit of applying the principle in this type of case has not been brought to a halt. The most recent court case concerns a corporate taxpayer named *Graceful Mark Ltd*,<sup>59</sup> the judgment of which is still pending. It is also understood that there are similar cases in the pipeline. It thus seems that the Commissioner may take the 'wait and see' approach instead of the more controversial step of proposing the enactment of anti-avoidance provisions, general or specific, to bolster the EDO. This seems a measured and fair approach in light of the continued development and refinement of *Ramsay* and arguably supports our submission that the appropriate focus should be upon simplifying estate duty and reducing the inequities in existing legislation.

## Reform directions<sup>60</sup>

### Simplification generally

The EDO is excessively complex, imposes a comparatively high maximum rate of duty on the whole of a dutiable estate, requires an understanding of archaic English case law and is redolent of a land and time with economic and social conditions far removed from modern day Hong Kong. In the latter regard, it is more than enough to remind ourselves that the charging provisions, mainly contained in EDO section 6(1), are derived from the United Kingdom Finance Act 1894!<sup>61</sup>

<sup>52</sup> Ibid, para 16.

<sup>53</sup> Ibid, para 20.

<sup>54</sup> Ibid, para 27.

<sup>55</sup> Ibid, para 26.

<sup>56</sup> EDO, s 36 and Schedule 2, which, by itself, attracts criticisms as well.

<sup>57</sup> The principle has its origin from the case *WT Ramsay Ltd v CIR* [1982] AC 300 which is applicable in the Hong Kong estate duty context: see *Shiu Wing Ltd v Commissioner of Estate Duty*, note 19 above.

<sup>58</sup> See note 19 above.

<sup>59</sup> The case was heard on 28 September 2004 at the Court of First Instance.

<sup>60</sup> See Professor Halkyard's article referred to in note 1 above for more detailed suggestions for reforms.

<sup>61</sup> Previous calls for simplification have met with the coldest of shoulders from Government particularly by the Financial Secretary in *The 1982/83 Budget Speech* who stated on 24 February 1982: 'But first I intend to use this opportunity to comment on certain criticisms of Estate Duty at large, ... The facts however are that the legislation is well understood by those who have to deal with it professionally, and by the officers of the department who administer it.'; *Hong Kong Hansard*, 24 February 1982, p 449.

Various models could be suggested for Hong Kong to consider. One option is the Singapore-style simplification package. Singapore now imposes estate duty under a regime having the following features: a high threshold of duty, a low rate of duty and substantial exemptions.<sup>62</sup> In any event, fundamental reform should proceed on the principle that simplification of estate duty should be designed to allow the administration of estates to be settled more quickly than at present but yet not reduce revenue. Any shortfall in revenue resulting from simplification could be balanced by changes to the rate structure<sup>63</sup> or by a general denial of deductions which, interestingly, is a defining feature of a probate tax that has once been suggested for Hong Kong as a replacement for estate duty.<sup>64</sup>

### Reducing inequities

#### *Progressive rates*

In addition to a higher chargeable threshold as suggested above, the rates of duty should be changed to reflect a truly progressive system, rather than continuing with the current 'slab' system whereby there is essentially one rate for the whole estate. This may help ensure that the regime will rest as lightly as possible on those at the lower end and thus, portray a more equitable system. In fact, regional competitors such as Singapore, Korea and Japan adopt such progressive rates in levying their estate taxes.

#### *Summary procedure*

Subject to other requirements prescribed being fulfilled, there exists a simplified procedure which enables applicants to obtain grants of probate or letters of administration without delivering the affidavits and accounts if the principal value of the estate does not exceed \$400,000.<sup>65</sup> The figure was first introduced in 1981 when the chargeable threshold was just \$1 million. It may be timely to consider revising the figure and/or relaxing some of those other requirements.

#### *Interest on unpaid duty*

In addition to any duty payable, interest starts to accrue on unpaid duty at the rate of 4% per annum from the date of death of the deceased for the first 6 months and at the rate of 8% per annum thereafter.<sup>66</sup> In one aspect, the duty has therefore been criticized of being 'unethical' since this means that the HKSAR Government 'expects

<sup>62</sup> The Estate Duty Act (Cap 96, 1997 Ed) imposes duty on the net value of the estate up to S\$12 million at the rate of 5% and thereafter at the rate of 10%. Exemptions include S\$600,000 for a deceased's movable assets, an amount up to S\$9 million for all dwelling houses (not restricted, as in Hong Kong, to one matrimonial home) as well as a whole range of exemptions available to non-residents whose immovable property in Singapore only is liable to estate duty. See generally, *Singapore Master Tax Guide Manual* (Singapore: CCH Asia, 1989-) §4000 et seq.

<sup>63</sup> Unless any shortfall was made up from other sources. See the section 'Estate Duty: Complex and not cost-effective' above.

<sup>64</sup> See letter dated 2 December 1997 from JLCT to Donald Tsang, Financial Secretary, a copy of which Professor Halkyard has on file.

<sup>65</sup> EDO s 14A(1).

<sup>66</sup> EDO s 12(4).

family members to calculate and settle the duty on the day of their bereavement.<sup>67</sup> In this regard, a grace period may well be considered and the personal representative may plead exceptional circumstances or hardship for another slight delay.

In another aspect, the current interest rates are fixed in the main legislation, which fail to reflect the market rate particularly in recent years. In contrast, the interest rate applicable for tax reserve certificates fluctuates from time to time,<sup>68</sup> so does that for judgment debts.<sup>69</sup> A similar drafting technique can be applied to the provision leaving the power to prescribe the rates to, say, the Financial Secretary with reference to the market situation by way of legal notices.

### Conclusion

This article has endeavoured to analyse various options relating to the future of estate duty in Hong Kong. Notwithstanding the weight of critical commentary, the fact remains that estate duty is not yet a particularly burdensome form of taxation nor does it seem to have inhibited Hong Kong's development as an international financial and service centre. On this basis, it is concluded that, contrary to many voices raised in opposition, estate duty should have a future and the case for its abolition has not been adequately established.

However, that is not to say that reform of estate duty should not be pursued. Looking back over the past almost 90 years since the enactment of the EDO, there has been little attempt to reform the now outdated legislation. By and large that legislation deals with legal relationships in vogue in the United Kingdom in the early days of the twentieth century, a place and time far removed from the Hong Kong of today. To maintain its cutting edge in the decades ahead, the HKSAR Government should take this opportunity to simplify the estate duty regime and remove the inequities and complexities to the greatest extent it can. The well-worn maxim: 'if it ain't broke, don't fix it' should no longer be myopically adhered to in our increasingly competitive era. It is not broke; but it does need repair.

<sup>67</sup> See Peter Wong's paper, referred to in note 10 above.

<sup>68</sup> Tax Reserves Certificates (Fourth Series) Rules (Cap 289 sub. leg.), r 7(2)(h).

<sup>69</sup> High Court Ordinance (Cap 4) s 49(1)(b) which provides that interest on judgment debts shall be at such rate as may be determined by the Chief Justice by order.