

Bills Committee on Revenue (Abolition of Estate Duty) Bill 2005**Administration's Response to the Article by Professor Andrew Halkyard and Professor Wilson Chow**

	Summary of views	Administration's Response
1.	Estate duty does not deter people from holding assets in Hong Kong because the local shares and immovable property cannot be directly moved outside Hong Kong.	<p>It costs time and money to set up and maintain a plan to avoid estate duty. The avoidance schemes often involve significant costs and normally require the asset holders to give up direct control of the assets. Moreover, there are risks that such schemes might not always work.</p> <p>Without estate duty, investors would be free to acquire immovable property in their own name or through a local company which they own and control. Similarly, they could have share portfolios in their own names, managed by local fund managers with expertise in the local market. This would increase the demand of middle level asset management and professional services, create employment opportunities and expertise in the industry and in turn make Hong Kong more competitive as an international financial centre.</p>
2.	There does not appear to be any direct causal relationship between the risk of duty exposure and the market trend.	The HKMA gathered from a website for the World Bank/IMF 2006 meetings in Singapore that "Total Assets under Management (AUM) for the asset management industry grew by 35% to S\$465.2 billion at end 2003 from that of S\$343.8 billion at end 2002." This coincides with the exemption of non-domiciles from estate duty in 2002 but of

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		<p>course the increase could be due to a variety of causes including other tax incentives offered by Singapore. It is difficult to isolate the effects of estate duty.</p>
3.	<p>It is true that Hong Kong shares, loans and capital and immovable property can be metaphorically shifted outside Hong Kong by holding such property through offshore companies and trusts. Opportunities for the avoidance, or mitigation, 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. 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.</p>	<p>The avoidance schemes often involve significant costs and normally require the asset holders to give up direct control of the assets. There is no guarantee that such schemes will always work. To avoid the possibility of being caught under estate duty, some people may simply choose to put their money elsewhere. The abolition of estate duty will reduce the costs and thus increase the return on investments, hence increasing the attraction of Hong Kong as a place of investments.</p> <p>The attraction would be particularly obvious for movable assets (e.g. bank deposits) which could be easily located offshore to avoid the duty. Abolishing estate duty will encourage people to transfer their overseas deposits back to Hong Kong. According to major players in the asset management industry, out of their HNWI (high net worth individual) accounts opened in Hong Kong, about 40% of the bank deposits were placed outside Hong Kong, although there are many reasons affecting the choice of location of bank deposits.</p> <p>Without estate duty, investors would be free to acquire immovable property in their own name or through a local company which they</p>

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		<p>own and control. Similarly, they could have share portfolios in their own names, managed by local fund managers with expertise in the local market. This would increase the demand for middle level asset management and professional services, create employment opportunities and expertise of the industry and in turn make Hong Kong more competitive as an international financial centre.</p> <p>While it is possible for overseas investors to make themselves exempt from estate duty by keeping their investments in Hong Kong below the liability threshold, we have been told by some investment advisers that in order to avoid any uncertainty over tax liability, it is easier for them to simply advise their overseas clients to invest elsewhere, rather than trying to make efforts to keep the investments under the threshold. HNWIs (particularly in Asia) may well use more than one private bank to manage their wealth. Therefore, as no one single adviser has an overall picture of their clients' various investments, it would be virtually impossible to ensure the threshold for estate duty is not exceeded.</p> <p>Abolition of estate duty would eliminate any such uncertainty and make Hong Kong more attractive to overseas investors. The abolition would also avoid any need for estate duty planning schemes which could be costly and cumbersome. According to SFC's informal consultation with some major banks which offer financial</p>

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		<p>planning services and major independent financial planner firms, they would advise clients to invest more in Hong Kong, such as in Hong Kong authorized funds. They would no longer need to recommend clients to place more assets offshore.</p>
4.	<p>Based on the informal survey conducted in late 1997, 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.</p>	<p>It was a crude study conducted in 1997 and selected only a handful of active dutiable cases (49 out of 468 such cases reported in the years 1995/96 and 1996/97) for the informal study. There were limitations in the study – the sample size was small and not representative at all, and the study was based on the accounts disclosed to or found by the Estate Duty Office. It could only at best reflect certain phenomena of ad hoc estate planning.</p> <p>The phenomenon of longer-term estate planning is actually better reflected in the following- according to some major players in the asset management industry, out of their HNWI accounts opened in Hong Kong, about 40% of the bank deposits were placed outside Hong Kong, although there are many reasons affecting the choice of location of bank deposits. They also indicate that abolishing estate duty will encourage people to transfer their overseas deposits back to Hong Kong.</p> <p>It should also be noted that whilst it is likely that funds in the form of deposits placed offshore may find their way back to Hong Kong, there</p>

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		<p>will always be leakage in this process. For example, HKD deposits placed offshore are more likely to be channelled back to Hong Kong since the foreign banks concerned holding such deposits will have no use for HKD funding. This scenario is however less likely to happen in the case of foreign currency deposits placed offshore. Furthermore, when HKD funds placed offshore are channelled back to Hong Kong, they would most likely take the form of interbank placements. In other words, the funds will not be shown as part of the total deposits of the Hong Kong banking sector.</p> <p>If we can attract depositors to repatriate such funds back to Hong Kong in the form of deposits, this would increase the total deposit size of the Hong Kong banking sector, which is an important indicator of the scale of the local banking industry. More importantly, with a larger deposit size, the banking sector will have greater flexibility in conducting their business particularly at a time when the demand for loans picks up and the loan to deposit ratio of individual banks becomes a constraint on their ability to expand the loan book. Retail deposits also tend to be a more stable funding source than interbank placements, meaning that in difficult conditions banks may be more prepared to lend on the back of deposits. Last but not least, when depositors place their deposits offshore, it is naturally more likely for them to subsequently use such deposits to invest in offshore financial assets. If such deposits are repatriated back to Hong Kong, it will be</p>

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		<p>more likely for the depositors concerned to subsequently decide to invest in local financial assets given such considerations as convenience.</p> <p>Besides, the informal study was done eight years ago and the situation might have changed.</p>
5.	<p>The examples of abolition by other jurisdictions do not reflect the full picture. Capital is still taxed in other ways – directly under capital gains tax (Australia, India, Indonesia, Japan and South Korea) or indirectly under goods and service tax (Australia, Indonesia, New Zealand, Japan, Singapore, South Korea and Thailand. There is no direct causal relationship between estate duty and the development as an international financial and asset management centre [All financial centres such as the UK, the USA, Japan, Switzerland, Luxembourg and Ireland have estate duty whereas Indonesia and Thailand which have no estate duty have not developed as an international financial centre.]</p>	<p>We should note that London and New York are both well established international financial centres, and Tokyo is well backed up by its very large domestic economies. Centres in smaller economies like Ireland, Luxembourg and Switzerland are positioned within the legal framework of European Union and enjoy unimpeded access to its vast markets. In our case, the financial markets in the Asia Pacific region have quickened the pace of their development in recent years. Hong Kong is facing increasing competition particularly from other economies in the region in the financial sector. We need to increase our competitive edge vis-à-vis our competitors.</p> <p>Hong Kong adopts a simple and low taxation regime. It is one of our attractions to investors that we do not impose a capital gains tax.</p> <p>We are currently considering broadening our tax base by the introduction of a Goods and Services Tax on consumption.</p>

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6.	There is no phasing out of the repeal like in the US.	Except for the US, no other jurisdictions have abolished their estate duty by phases. We prefer an outright abolition so that the estates of all people passing away after the enactment of the Bill will benefit on equal terms. This will also ensure an early achievement of our objectives to develop Hong Kong into a premier asset management centre and relieve the current hardship faced by heirs to estates.
7.	Estate duty represents approximately 1.6% of total government tax revenue and is revenue productive. Any abolition of estate duty may mean that it would need to be replaced by increases in other taxes.	While estate duty has been a stable revenue source, its contribution to total revenue has been on the decline. We can expect such trend to continue in the years to come when the public become more financially sophisticated and engage in more estate planning. The cost of collecting estate duty has increased over the past couple of years, rising from 0.96% in 2001/2002 to 1.26% in 2003/04 and 1.24% in 2004/05. The costs of collecting estate duty in the recent two years are higher than the average cost of collecting other taxes which was 1.14% in 2003/04 and 0.86% in 2004/05. One of the reasons is that the assessment and collection of estate duty is generally more technical and labour-intensive. It is difficult to bring the cost of collection down by business re-engineering process and IT applications. Another reason is that the collection has been rather stagnant despite the general growth in wealth. This may be due to the higher awareness and incidence of avoiding the tax particularly after the judicial decisions on recent cases.

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		<p>We believe that abolition of estate duty would bring in additional stamp duty income from the increase in both the stock and property activities. Though the actual effect is difficult to assess at this stage, we could look at the stamp duty revenue collected in recent years. A modest recovery in the stock and property market since the easing of restrictions on Mainland tourists coming to HK under the "individual visits" programme and the signing of CEPA in early 2003/04 has already brought in more than \$8 billion additional stamp duty. We estimate that the revenue forgone by the abolition of estate duty could be partly offset by the increase in stamp duty revenue.</p> <p>While we would be foregoing revenue from estate duty after its abolition, its retention is not without costs. In view of the competition both regional and worldwide for development of the financial market, we need to move proactively. Abolition of estate duty is a strategic investment which we believe would be beneficial to the economy as a whole.</p>
8.	<p>It is true, as in the US, 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. These matters are best countered by simplifying the charge to estate duty, rather than by</p>	<p>This will not achieve our objectives to attract foreign investment, encourage repatriation of capital, develop Hong Kong into a premier asset management centre and relieve the current hardship faced by heirs to estates, particularly for the SMEs.</p>

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	abolition.	
9.	One further argument raised by taxation policy theorists in the US, and elsewhere, is that estate duty does virtually nothing to equalize the distribution of wealth. 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'.	Agree that there are many opportunities for avoidance or mitigation in estate duty. One of the reasons to propose abolition of the tax is that there is some unfairness in the tax.
10.	Estate duty does have a role to play in assisting the Investigations Unit of the IRD to uncover cases of tax evasion.	While disclosure in an estate duty affidavit of substantial assets inconsistent with tax returns of the deceased person during his/her life may sometimes provide hints for an investigation into possible liability to taxes under the Inland Revenue Ordinance (IRO), the existence of such assets is not a direct proof of understatement in the tax returns. In recent years, IRD has introduced some new methods to identify

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		<p>potential cases of tax evasion for early investigation. IRD's reliance on estate duty affidavits as a source of information to identify tax evasion cases has considerably reduced over the years and the estate duty affidavit only constitutes a minor and indirect source of information. After the abolition of estate duty, IRD will continue to receive relevant information from the Immigration Department and the Probate Registry, which would help IRD review the relevant tax files of the deceased persons.</p>
11.	<p>It appears fair to say that in the majority of cases, no undue delay occurs in the issue of estate duty clearance.</p> <p>The availability of the issue of provisional estate duty clearance subject to the production of a satisfactory security can facilitate early administration of the estate.</p>	<p>The assessment time aside, it takes time to ascertain all the assets and liabilities of the deceased person for the preparation of an estate duty return. We are aware of certain hardship cases. Hardship may be caused when their assets were frozen for assessment and in certain cases, the prices of their assets may have gone down during the period in which their assets are frozen. From the statistics, it is also noted that within 2003/04, 41% of all dutiable cases took more than two years to complete assessment.</p> <p>But after the abolition of estate duty, there is no need to go through the estate duty assessment process and the probate procedures would be much simplified, hence substantially shortening the time to obtain the grant.</p>
12.	<p>The case has not been made that estate duty undermines Hong Kong's attractions as a place for</p>	<p>In view of the competition both regional and worldwide for development of the financial market, we need to move proactively.</p>

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	<p>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.</p>	<p>Abolition of estate duty is a strategic investment which we believe would be beneficial to the economy as a whole. Foregoing the revenue is therefore a price worth paying.</p>
13.	<p>On the proposal to exempt 'non-Hong Kong-domicile' or 'non-Hong Kong-resident' investors and the proposal to exempt certain types of movable assets, no empirical evidence so far has been produced, either locally or in either case of the UK or Singapore, to show the extent to which such an exemption may benefit the economy. Two obvious reasons to reject such proposals are: 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 and 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</p>	<p>Agreed. However, in the case of Singapore, HKMA has gathered from a website for the World Bank/IMF 2006 meetings in Singapore that "Total Assets under Management (AUM) for the asset management industry grew by 35% to S\$465.2 billion at end 2003 from that of S\$343.8 billion at end 2002." This coincides with the exemption of non-domiciles from estate duty in 2002 but of course the increase could be due to a variety of causes including other tax incentives offered by Singapore. It is difficult to isolate the effects of estate duty.</p>

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14.	<p>The concessions in practice have been said to cause unnecessary confusion and even erode the overall effectiveness of the controlled company's provisions. The charging provision has rarely been invoked. If the offshore vehicle is a trust, the controlled company provisions are totally irrelevant.</p>	<p>The DIPN issued on 21 December 2000 has granted a few concessions including limiting the liability to transferors of property which is considered to be fair and reasonable, given the resemblance of the charge to gifts with reservation.</p> <p>The controlled company provisions have been rarely applied because of the common use of offshore discretionary and unit trusts to hold local assets to avoid the duty, and the provisions do not apply to these. The proposed legislative amendment would complicate the law and constitute a departure from the principles of neutrality and territoriality currently followed in Hong Kong, not least its deterrent effect on inflow of investment.</p>
15.	<p>Certain reforms should be introduced to the estate duty system, including more progressive rates, raising the threshold for "summary procedure", and marked-to-market interest rates together with a grace period for the calculation of interest on unpaid duty.</p>	<p>Hong Kong adopts a progressive rate structure for estate duty, which actually charges a higher amount of duties on the larger estates than a progressive marginal rate system. Higher amount of duty is payable under our progressive flat rate system than under a progressive marginal rate system, unless the rates are increased.</p> <p>Our existing progressive flat rate or "slab" system is more efficient and less onerous than a progressive marginal rate system in that far</p>

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		<p data-bbox="1131 252 2112 336">fewer additional assessments need to be raised upon discovery of additional assets or gifts.</p> <p data-bbox="1131 395 2112 576">In law, each accountable person bears his own portion of duty on the property passing to him upon the death of the deceased – executor for free estate, donee for gift inter vivos, surviving joint tenant for joint property and trustee for life interest.</p> <p data-bbox="1131 639 2112 1054">Under the current “slab” system, the duty is levied at a flat percentage on the principal value of the estate. No deduction for the threshold is given. There are three rate-brackets with increasing duty rates for the larger estates. There is provision for marginal relief to prevent hardship where a very small increase in the value of an estate may otherwise result in a large additional liability. It is available at the commencement of each estate duty rate band by applying the next lower rate on the respective ceiling value (i.e. \$7.5 million, \$9 million and \$10.5 million) plus a 100% rate on the remainder.</p> <p data-bbox="1131 1118 2112 1390">There is no statutory time limit for the estate duty assessment. Very often, additional assets are uncovered long after an estate has been finalized. When new assets or gifts are found and where there is no jump in rate, other accountable persons will not need to pay any additional duty. But if the initial estate has been exempt from duty or has been charged at one of the two lower rates of duty (currently</p>

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		<p>5% and 10%), assessment/additional assessment will have to be issued to other accountable persons.</p> <p>If a progressive marginal rates structure is adopted, the problems will be compounded. The total amount of duty will have to be recalculated. That means the effective rate of duty will increase each and every time an additional asset or gift is reported or discovered. The Revenue will be faced with recovery problem because the additional duty levied on persons other than the accountable person for the omitted asset or gift might become irrecoverable due to the effluxion of time, particularly for gifts inter vivos. The accountable persons are, therefore, uncertain of the total amount of estate duty chargeable in respect of the property passing to them and when they might be called upon to make further payments.</p> <p>Comparing the two systems, the degree of uncertainty under the "slab" system is limited to cases below the highest rate band, but, under the "marginal" system, it affects all dutiable cases. For both administration and compliance, the "slab" system is more simple, straightforward, and certain.</p> <p>We accept that there is room for improvement in the areas of summary procedures and interest charge under the current system.</p>

Financial Services and the Treasury Bureau (Treasury Branch)
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