An Alternative to Abolishing Estate Duty

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Introduction

Estate duty is currently under review in Hong Kong. There are suggestions to abolish the tax, which are mainly based on the arguments that the tax (1) is not effective in raising revenue (it only accounts for an average of 0.7 percent of the total government revenue) and (2) is unfair (the rich can use elaborate estate duty planning[2] to avoid paying the tax). It is also alleged that estate duty deters inflow of capital and hinders Hong Kong's development as a premier asset management center. On the other hand, estate duty is appealing on the efficiency ground, because it is least distortionary (John Stuart Mill, A. C. Pigou, and Richard Musgrave). Hence, we are interested in modifying the existing estate duty that, without compromising its relative efficiency, can address ineffectiveness and unfairness of the tax. Our proposal is to add an option of paying a lump sum estate duty to the existing progressive schedule. By the principle of "incentive compatibility", the lump sum is set commensurate with the cost of estate duty planning. If the lump sum is set higher than the cost of estate duty planning, the rich will continue using estate duty planning to avoid paying the tax.

Estate Duty as the "Death Tax"

Estate duty is also called the "death tax". This label is used by opponents to deride estate duty. Some critics even argue that the tax is morally repulsive by appealing to the practice that assessment of the tax liability is conducted upon a person's death. Neither the effectiveness of the name-calling strategy, nor a moral judgment of estate duty will be discussed here. Our point is that if we detach the negative connotation from the label, it helps us identify two unique features of the tax. Estate duty is levied *at most once* in and at the *last moment* of a person's lifetime.

Estate duty is levied at most once in a person's lifetime because, in general, only those with sizeable estates are required to pay estate duty. Furthermore, assessment of the estate tax liability often involves complicated rules, which can be circumvented by elaborate tax planning (see the next section). As a result, only a small portion of the population ends up paying estate duty.[3] Hence, for most people (who expect no estate tax liability), estate duty has little disincentive effect on their labor supply and consumption/saving decisions. Even for the few who expect to pay estate duty, the disincentive effect on their labor supply and consumption/saving decisions is minimal, because they need to guard themselves from various unforeseen contingencies during their retirement that can last for many years.[4] Although the disincentive effect on consumption/saving decision is increasing during retirement, it is of second order due to tax avoidance. We subscribe to the view, as advocated by John Stuart Mill, A. C. Pigou, and Richard Musgrave, that estate duty is the least distortionary tax (see Gale and Slemrod, 2001).

As a result, estate duty is appealing on the efficiency ground, because the least distortionary tax is the tax with the smallest efficiency loss. Note that the efficiency loss is minimized by tax avoidance, *inter alia*. Tax avoidance is a double-edged sword which, on the other hand, reduces tax revenue. The ineffectiveness of using estate duty to raise revenue is discussed next.

Estate Duty as a "Voluntary Tax"

Alternatively, estate duty is known as a "voluntary tax". Estate duty often involves complicated rules. These rules are bound to be imperfect and, hence, can be circumvented by elaborate estate duty planning. Elaborate estate duty planning is costly and is justified only when the estate is sufficiently sizeable. Consequently, people pay estate duty when their estates are not large enough to justify the cost of estate duty planning. The tax avoidance problem has two undesirable effects. First, it is unfair to levy estate duty only on the middle class, while the rich can use estate duty planning to avoid paying the tax. In Hong Kong, 69% and 47% of the dutiable cases were worth over HK$10 million, and 11% and 8% were worth over HK$50 million for the assessment years 2002–03 and 2003–04, respectively. Only two cases were worth over HK$1 billion in 2002–03. Second, it is not effective to use estate duty to raise revenue. In Hong Kong, estate duty represented an average of 0.7 percent of the total revenue in the past five consecutive fiscal years from 1999–2004[5] (Financial Services and the Treasury Bureau, 2004). The two effects are further illustrated in the context of Hong Kong.[6]

Threshold

A relatively high threshold has been adopted in Hong Kong, which is currently set at HK$7.5 million. The threshold applies to estates after all exemptions and deductions. The most notable exemption is matrimonial home inherited by the surviving spouse. Given the high housing price in Hong Kong, a flat is usually the most significant component of one's estate. Most people do not reach the threshold if they can use this exemption. Life insurance benefits are also exempted, *inter alia*. For estates exceeding the threshold, the current duty rate is 5% when the values are between HK$7.5 million to HK$9 million, 10% for the range between HK$9 million to HK$10.5 million, and 15% for over HK$10.5 million. *De facto* rates can be substantially reduced by estate duty planning, especially for sizeable estates.

Gifts

Giving properties away prior to death is a direct way to reduce estate duty exposure. A typical countervailing measure to this strategy is to impose gift tax and is adopted, for example, in the US. Hong Kong does not have gift tax and employs the following measure. In general, gifts made by the decedent within three years prior to death are clawed back to form part of the decedent's estate and subject to estate duty. This measure is less effective than gift tax, because no tax is levied on properties given away by the decedent more than three years prior to death.

Nonetheless, this measure can be effective on the ones who worry giving their properties away too early, so they may end up giving the properties away too late or being too late to give them away.

Not all gifts made within three years prior to death are subject to estate duty. For example, gifts for charitable purposes are exempted from estate duty. Gifts with a value of HK$200,000 or less to any one recipient are also exempted. Hence, estate duty liability can be reduced by giving away HK$200,000 to as many relatives and friends as practical. Note that gifts are valued at the time of death and their original value is not relevant for assessing the estate duty liability. Hence, if gifts no longer exist at the time of death, the duty liability disappears. This is called the "disappearing trick" in estate duty planning. For example, gifts in the form of company shares can be made to disappear if they are bought back or if the company is wound up by the time of death. Another notable exemption is a result of the principle of territoriality. Gifts situated outside Hong Kong at the time of death have no estate duty exposure.

Principle of Territoriality

The principle of territoriality applies to all estate properties. Properties situated outside Hong Kong at the time of death are exempted from estate duty. For example, movable properties that are parked outside Hong Kong around the time of death are not subject to estate duty. Immovable properties cannot be moved physically outside Hong Kong and need to be handled differently.

There are different ways to exploit the principle of territoriality to deal with immovable properties. Some are simple and others are more elaborate. They have different implications on capital flows. The simple way is to sell immovable properties and deposit the consideration in an offshore account. This will cause an outflow of capital. Seemingly the same method is to sell immovable properties in exchange for an offshore debt or promissory note. The difference is that there is no net flow of capital under this method. From an economic viewpoint, these two methods are quite distortionary. They change not only the location, but also the type of the assets. A more elaborate, and less distortionary, method is devised to make use of deductions to reduce estate duty exposure. A typical deduction is loans charged on properties situated in Hong Kong. If the money borrowed from banks is deposited in an offshore account, the deduction allows one to reduce estate duty liability substantially. To economize bank charges and interest payments, such loans are usually short term. The corresponding impact is a temporary outflow of capital.

Discretionary Trusts

The most elaborate estate duty planning involves establishing discretionary trusts. The general idea of using discretionary trusts in estate duty planning is that owners of properties become beneficiaries of a trust after selling or transferring the properties to the trust. The key is to structure the trust in a way that the beneficiaries have no vested interest in the underlying assets of the trust. Consequently, there will be no interest passing on the death of the beneficiaries and, hence, estate duty does not apply. In a sense, setting up a trust for the purpose of estate duty planning is like paying a fixed charge to eliminate the estate duty exposure. A fixed charge has little impact on the allocation of assets. In other words, using trusts for estate duty planning is essentially nondistortionary and, in particular, has little impact on capital flow.

The preceding discussion shows that there are many ways to avoid paying estate duty,[7] which make the tax ineffective in raising revenue. Elaborate estate duty planning is costly and is justified only when the estate is sufficiently large. It will not be used by the middle class. Hence, the tax is levied on the middle class and is unfair, because the rich can avoid paying it. However, we do not have a clear-cut case to abolish estate duty. The tax is appealing on the efficiency ground, because it is least distortionary. Therefore, we are interested in exploring the possibility of preserving the relative efficiency of estate duty and, at the same time, making it fairer and more effective in raising revenue.

The Proposal

We should recognize that there is a general trade-off between a more effective tax and a more distortionary tax and between a fairer tax and a less efficient tax. For instance, introducing countervailing measures to stop tax avoidance of the rich (and assuming that the measures are effective in closing the existing loopholes) can further complicate the tax rules and create new loopholes. The new loopholes can induce tax-avoidance behavior that is more distortionary.

Specifically, we believe that effective countervailing measures for estate duty in Hong Kong will require a change in the principle of territoriality or restrict the use of discretionary trusts for estate planning purpose. First, the principle of territoriality is a fundamental pillar to the Hong Kong tax system. A change in this principle will not only affect estate duty, but also salaries tax and profits tax. The latter two are a lot more important than estate duty. Second, discretionary trusts can be set up for purposes other than estate duty planning. Adopting measures to prevent using trusts for estate duty planning will inevitably affect the use of trusts for the genuine productive purposes. Hence, introducing countervailing measures will generate far-reaching distortions and is not recommended.

Our proposal does *not* involve countervailing measures. It is based on the analysis of tax avoidance in the preceding section. In particular, the cost of estate duty planning is viewed as a fixed charge to eliminate the tax liability.[8] One will not pay estate duty if the tax liability exceeds the fixed charge. Our proposal is to introduce a lump sum estate duty and allow taxpayers to choose between paying the lump sum and being assessed according to the current schedule. The lump sum is set, by the principle of "incentive compatibility", commensurate with the cost of estate duty planning. This is the maximum amount that the rich will find it not worthwhile to use estate duty planning. If the lump sum is set higher than the cost of estate duty planning, the rich will continue using estate duty planning to avoid paying the tax.

"Self sorting" is expected. The rich will choose to pay the lump sum after they realize that it is not worthwhile to use estate duty planning. Although estate duty planning will no longer be needed, the demand for estate planning for investment purpose remains. Hence, our proposal rationalizes the current estate duty. The middle class will choose to be assessed by the current schedule, because they find it not justified to pay the fixed charge of using estate duty planning in the first place. Since the lump sum equals to the fixed charge, the rich will pay a higher estate duty than the middle class. Hence, the proposed scheme makes estate duty fairer and more effective in raising revenue. In addition, no distortion is introduced when the fixed charge is replaced with a lump sum tax payment. It is even possible that some distortions can be ameliorated when estate duty planning is not needed. For instance, it no longer pays to move properties outside Hong Kong for tax purpose if the lump sum tax is incurred anyway.[9]

Conclusion

Our proposal is not only a rationalization of the current estate duty, but also an extension of the Hong Kong tax system. The key in our proposal is giving taxpayers an option to choose between paying a lump sum estate duty and being assessed by the prevailing schedule. This is not a totally new idea to the Hong Kong tax system. Indeed, allowing taxpayers to choose different assessment methods has been practiced in Hong Kong. For instances, in salaries tax, taxpayers are allowed to opt for personal assessment; couples can choose to be assessed together or individually. The more unique feature of our proposal is that it manages to achieve trade-off. The refined estate duty is not only fairer and more effective in raising revenue, but also at least as efficient as the existing estate duty.

References

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Appendix

As noted in footnote 2, estate planning serves two functions: tax avoidance and wealth management (investment), so the cost of estate planning C can be split out into the cost of estate duty planning and the cost of wealth management as follows:

$$C = (at + btW) + (aw + bwW)$$

Where $at + btW$ is the cost of estate duty planning
$aw + bwW$ is the cost of wealth management
W is the value of the wealth

The term bt is dominated by bw, because estate duty planning does not require management as active as wealth management. Estate Duty Ordinance does not change as often as innovations and developments in the financial market. Hence, the relatively unimportant term bt is assumed to be zero. It follows that the cost of estate duty planning is essentially a fixed charge.

Endnotes

1. School of Economics and Finance, The University of Hong Kong, Pokfulam Road, Hong Kong. I am very grateful to Alan Siu for a stimulating discussion and an anonymous referee for useful comments. All remaining errors are mine.

2. In this article, we distinguish "estate duty planning" from "estate planning". "Estate planning" serves two functions: tax avoidance and wealth management (investment), and is more general than "estate duty planning". "Estate duty planning" refers to the restrictive use of "estate planning" for tax purpose only.

3. In the US, only 2% of the decedents in 1997 had estate tax liability. We do not find the corresponding figure for Hong Kong in the Estate Duty Review Consultation Document prepared by the Financial Services and the Treasury Bureau (2004).

4. Implicit in the argument is the assumption of bounded rationality.

5. *Cf* Federal estate duty and gift tax in the US accounted for a higher, but still a marginal, fraction of about 1.5 percent of federal revenues in 1999.

6. In no circumstance should the following discussion be taken as tax advice. The discussion is based on PricewaterhouseCooper (2001).

7. The discussion on the use of offshore companies in estate duty planning is deliberately left out. The use of offshore companies is generally ineffective due to the anti-avoidance "controlled company provisions" in the Hong Kong Estate Duty Ordinance.

8. A more precise statement is provided in the appendix.

9. Improper enforcement of the Estate Duty Ordinance is another explanation for estate duty being ineffective in raising revenue in Hong Kong. The ordinance should be properly enforced. A proper enforcement of the ordinance, under our proposal, will make the tax more effective in raising revenue in two ways. First, it will enhance the effectiveness directly. Second, it will raise the cost of estate duty planning and the principle of incentive compatibility allows the lump sum be increased correspondingly. As a result, more revenue is collected.