LC Paper No. CB(2)1752/04-05(01)

STEP

30 May 2005

The Clerk of the Bills Committee
For the Revenue (Abolition of Estate Duty) Bill 2005
Legislative Council of Hong Kong
Jackson Road
Hong Kong

Dear Madam,

Re: Revenue (Abolition of Estate Duty) Bill 2005

We understand that your Committee is seeking views on the above-mentioned Bill. The Society of Trust and Estates Practitioners (Hong Kong) Limited is keen to submit its views on the question of the abolition of Estate Duty in Hong Kong.

Our society made a lengthy submission to the Principal Assistant Secretary for the Treasury on 19 October 2004 in response to the Government's consultation paper on that subject issued in July 2004 which we now attach.

In summary:

1. We oppose abolition because we believe that the case for abolition must be made out by the abolitionists rather than its retention justified and we are firmly of the view that the case for abolition is poor.

2. The principle reason for the Financial Secretary's justification for abolition is that it advances Hong Kong's position as a regional finance centre. For the reasons detailed in the attached submission, it is clear that there is no evidence to support this claim and that comparisons with other jurisdictions suggest the contrary.

3. Our submission supports the retention of estate duty but proposes changes to it which would help the asset management industry in Hong Kong, remove perceived hardships by de-linking probate procedures from payment of estate duty, and which would restore the integrity of the tax and ensure that a greater portion of estate duty raised falls on those most able to pay.

4. Our submission is that far more important areas for reform as regards its effects on Hong Kong as a finance centre are profits tax reform with respect to the taxation of offshore fund managers and the updating of the Trustee Ordinance and the Companies Ordinance.

Should you require any further details of our submission, we would only be too happy to comply with such a request.

Yours faithfully,

Susan Collins

Susan Collins
Chairman

STEP Hong Kong Limited (Society of Trust and Estate Practitioners)
c/o 201 St. George's Building, 2 Ice House Street, Hong Kong
香港中環雪廠街二號聖佐治大廈201室
Tel 電話: 2559 7144 Fax 傳真: 2559 7249 Email 電郵: queries@hktrustees.com
Website Address 網址: www.hktrustees.com

THE SOCIETY OF TRUST & ESTATE PRACTITIONERS – HK BRANCH (STEP) SUBMISSION ON THE ESTATE DUTY REVIEW CONSULTATION DOCUMENT (CD)

1. INTRODUCTION

1.1 The Hong Kong branch of STEP welcomes the Government's initiative to review whether the current estate duty regime should be adjusted to attract more foreign capital.

1.2 STEP is a unique professional body providing its members with local, national and international learning and an international business network. STEP provides education, training, representation and networking for its members who are professionals specializing in trusts and estates, executorship, administration and related taxes. STEP has over ten thousand members worldwide and 239 members in Hong Kong.

1.3 STEP Hong Kong shares its secretariat with the Hong Kong Trustees Association (HKTA) and has many joint committees with HKTA such as the Government Liaison Committee which jointly developed the attached submission and which has been separately submitted by the HKTA.

1.4 Many of our members advise on Hong Kong estate duty and Hong Kong estate duty has a direct impact on the trustee service business in Hong Kong. Our members are therefore both directly affected by the existence of estate duty and uniquely qualified in estate duty law and practice.

2. SUBMISSION SUMMARY

2.1 This submission addresses directly the questions posed by the CD. However, we submit that the questions should be addressed in a different order than they appear in the CD. We consider, for reasons which are set out in the answers we give, that the questions should be addressed in the following order.

2.1.1 Whether estate duty should be abolished?

2.1.2 Whether the estate duty regime should be adjusted through provision of exemption by reference to domicile or residency?

2.1.3 Whether the estate duty regime should be adjusted through provision of exemption by reference to asset type?

2.1.4 Whether other measures should be adopted to otherwise adjust the regime?

2.2 A consequence of answering the questions in this order is that it becomes unnecessary to answer the questions under the heading "Whether the current estate duty regime should be retained?"

2.3 Below is an Executive Summary of this submission. There follows in Part 3 more detailed reasoning, arguments and proposals.

2.3.1 The case for abolition must be made out rather than its retention justified.

2.3.2 Given recent history of structural deficits and the Government's stated policy to avoid budget deficits, and weighing the arguments for abolition against those for its retention, it is our submission that the case for abolition is not made out. In particular there is no evidence whatsoever that abolition of estate duty will affect foreign investment in Hong Kong or contribute significantly to Hong Kong's claim as the region's premier financial centre.

2.3.3 We submit that case for radically altering the territorial tax system in Hong Kong by moving from a situs of assets regime to a domicile or residency basis for liability is not made out.

2.3.4 The existing regime should be basically preserved but bank deposits should be exempted which will assist in attracting private banking business to Hong Kong.

2.3.5 Other adjustments to the estate duty regime that should be explored in detail include:

- Simplification of the controlled company provisions, or alternatively their substitution with "HK asset rich" provisions, coupled with stronger enforcement of those amended/substituted provisions
- Adjustment of the duty bands, rates and a move to a marginal rate system
- Procedural and other improvements

2.3.6 The most effective taxation measure that can be taken to assist the wealth management industry in Hong Kong is to exempt offshore funds from profits tax.

3. DETAILED SUBMISSION

The submission addresses the questions posed in the CD but, as explained in paragraph 2.1 above, in a slightly different order.

3.1 Whether estate duty regime should be abolished?

Q1(a): ***Do you think estate duty should be abolished? If so, the reasons for this?***

A1(a): We submit that the case for its abolition is not made out, for the following reasons:

1) As the starting point in considering abolition, it is clear in these times of structural deficits, that if estate duty were abolished, the revenue lost, even if small in percentage terms of total capital revenue, would have to be found elsewhere. Profits tax or salaries tax collections would need to be increased or sales tax would need to be introduced (or its rate increased) to raise revenue lost through the abolition of estate duty. Such measures would inevitably fall on a broader, and accordingly less well-off, cross-section of the community which is generally considered to be unfair (see 2) below. We therefore believe that the case for abolition needs to be made clear rather than its retention justified.

2) As the CD notes in paragraph 1, this tax was first introduced in 1915 to generate revenue and 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 progress of Hong Kong to which the whole community contributed."* This remains the case today. There are no capital gains taxes in Hong Kong. There is no tax on interest nor on dividends or foreign sourced income. Income based taxes on locally sourced corporate profits, property rentals and on salaries are comparatively low. This means that Hong Kong people can, and some indeed do, grow very rich and pay very little tax during their lives. Given this, we submit that requiring people, at the end of their lives, to contribute a relatively small percentage of their wealth (acquired, or inherited by them) is a comparatively equitable means of raising revenue.

3) Estate duty in Hong Kong is clearly not a disincentive to acquire wealth. It is not as if (such as is the case in the United Kingdom and the United States that have worldwide, comprehensive, well-enforced and high rate income estate and capital gains tax systems) Hong Kong people contribute substantially through taxes to the community during their lives and are then asked to pay further substantial taxes on what they have managed to acquire despite high taxes.

4) Abolitionists assert that estate tax is unfair because it can be easily avoided by the well-advised. This unfairness, to the extent that it exists, results, in our submission, mainly from poor enforcement of existing laws and not the nature of the tax itself. Poor enforcement is no justification for abolition. We agree that the evidence suggests that the larger estates should bear a greater portion of total duty and our submissions for adjustment of rates and bands and stronger enforcement will achieve this.

5) Abolitionists assert that estate duty provides disincentives to foreign investment in Hong Kong. We agree with the CD that there is no evidence to support this contention and submit that this concern can be addressed by the provision of particular exemptions rather than abolishing the tax altogether. See further detailed arguments for this proposal at paragraph 3.3 below. See also A3(2) below where we point to experience in other countries which supports our contention that estate duty does not provide disincentives to foreign investment. We note also that in the recently published "The Global Competitiveness Report 2004-2005" Hong Kong's tax rates and tax regulations were on a scale of 2% as problematic factors for doing business in Hong Kong compared with 20% for inadequately educated workforce.

6) Estate tax also helps support the non-profit sector by providing incentives to the wealthy to give to charities at precisely the time when people are distributing large amounts of wealth.

7) Furthermore, it is generally accepted that we are now at the beginning of the most significant inter-generational transfer of wealth in our history. To abolish estate duty now would forego a unique opportunity to raise significant revenues in a comparatively equitable manner.

8) Estate tax is the most progressive form of tax in Hong Kong. Only some 2.67% of estates suffer the tax (IRD Annual Report 1998-99). In a climate of the realization of the need to broaden our tax base and at a time when measures such as taxing foreign domestic helpers and reducing old age pensions are being introduced, the abolition of estate duty seems counter-intuitive. We submit that the recommendations for amending the regime (see 3.4.1 below) would see fewer, but wealthier, people paying estate tax.

9) We agree with the CD that there is little evidence that estate duty causes hardship on relatives of deceased persons.

10) It is generally accepted that estate duty returns provide the IRD with an excellent source of information to uncover profits tax evasion – which means its contribution to tax revenue is greater than direct estate duties raised.

11) As the CD points out in paragraph 18, estate duty is an efficient tax to collect.

Q1(b) ***How would the abolition of estate duty affect different industries (e.g. private wealth management, estate duty planning, the legal, accountancy and surveying profession, investment banks and trustee companies)?***

A1(b)

1) Abolition would remove directly jobs that provide specialist estate duty advice work and, to some extent, jobs in the trustees services sector because a certain amount of trusts are created primarily for estate duty minimization purposes.

2) Although not the only factor, estate duty in Hong Kong has been a contributing factor to the development of the trustee services sector here. There is now a significant depth of knowledge and expertise in estate duty and succession planning such that Hong Kong may now be fairly regarded as the leading trust administration centre in the region. Singapore is trying hard to become the "Switzerland of the East" and New Zealand is also vying for market share. Ironically therefore, abolition of estate duty would remove part of the need for existing expertise and thus in some way weaken Hong Kong's leading position.

3) We do not consider abolition would affect the business of investment banks.

Q1(c) ***What effects, if any, on the asset management industry and the Hong Kong economy as a whole (e.g. in terms of employment levels, value of assets managed, repatriation of capital form Hong Kong people and inflow of foreign capital) do you think would be brought about by abolishing estate duty? Please try to quantify the benefits and explain the basis of your estimate.***

A1(c) It is very difficult to seek to quantify the impact of abolition on the matters posed by the question. We submit that, for the same broad reasons advanced in A1(b) above, abolition is unlikely to benefit the asset management industry in any perceptible way but as stated above would negatively impact on the trustee services industry and the legal and accounting profession that support it. We are unable to give an accurate quantification of this submission. However, we re-iterate that any ill-effects of the current estate duty regime on both private wealth management and asset management can be significantly ameliorated by the submission we make below concerning adjustments to the existing regime (see answers to Q4 below).

Q1(d) How best may we ascertain and measure the costs and benefits of abolishing the tax in terms of the next employment losses/gains, potential for increased investments and boost to the asset management industry?

A1(d) Any attempt to ascertain and accurately measure the costs and benefits of abolition is unlikely to succeed. This is because there is simply no information readily available in the industry to approach this task with any certainty. This, coupled with industry participants' general lack of willingness to divulge the information with respect to their businesses or that of the clients, makes this task extremely difficult.

3.2 Whether the estate duty regime should be adjusted through provision of exemption by reference to "domicile" or "residency"?

Q2(a) Should exemptions based on "domicile" and "residency" be provided? If so, why? And which basis do you prefer domiciled or residency? What do you suggest for the definition and test of "domicile" and/or "residency"?

A2(a) We do not believe that the essential basis for imposition of estate tax in Hong Kong should be changed from the current territorial basis. This would represent a seismic shift in Hong Kong's tax policy and it would involve significant complexities in the determination of a person's domicile or residency. We submit that the discussion in paragraphs 23, 24 & 25 of the CD provide sensible and persuasive arguments for not adopting a domicile or residency test for liability. We would only add Hong Kong is, and has always been, a free trading entrepot where people who live here temporarily, permanently or not at all have made their fortunes. This non-discriminatory territorial tax system reflects that reality and should not, in our submission, be tampered with. If our principal submission is rejected, we favour a system exempting persons based on domicile rather than residence because we think it is fairer, even though domicile is more difficult to ascertain than residence. It seems to us that mere residence is too ephemeral a connection with a place to justify estate duty which would, in such a system, necessarily extend to world-wide assets.

Q2(b) Would the proposal to provide exemption from estate duty by reference to "domicile" or "residency" create problems for the estate duty regime? What practical difficulties might there be and how best can they be overcome?

A2(b) Our answer to 2(a) above mostly answers this question. It is difficult to predict how the practical difficulties, particularly with respect to domicile, might be overcome. However, it should be acknowledged that, if the Law Reform Commission's Recommendations for the change of domicile law in Hong Kong are adopted, the distinction between residency and domicile would become less marked and a person's domicile more easily ascertained.

Q2(c) ***What effects, if any, on the asset management industry and the Hong Kong economy as a whole (e.g. in terms of employment level, value of assets managed and inflow of foreign capital) do you think would be brought about by providing exemption by reference to "domicile" or "residency"? Please try to quantify the benefits and describe the basis of your estimate.***

A2(c) We submit that providing the exemption by reference to domicile or residency would have an imperceptible impact on the asset management industry and the Hong Kong economy as a whole. We have already stated that there is little, if any, evidence to suggest that the existing system (other than the failure to exempt bank accounts) has any real impact on the industry. We do not consider people, either in Hong Kong or outside Hong Kong, are significantly motivated in their investment decisions by the existence of estate duty in its current form nor do we think that changing the basis for exemption would significantly impact on those same investment choices.

3.3 WHETHER THE ESTATE DUTY REGIME BE ADJUSTED THROUGH PROVISION OF EXEMPTION BY REFERENCE TO ASSET TYPE?

Q3(1) ***Should exemptions be given to specific assets such as bank deposits, listed securities, and collective investment schemes that are authorized by the Securities and Futures Commission under the Code on Unit Trusts and Mutual Funds? If so, the reasons for this?***

A3(1) We submit the following with respect to this question

1) ***Exempt bank account balances***

We advocate the exemption of bank deposits from estate duty because it is now very simple to avoid Hong Kong estate duty on Hong Kong bank deposits of either local or foreign currencies by establishing those accounts with the non-Hong Kong branches of Hong Kong or foreign banks. Although we do not have statistics to support this, we feel sure that the duty paid on bank account/balances falls more heavily on the lower value estates than on higher value estates. Given the territorial system of Hong Kong estate duty i.e. the non-Hong Kong property exemption, it would be impossible to tighten up estate duty law or enforcement procedures to stop people avoiding Hong Kong estate tax on bank deposits by moving them out of Hong Kong. Further, in the electronic age, the "locality" of bank deposits is entirely fungible in the banking system's accounting procedures and therefore the concept with respect to this asset type is a myth. Estate tax on the locality of bank deposits is simply anachronistic. See also A3(3) below where we cite the positive effects of bank account exemption for Hong Kong. Exemption of bank account balances will result in a loss of revenue. The IRD's 2002/3 Annual Report shows some 18.5% of dutiable estates are comprised of bank account balances which would indicate a corresponding loss of duty. We are confident that such a shortfall would be easily made up through proper enforcement of the controlled company provisions as amended (see paragraph 3.4.1 below).

2) Do not exempt publicly listed shares.

We do not advocate the exemption of Hong Kong public company incorporated or listed securities from estate duty for the following reasons.

As the CD suggests, there is no evidence that foreign individuals pay significant amounts of Hong Kong estate tax on public listed shares on their death. Therefore, there seems to be little disincentive in investing in a Hong Kong stock market caused by estate tax exposure on this asset class. We note also, by way of comparative empirical evidence, that more than 50% of the world's stock market capitalization resides on US exchanges, mostly in US incorporated companies. The US taxes non-US persons at up to 48% of the value of US property passing on death with exemptions as low as USD60,000 and the UK taxes non-domiciliaries at 40% of the value of US property passing on death with an exemption threshold of GPB263,000. The existence of high estate taxes in these jurisdictions does not appear to have had a detrimental effect on these markets. Our research suggests few foreigners pay US or UK estate taxes particularly with respect to listed shares. This is through a combination of factors including difficulty of detection/enforcement against foreign estates, relative ease of planning through corporate vehicles and the fact that much of foreign investment occurs through institutional investors (mutual funds etc) which does not give rise to liability. We think the same applies to Hong Kong. In other words, it may be that estate taxes do not discourage foreign investors in stock markets because few foreign investors in fact pay estate taxes on stock market investments. Nor are we aware of any evidence that suggests jurisdictions like Australia (which long ago abolished estate taxes) have experienced consequential increased investment in their stock markets.

To provide such an exemption would benefit only Hong Kong's wealthiest members of society. Generally speaking, it is the wealthier families that have their businesses held through public companies and the less wealthy through private companies. To discriminate against small or private companies in favour of wealthier families who hold businesses through public companies would be very difficult to justify.

3) No need to exempt unit & mutual funds

In our experience, these vehicles are rarely Hong Kong incorporated or constituted and are therefore outside the HK estate duty net in any event. We understand that SFC approval does not alter that fact. However, if greater use of Hong Kong incorporated/constituted vehicles would result from such an exemption we would support it as no revenue would be lost as a result and greater spin off business would come to Hong Kong.

Q3(2) Would the proposal to exempt specific assets create problems for the estate duty regime? What practical difficulties might there be and how best could they be overcome?

A3(2) We think little difficulty would be created by exempting bank deposits which are easily identifiable as such. This would also allow families access to locally kept cash on death to discharge liabilities with respect to non-cash assets that are dutiable.

Q3(3) What effects, if any, on the asset management industry and the Hong Kong economy as a whole (e.g. in terms of employment level, value of assets managed and inflow of foreign capital) do you think would be brought about by providing exemption by reference to asset type? Please try to quantify the benefits and explain the basis of your estimate.

A3(3) We submit that the exemption for bank accounts should have a significant positive and permanent impact on the inflow of cash into Hong Kong which would have corresponding employment benefits and offer a general fillip for Hong Kong as a financial centre. We submit also that it would help Hong Kong attract more private banking headquarters/booking centres especially vis-à-vis Singapore which exempts bank deposits of non-domiciliaries. We are unable to quantify these benefits by reference to statistics.

3.4 ***Do you think Hong Kong needs to adopt any other measures or changes together with or instead of adjustments to estate duty in order to develop its role as the premier asset management centre for Asia?***

3.4.1 We suggest the following changes to the estate duty regime be explored.

a) De-link estate duty clearance and probate

Remove estate duty clearance as a prerequisite for grant of probate and de-link the two procedures so that ascertainment and payment of liability to estate duty and grant of probate can be pursued in parallel. This de-linked system works well in the United States.

b) Change bands, rates and the dutiable base in order to make estate duty even more progressive in its effect.

We submit that consideration be given to increasing the thresholds so that there is no duty on the principal value of an estate up to, say, the first HKD7.8 million, that the rate on the value of estates between, say, HKD7.8 million and HKD15 million should, say, be 10% and that the rate on the value of an estate in excess of, say, HKD20 million should, say be, 20%. In other words, we suggest moving to a marginal rate system instead of the existing system where estates which exceed a certain aggregate value attract a rate on the entire aggregate value. This change, coupled with rate and band adjustments, will help ensure that larger estates contribute a greater share of total revenue. Clearly modeling needs to be done, based on recent history of dutiable estates, to set the bands and rates at levels that will be revenue neutral.

c) Retain the interest charge

With respect to interest charges on outstanding liabilities, we think that these should be maintained, but linked to market rates, as it correctly deprives estates of the benefit of deferral of estate duty liability through lax administration. However, consideration should be given to only charging interest from six months after death.

d) Simplify or replace the controlled company provisions and enforce them.

With respect to anti-avoidance provisions, we think that the biggest gap that needs to be plugged is with respect to the controlled company provisions. We think that these provisions (which are, of course, designed to stop the abuse of the non-Hong Kong property exemption by transferring Hong Kong assets into foreign companies) should be simplified (or see below, replaced) but then properly enforced. Currently, we have an extraordinary situation of having an anti-avoidance provision on our statute books but a Departmental Practice Note (No. 1) giving taxpayers the blessing to ignore it. We consider this is partly due to the complexity of the provisions and their potential for extremely wide and unfair operation and partly due to administrative concerns that full compliance under current laws would result in the Commissioner being swamped with data.

We consider it possible to narrow the ambit of the provisions in the area of what “benefit” ought to be included to determine both liability and the formula to determine quantum. We submit that the nexus for liability should be limited to transferors of property who receive actual benefits and not “potential”, “notional” and “surrendered” benefits. Singapore’s controlled company provisions provide an excellent starting point for reform in this critical area.

Alternatively, we submit that consideration be given to repealing the controlled company provisions in favour of provisions that would deem shares of non-Hong Kong companies whose Hong Kong assets (traced through holding vehicles to ultimate assets) constitute more than 50% of the total value of the company’s assets (measured over, say, a three year average) to be Hong Kong situated assets. This would achieve the result of countering the abuse of the non-Hong Kong property exemption through use of foreign holding companies for Hong Kong assets.

Once these changes are decided upon the form of the estate duty return should be amended to ask more questions targeted at unearthing arrangements which may be caught by these new provisions and indeed existing provision.

There are numerous other procedural improvements that can be made to the EDO. These are well known to the Commissioner and are very well summarized in Andrew Halkyards” excellent paper entitled “Hong Kong Estate Duty: A Blueprint for Reform in 2000 (HKLJ). We attach a copy for your convenience.

We respectfully adopt Halkyard’s suggestions regarding simplification of controlled company provisions, remission of estate duty and the controlled company provisions, small and exempt estates, quick succession relief, rates of duty and indexation relief, jointly owned property, technical corrections, the estate duty charge on land, limitation of the Commissioner’s right to assess and recover duty, estate duty appeals and valuation issues.

3.4.2 We submit that a far more important area for reform as regards its effect on Hong Kong as a finance centre is profits tax. We urge the Government to move quickly to remove the uncertainty over the profits tax liability of offshore fund managers in relation to Hong Kong profits by exempting those funds from tax on those profits.

HONG KONG
19th October 2004