# Bills Committee on Revenue (Abolition of Estate Duty) Bill 2005

We provide herewith information requested by Members at the Bills Committee meeting held on 31 May.

## The Administration's opening Remarks at Bills Committee on 31 May

2. A copy of the opening remarks delivered by the Deputy Secretary for Financial Services and the Treasury at the Bills Committee meeting on 31 May is provided at ***Annex A***.

## Why not exempt non-domiciles from estate duty?

3. Hong Kong adopts the territorial-source taxing principle. In line with this, our estate duty system treats all types of investors/taxpayers alike without having regard to their place of domicile or residency in assessing their estate duty liability. ("Domicile" is a general law concept adopted by overseas tax jurisdictions. Broadly speaking, a person is domiciled in the country where he has his permanent home.) To exempt "non-domiciles" or "non-residents" from estate duty would be inequitable to local residents and may discourage people from moving to Hong Kong and bringing with them valuable human and monetary capital.

4. In addition, the application of "domicile/residency" rules to the taxation of property passing on death is far more complex than the application to the taxation of employment income. This is because the latter is usually linked to the geographical location wherein the income was earned in the tax year, whereas a person's being a resident in one year does not necessarily mean that he will be or was a resident in a subsequent or earlier year. A determination of the "domicile/residency" of the deceased by reference to his status/presence in Hong Kong in the year of death may not be fair and can easily be abused. The physical presence and right of abode test aside, rules would have to be created to distinguish people with a long-term connection to Hong Kong from those

with only a short-term connection, and to determine when a long-term connection is severed or restored.

<u>Procedures with and without estate duty and statistics on processing time</u>

5. A flow chart showing the procedures with and without estate duty is at ***Annex B***. With estate duty, it takes 4 months to 4 years to unfreeze the assets. Without estate duty, it is estimated that it will only take 1.5 to 13 months.

6. Executors/administrators of an estate usually take a number of months' time to collate information and file an affidavit. After the Estate Duty Office (EDO) has received an affidavit, it will begin estate duty assessment work. The tax assessment process, counting from the time an affidavit has reached the EDO, normally takes six weeks to two years to complete. For example, in 2003/04, there were 15,620 estate duty cases finalized. Out of these cases, only 258 cases, or 1.7% were dutiable. Of simple and exempt cases without landed property and business, tax assessment for the majority was completed within six weeks. However, of some 920 more complicated cases, tax assessment for the majority took more than six months to complete. For 169 or 18% of such cases, assessment took more than two years to complete. The cases whose tax assessment process took more than two years to complete accounted for 41% of the dutiable cases in 2003/04. A table setting out the tax assessment time for simple and complicated estate duty cases finalized in 2003/04 and 2004/05 is at ***Annex C***. We have no information as to which of these cases involved disputes between beneficiaries and estate administrators. But according to information provided by the Probate Registry, there were 13, 19 and 15 Probate Actions in the calendar years 2002, 2003 and 2004 respectively.

<u>Data on the size of the asset management market and Hong Kong's share of it</u>

7. According to the World Wealth Report 2004 published by Merrill Lynch and Capgemini, the total global wealth of high net worth

individuals (HNWIs) amounted to US$28.8 trillion. The trend for continued increases in worldwide wealth has stayed intact and HNWIs wealth is predicted to grow by 7% per annum and to exceed US$40 trillion by 2008.

8. For the Asia Pacific Region, total HNWI financial wealth stood at US$6.5 trillion in 2003 and was expected to increase by 7.4% per annum to US$9.3 trillion in 2008. It is worth noting that the Mainland's savings rate is about 30% to 40%. According to the People's Bank of China, outstanding household savings in RMB and foreign currency were 13.79 trillion yuan at the end of April. Given Asia's high domestic savings, promising regional economic outlook and the vast pension scheme assets held by banks, fund managers and insurance companies in the region, as well as the Mainland's policy direction towards expanding investment channels, there is great potential for Hong Kong to expand our asset management business further.

9. In 2003, total assets of our fund management business were $2,950 billion, of which $1,860 billion was sourced from overseas investors and accounted for 63%. Abolition of estate duty will remove a major obstacle to the further development of our asset management business.

10. It should also be noted that, in recent years, the European Union (EU), the US and the Organization for Economic Co-operation and Development have all initiated a crackdown on tax havens and unfair tax practices. Starting from July 2005, the EU will implement a Savings Tax Directive to facilitate the automatic exchange of information about interest and other income from savings between Member States, etc. It is believed that the above measures would force funds currently parked in certain European banking centres and offshore tax havens to move to lower tax regimes such as Hong Kong and Singapore.

<u>Measures taken by the Administration to further develop Hong Kong as an asset management centre</u>

11. A note explaining the measures taken by the Administration to

----- further develop Hong Kong as an asset management centre is at ***Annex D***.

Impact of the profits tax exemption for interest income

12. According to the Hong Kong Monetary Authority (HKMA), the impact of the measure to exempt interest income on corporate deposits from profits tax starting from 22 June 1998 is as follows: the total deposits of the Hong Kong banking sector hovered around HK$2.7-2.8 trillion during the first half of 1998. As at end-June 1998, that level was HK$2.74 trillion. After the tax exemption was introduced in late June 1998, we saw the total deposit figure jump by 4.4% to over HK$2.84 trillion in the month of July alone. The rise in total deposits continued over the following months. By end-December 1998, total deposits had grown to HK$3 trillion, representing an impressive 9.5% increase over the level at end-June 1998. The figure then stayed at around the same level for the following months. These figures help demonstrate that tax reforms do indeed result in behavioural changes on the part of depositors and investors.

Impact of abolition of estate duty

13. The HKMA gathered from a website for the World Bank/IMF 2006 meetings in Singapore which states 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.

Information on the reasons why overseas jurisdictions abolished estate duty

14. A number of economies have abolished estate duty over the past

20 years or so. These places include Canada, Australia, India, Malaysia, New Zealand, Macau, Italy, Slovakia and Sweden. The USA is considering a permanent repeal of the tax.

15. According to information to hand, in the case of Sweden, a press release issued by the Swedish Government in 2004 stated that Sweden abolished its inheritance and gift tax in 2005 to improve conditions for Small and Medium Enterprises (SMEs), partly to facilitate the transition from one generation to the next in family businesses.

16. According to an article published in 'European Taxation' in March 2002, Italy's reasons for abolishing its inheritance and gift tax, as described in the explanatory notes accompanying the Law, included the following- "politically, inheritance and gift tax has been overtaken by history. This type of tax, which was the expression of an ideology developed in the nineteenth century against rentiers, has been overtaken by the progressive extension of other, more efficient, social and fiscal instruments aimed at equity and welfare." On the economic side, it was argued that the tax "has been crowded out by changes in the structure of wealth. The original scene, consisting of localized and controllable physical assets, has gradually been replaced by one where the most strategically important parts of wealth have gradually become dematerialized and globalized, so as to escape the scope of the territorial fiscal instruments that originally typified the national taxation system."

17. We also understand from that one of the main objectives of advocates for the abolition of estate duty cited was to help SMEs. According to a study entitled "The Economics of the Estate Tax" prepared by the Joint Economic Committee of the US Congress in 1998, the estate tax is a leading cause of dissolution for thousands of family-run businesses. The US House of Representatives has recently passed a Bill to repeal estate duty permanently and the Bill has now been submitted to the Senate for consideration.

Whether there should be consequential amendments made to the Land Titles Ordinance?

18. Upon the enactment of the Revenue (Abolition of Estate Duty) Ordinance 2005 (the revenue ordinance), the Estate Duty Ordinance (Cap. 111) (EDO) will continue to apply to deaths occurring immediately before the coming into operation of the revenue ordinance but will not apply to deaths which occur after the coming into operation of the revenue ordinance. In preparing the Bill, we have conducted a search of the ordinances which make reference to estate duty and have reviewed the need for consequential amendments. A list of such ordinances is attached at ***Annex E***.

19. In respect of the Land Titles Ordinance (Cap. 585) (LTO), there are references to "estate duty" in sections 28(h), 63(2), 71(8), 73(3) and schedule 3(38). As the LTO is already worded in a way that would not be affected by the non-applicability of the EDO to deaths occurring after the coming into operation of the revenue ordinance, it is considered not necessary to make any consequential amendments under the LTO. Ordinances which need to be amended consequentially have already been included in Part 4 of the Bill.

Financial Services and the Treasury Bureau (Treasury Branch)
2 June 2005

**Annex A**

**Bills Committee on Revenue (Abolition of Estate Duty) Bill 2005**

**Points made by the Deputy Secretary for Financial Services and the Treasury at meeting on 31 May 2005**

- The Revenue (Abolition of Estate Duty) Bill 2005 seeks to implement the 2005-06 Budget proposal to abolish estate duty.

- To promote the development of our asset management business, the Government consulted interested parties and the public at large last year on the abolition of estate duty. While abolition and retention both have their pros and cons, the majority view tends to support abolition.

- Those in support of abolition take the view that, although the tax is targeted at the better-off, in practice the latter may avoid it through various legal means. They point out that estate duty avoidance is also very common in other places and it is no easy task to plug these loopholes. There is some unfairness in the tax in the sense that most paying the tax do not belong to the wealthiest class of the community but to middle class families. Others think that, as the assessment of estate duty takes time, and the assets of citizens, particularly operators of small and medium enterprises (SMEs), may be frozen during the assessment period, this causes them cash flow problems. In settling estate duty, some enterprises may have to sell their assets to raise cash and as a result encounter operating difficulties. We understand that one of the main reasons for the decision by some countries to abolish estate duty is the adverse impact on SMEs.

- With the abolition of estate duty, Hong Kong will become more attractive to investors. Those who currently avoid estate duty by investing overseas would be encouraged to transfer their investments back to Hong Kong. The proposed abolition will also encourage people, including overseas investors, to hold assets in Hong Kong through a Hong Kong corporate vehicle or trust. More overseas companies and professionals will come here to support this additional activity, and this will facilitate the further development of our asset management services, create more employment opportunities, and in turn make Hong Kong more competitive as an international financial centre.

- The measure will help promote trading in Hong Kong's financial market and contribute additional revenue from stamp duty and other taxes. In addition, expanded asset management business will bring additional job opportunities to Hong Kong and facilitate the development of other related industries, benefiting not only asset owners but also many other citizens. The economy as a whole will benefit.

- A number of countries in the region, including India, Malaysia, New Zealand and Australia, have abolished estate duty over the last two decades. Italy and Sweden in Europe have abolished the tax. In the United States, the House of Representatives has also recently passed a Bill to repeal estate duty permanently and the Bill is now being scrutinized by the Senate.

- The increasing competition amongst financial centres in the world and the growing trend in other places to remove inheritance taxes means that Hong Kong could lose its business to other financial centres and its financial market may shrink in size and share if it does nothing to counteract these competitive pressures. Eventually this would have an adverse impact on revenue as a result of reduced transactions and profits in the financial sector and the economy as well.

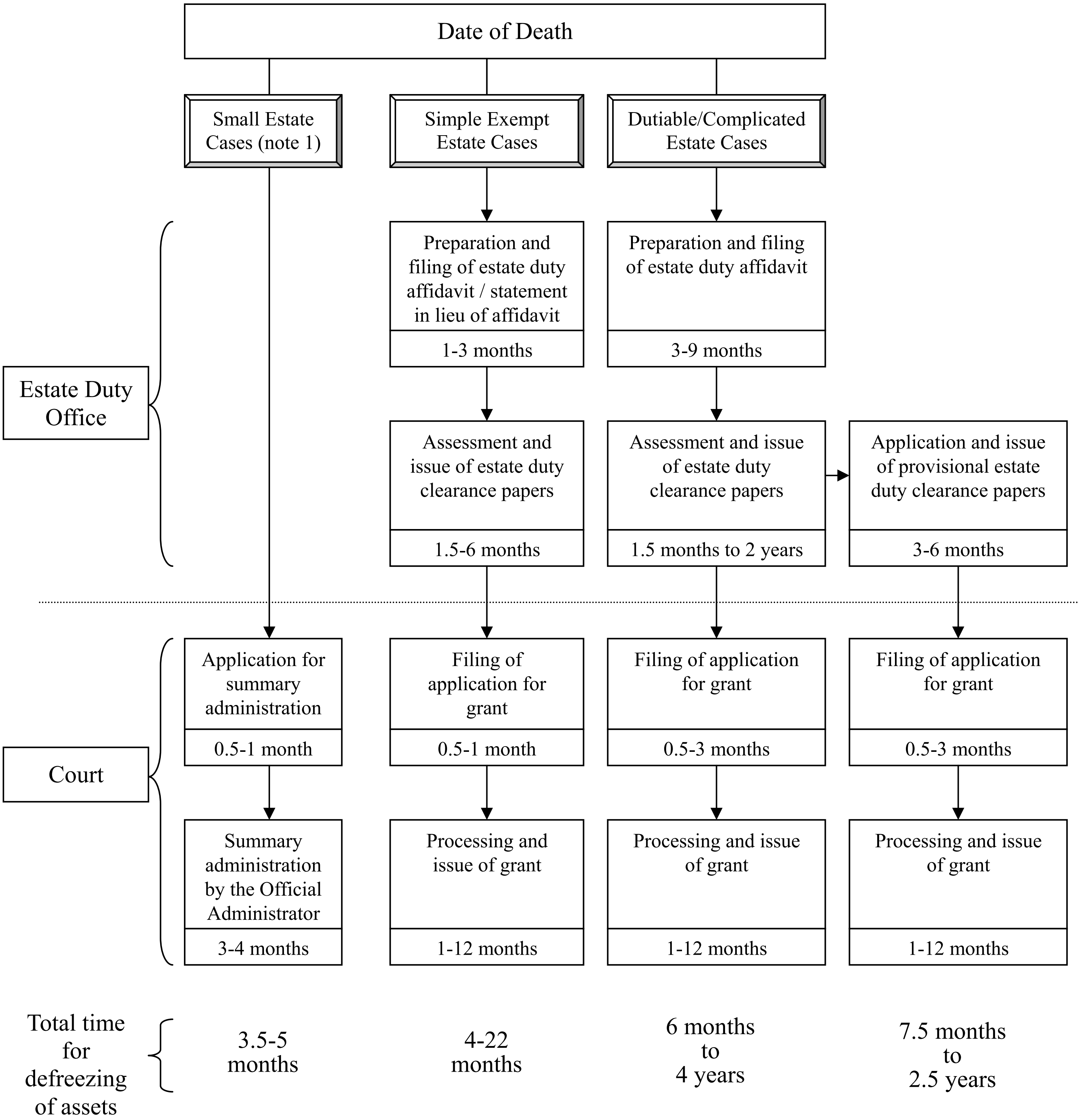
- There are suggestions that abolition of estate duty is a measure that "robs the poor to help the rich". In fact, experience shows that the majority of the dutiable cases involve assets with an estate value, after exemptions, below $20 million. SMEs and the middle class who benefit from the abolition would significantly outnumber the rich.

- I would like to reiterate that abolition of estate duty is aimed mainly at attracting or retaining capital to promote the development of Hong Kong's financial services industry which is expected to bring significant economic benefits to the community. It is a long-term strategic investment in the economy of Hong Kong. The above benefits will not be achieved by other proposals such as adjusting the exemption threshold, streamlining the assessment procedures or strengthening the anti-avoidance provisions.

- I hope that Members will therefore support the abolition of estate duty.

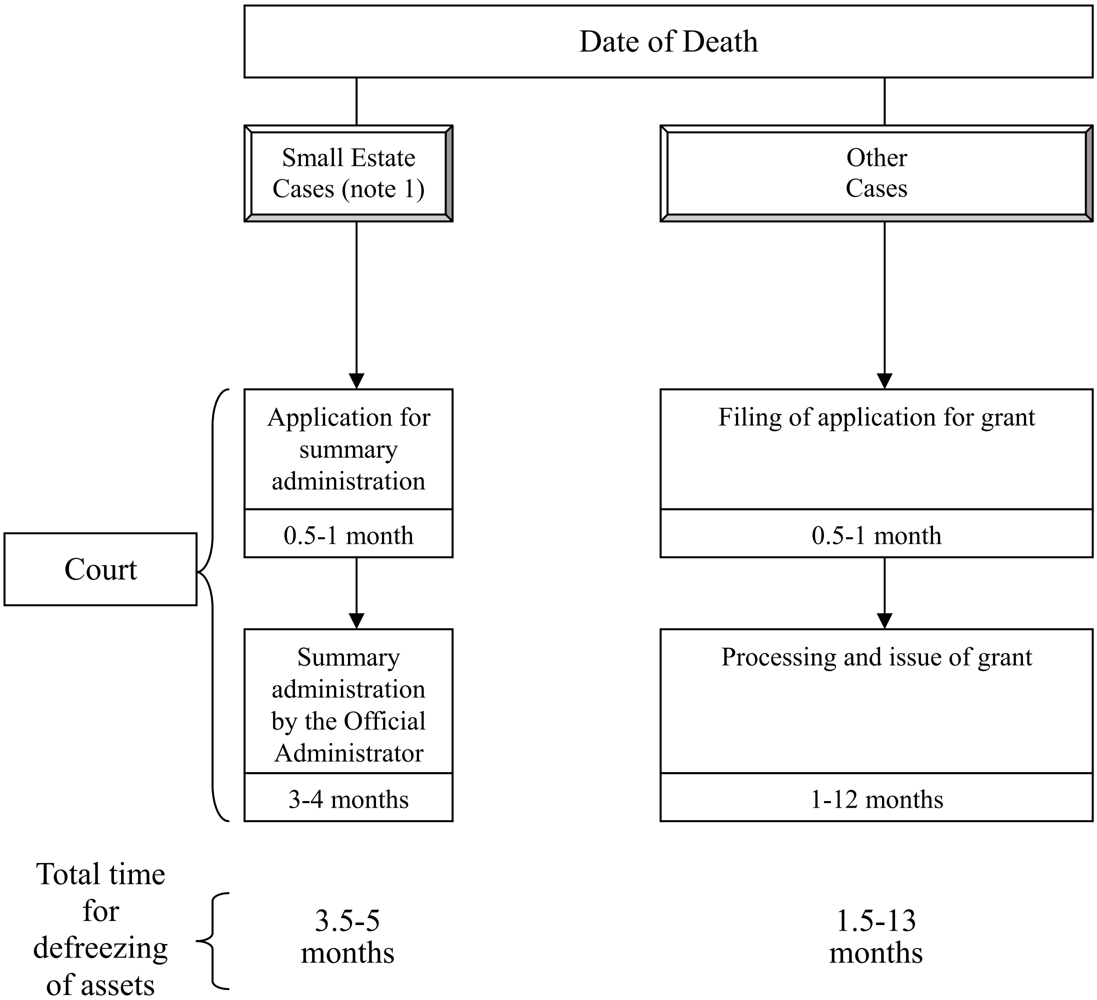
**Annex B**

## Flowchart of Time Taken to Defreeze the Assets with Estate Duty




Note 1: Small Estate means estate comprising only of bank deposits of not exceeding $150,000 and with no wills.

## Flowchart of Time Taken to Defreeze the Assets without Estate Duty




Note 1: Small Estate means estate comprising only of bank deposits of not exceeding $150,000 and with no wills.

# Analysis of finalized cases by processing time

**Case finalized during 2003/04**

| Processing Time | 'N' Code | % | Cum % | 'P' Code | % | Cum % | 'D' Code | % | Cum % | Total | % | Cum % |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Within 1.5 m | 8,172 | 99.60% | 99.60% | 5,600 | 86.18% | 86.18% | 144 | 15.70% | 15.70% | 13,916 | 89.09% | 89.09% |
| Between 1.5 m and 3 m | 29 | 0.35% | 99.95% | 493 | 7.59% | 93.77% | 93 | 10.14% | 25.85% | 615 | 3.94% | 93.03% |
| Between 3 m and 6 m | 3 | 0.04% | 99.99% | 288 | 4.43% | 98.20% | 144 | 15.70% | 41.55% | 435 | 2.78% | 95.81% |
| Between 6 m and 12 m | 1 | 0.01% | 100.00% | 114 | 1.75% | 99.95% | 206 | 22.46% | 64.01% | 321 | 2.06% | 97.87% |
| Between 12 m and 24 m | | | | 3 | 0.05% | 100.00% | 161 | 17.56% | 81.57% | 164 | 1.05% | 98.92% |
| Over 24 m | | | | | | | 169 | 18.43% | 100.00% | 169 | 1.08% | 100.00% |
| | 8,205 | 100.00% | | 6,498 | 100.00% | | 917 | 100.00% | | 15,620 | 100.00% | |

**Case finalized during 2004/05**

| Processing Time | 'N' Code | % | Cum % | 'P' Code | % | Cum % | 'D' Code | % | Cum % | Total | % | Cum % |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Within 1.5 m | 8,231 | 98.20% | 98.20% | 4,686 | 69.01% | 69.01% | 55 | 7.25% | 7.25% | 12,972 | 81.43% | 81.43% |
| Between 1.5 m and 3 m | 148 | 1.77% | 99.96% | 1,387 | 20.43% | 89.44% | 73 | 9.62% | 16.86% | 1,608 | 10.09% | 91.52% |
| Between 3 m and 6 m | 2 | 0.02% | 99.99% | 542 | 7.98% | 97.42% | 136 | 17.92% | 34.78% | 680 | 4.27% | 95.79% |
| Between 6 m and 12 m | | | | 170 | 2.50% | 99.93% | 183 | 24.11% | 58.89% | 353 | 2.22% | 98.00% |
| Between 12 m and 24 m | 1 | 0.01% | 100.00% | 5 | 0.07% | 100.00% | 167 | 22.00% | 80.90% | 173 | 1.09% | 99.09% |
| Over 24 m | | | | | | | 145 | 19.10% | 100.00% | 145 | 0.91% | 100.00% |
| | 8,382 | 100.00% | | 6,790 | 100.00% | | 759 | 100.00% | | 15,931 | 100.00% | |

Note: (1) 'N' Code represents exempt and simple cases not involving landed properties, private company shares or interest in business.

(2) 'P' Code represents exempt and simple cases involving landed properties, private company shares or interest in business.

(3) 'D' Code represents dutiable or complicate cases.

**Annex D**

# Promotion of Asset Management in Hong Kong

Located in the heart of Asia with the Mainland as its hinterland, Hong Kong is well positioned to develop into an international asset management centre. Like other successful asset management centres in the world, Hong Kong has a number of strengths in the development of asset management business which include –

* Rule of law;
* A well-established financial system;
* An effective regulatory regime;
* A rich pool of talent;
* A stable currency;
* Absence of currency control and restriction on capital flows; and
* A low and simple tax regime.

2. According to the Fund Management Activities Survey (FMAS) 2003 conducted by the Securities and Futures Commission (SFC), total assets in the fund management business which included asset management business, advisory business and other private banking activities (e.g. provision of financial services to private banking clients) amounted to HK$2,947 billion at the end of 2003, with 63% ($1,860 billion) sourced from overseas investors. Of the $2,250 billion assets under management, 53% or $1,194 billion was managed in Hong Kong.

3. The Government, together with the SFC, adopts a multi-pronged approach to facilitate the development of asset management in Hong Kong.

### *(a) Market and Product facilitation*

4. A key initiative to promote asset management is to provide a conducive business environment for fund management companies to operate business in Hong Kong and to facilitate the broadening of the choice of investment products for investors. In May this year, the SFC released a consultation paper on proposals to revise the Hedge Funds Guidelines which aimed at, among other objectives, providing greater flexibility in recognizing the experience of fund

managers' key personnel and enhancing transparency and safeguards for investors. In the same consultation, the SFC also sought the public's comments as to whether the minimum subscription level should be lowered and the restriction on collateralization should be relaxed. In addition, the SFC has recently proposed lifting the geographical restrictions on investments by SFC-authorised REITs so that they may invest in real estate anywhere in the world. In April 2005, the SFC revised the relevant code to allow SFC-authorised schemes to invest in listed REITs.

5. Since 2004, the SFC has also been processing applications of UCITS III funds. UCITS III is a new set of regulations issued by the European Commission governing funds domiciled in the EU member states. Since many SFC authorised funds are domiciled in European jurisdictions, they are required to convert to meet the new EU regulations. Up to mid May 2005, the SFC has authorized 390 UCITS III funds.

***(b) Tax initiatives***

6. For the benefit of Hong Kong's long-term competitiveness, the Government has proposed to exempt offshore funds from profits tax so as to attract new offshore funds to Hong Kong and encourage existing offshore funds to continue to invest here. The Government is also proposing to abolish estate duty, which will help encourage investors to hold assets in Hong Kong and transfer overseas investments back to Hong Kong.

***(c) Mutual recognition of investment products for cross-border distribution and trading***

7. With a view to fostering synergy among Asian economies, the SFC has embarked on regional initiatives for development of a cohesive Asian market for investment products. The SFC has signed co-operative agreements and Letters of Intent with some Asian countries (namely Indonesia, Thailand, Sri Lanka and India) to develop regulatory co-operation and long-term partnership to facilitate the cross-border distribution and trading of investment products. These efforts aim to enhance Hong Kong's position further as the strongest fund management centre in Asia (ex-Japan) and give Hong Kong investors access to a broader range of products.

***(d) Promotion***

8. Regular promotion efforts are taken to promote Hong Kong as a platform for global investment. For instance, the Government organized a large-scale fund management forum in Beijing in November last year. The forum aimed at fostering experience-sharing on the management of insurance funds between people in the industry in the Mainland and Hong Kong. Another large scale forum on Hong Kong as an international financial centre and fund management centre will be held in November this year.

***(e) Human Resources Development***

9. Sufficient good quality human resources are key to Hong Kong's further development as an international asset management centre. This requires talent from a wide spectrum of professions, including fund managers, financial analysts, lawyers and accountants.

10. In June 2000, the Government set up the Advisory Committee on the Human Resources Development in the Financial Services Sector (FinMan Committee). The Committee comprises members from industry associations, professional bodies, regulators, training providers and Government bureaux. In December last year, the Government and FinMan co-organised a forum to explore ways to enhance our financial services human resources.

11. The Government will continue to work with the SFC and the industry in enhancing Hong Kong's competitiveness as asset management centre.

Financial Services Branch
Financial Services and Treasury Bureau
June 2005

**Annex E**

## List of Ordinances which make reference to estate duty

| Item | Chapter | Description |
|---|---|---|
| 1. | 10 | Probate and Administration Ordinance |
| 2. | 10A | Non-contentious Probate Rules |
| 3. | 89 | Pensions Ordinance |
| 4. | 89A | Pensions Regulations |
| 5. | 99 | Pension Benefits Ordinance |
| 7. | 112 | Inland Revenue Ordinance |
| 8. | 128A | Land Registration Regulations |
| 9. | 179A | Matrimonial Causes Rules |
| 10. | 254I | Auxiliary Forces Pay and Allowances |
| 11. | 310 | Business Registration Ordinance |
| 12. | 401 | Pension Benefits (Judicial Officers) Ordinance |
| 13. | 481 | Inheritance (Provision for Family and Dependants) Ordinance |
| 14. | 585 | Land Titles Ordinance |