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SSD, the Basic Law, and a lesson from Singapore

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The proposed Special Stamp Duty (**SSD**) is still on the table in the Legislative Council, and the Government is attempting to address legislators' concerns about the unintended victims of this dragnet approach to impose a punitive tax on anyone who sells their property within 2 years of purchase - concerns which the Government itself cited in Jun-2010 (p5) when it originally rejected the idea.

We submitted our earlier article on this subject to LegCo, and on 4-Jan-2011 your editor appeared in person and fleshed out the reasons why we believe SSD would be unconstitutional, because it imposes a penalty on the exercise, within 2 years of purchase, of the right of disposal contained in article 105 of the Basic Law. The Government has now responded to Legislators on the Basic Law aspects of SSD with this document filed in January 2011 (they don't put an exact date on it) at page 6. The Government cites the case of Weson Investment Ltd (**Weson**) v Commissioner of Inland Revenue (**CIR**).

We'll go further in this article, explaining why *Weson v CIR* has little relevance, and why SSD is not a legitimate tax with a proper purpose. We'll also look at the lesson in political reality from Singapore's 1996-97 experiment, and we propose a fairer, focused alternative, in the form of a withholding system for profits tax. This article forms our second written submission to LegCo on SSD.

Rights in the Basic Law are not absolute or unlimited. For example, we have the right of free speech, but that is limited by laws against incitement of violence or terrorism. You cannot stand up and urge people to kill someone or burn down his home. There is a strong public interest reason for that limitation. But when we impose limitations on constitutional rights, including financial penalties for exercising them, then there must be some clear and present public interest reason for doing so, and the limitations must be no more than is necessary to achieve the public interest objective. This is known as the test of proportionality, and it applies as much to targeted taxation as it does to other restrictions.

Weson v CIR

It is necessary to explain the details of that case for you to understand why it has so little relevance to SSD. If that's all the Government has got, then they are on very shaky ground. *Weson v CIR* was a case which went to the Court of Appeal. Weson had been assessed for profits tax on land it had purchased, developed and sold. If a person wishes to object or appeal to a tax, then the CIR can order that tax be "held over" (delayed) on condition that the taxpayer purchases the same amount of Tax Reserve Certificate (**TRC**) from the Government, which is interest-bearing if the appeal is successful. There is a good public interest reason for requiring this security for tax which is in dispute, otherwise persons may challenge their taxes just to delay the payment, and then eventually be unable to pay if they lose. Section 71(2) of the Inland Revenue Ordinance provides for that security.

Instead of buying a TRC, Weson failed to pay anything, and as deadlines passed, and an automatic surcharge of 5% was added, until eventually the tax was paid on its behalf, but without purchasing a TRC, as it could have done. Weson then successfully challenged the tax at the Inland Revenue Board of Review, which decided that the gain on sale of the land was a capital gain, not subject to profits tax. The CIR then refunded the tax, without interest. Initially Weson claimed from the CIR the interest that it "would have earned" on a TRC. The IRD rejected that. Then Weston sued on a different basis, claiming that Articles 6 and 105 of the Basic Law had been breached, because it had been deprived of the use of its capital (i.e. the tax paid and later refunded), without compensation. Weson lost in the Court of First Instance and the Court of Appeal.

We provide you with this level of detail to demonstrate how different the case is to the issue of SSD. This case was about profits tax, a fair, broad and well-accepted mechanism for raising Government revenue, and it was about the temporary, not permanent, deprivation of capital during the successful challenge, and the loss of income on that capital was avoidable by the purchase of a TRC.

By comparison, the proposed SSD would be a permanent deprivation of up to 15% of the value of a property, not based on the profit or loss, and not even based on the fact that it had been sold, but on the <u>timing</u> of the sale relative to the time at which it was purchased. SSD's stated purpose is to deter "speculative" behaviour by a financial penalty or cost. Raising revenue is not a purpose of SSD, and the Government has said so. The regular stamp duty, which has been around for over a century, has no regard to timing, and its purpose is to finance government expenditure, not to deter certain behaviour by means of a financial penalty.

Article 108 of the Basic Law (**BL 108**) covers taxation:

> "The Hong Kong Special Administrative Region shall practise an independent taxation system.

> The Hong Kong Special Administrative Region shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation."

...and Article 105 of the Basic Law (**BL 105**) covers the rights to acquire, own and dispose of property:

> "The Hong Kong Special Administrative Region shall, in accordance with law, protect the right of individuals and legal persons to the acquisition, use, disposal and inheritance of property and their right to compensation for lawful deprivation of their property."

Clearly, it would make no sense to classify legitimate taxes as a "deprivation of property" - otherwise the Government could never collect a dollar of revenue without handing it straight back in compensation. As Justice Rogers put it in the Court of Appeal Judgment: "Article 105...has no application to legitimate taxation" (emphasis added). We agree, so that bring us on to:

What is legitimate taxation?

For taxation to be legitimate and hence covered by BL 108 and excluded from BL 105, it must have a proper purpose and not be arbitrary or capricious. Taxation cannot be used as a tool to "control" society without good reason. We submit that this proper purpose must either be:

1. raising revenue for general government expenditure, in which case the tax must be broad, fair and not selective; or
2. deterring some form of behaviour which is materially and demonstrably damaging to society as a whole, in which case the tax must be focused on its target, with minimal collateral damage, and proportionate to the harm caused.

In the first category, we have profits tax and salaries tax, each of which taxes a portion of GDP. We also have government rates, which tax property on its rental value (or on the rent avoided if it is owner-occupied) and the original purpose of which was to pay for the police, street lighting, water and the fire brigade (there's an excellent history here). It is broad and fair, because it is very difficult to earn a salary or make a profit in HK without occupying homes and premises.

In the second category, the tax on cigarettes can be justified in terms of the additional public costs they impose in the form of healthcare and even in terms of lower lifetime productivity (and hence lower taxpaying) due to ill health and premature death. It is also focused - you only pay a tax on smoking if you buy cigarettes - there is no collateral damage. A tax on vehicle fuel can also be justified in terms of the cost of roads and the costs of air pollution (but we don't do that properly - we exempt franchised buses from diesel duty and charge far less tax on diesel than petrol). Again, it is focused: if you don't use your vehicle, then you won't use the roads or pollute the air, you won't consume fuel, and you won't pay any fuel duty.

Even the regular stamp duty on property transfers fulfils *some* of the first category criteria; its purpose is certainly to raise revenue, and it is quite broad, although it taxes transactions whether they generate a profit or loss, so in that sense it is unfair. Aside from these criteria, stamp duty is just bad policy - it is a frictional tax which impedes the efficient allocation of capital, and it is distortive for numerous reasons - you don't pay stamp duty on other real assets (antiques, jewellery, art), or on financial assets other than shares (warrants, futures, options, bonds), and you don't pay much stamp duty if you rent. Many countries don't have stamp duty (New Zealand, for example, abolished it in 1999). Property rates are much fairer.

So those are all legitimate taxes.

What is illegitimate taxation?

If a tax is very narrow in its scope, and intended to satisfy the whims, biases or prejudices of officials without any demonstrated public benefit, such a Dress Tax on bow ties, or a Smelly Fruit Tax on durians, then it would not have a legitimate purpose. There is no public harm caused by bow ties, and no health issue attached to durians that we know of - certainly not when consumed in moderation. Furthermore, if the tax impinges on a Basic Law right, the burden of proof of proper purpose is even higher - for example, a tax on Islamic headgear or the public display of crucifix jewellery would impinge on freedom of religion (Article 32), while a tax on internet publications such as this site would impinge on freedom of speech (Article 27). Those kinds of taxes would be much harder to justify.

Why SSD is not legitimate taxation

SSD certainly does not fall into category 1 - the Government has clearly said that the purpose is not to raise revenue (they have plenty already) but to "curb speculation" and "substantially increase the frictional costs of speculative activities". In other words, to modify behaviour. Unlike regular stamp duty, it isn't a broad tax on all property transfers, but one based purely on the timing of the sale relative to the time of purchase. And SSD impinges on a constitutional right, so the burden of proof of legitimacy is high.

So then, to justify SSD as a behaviour-modifying tax and fall within the protection of BL 108, rather than a deprivation of property in breach of BL 105, the Government must show that:

1. speculators (however defined) are causing some significant harm to society by their behaviour; and
2. SSD is a proportionate and not excessive response; and
3. SSD is focused and does not damage large numbers of people who could not by any stretch be called speculators.

The Government fails on the first and second counts. It has not produced any evidence that speculators cause harm to society, much less quantified that harm, so it cannot calibrate the penalty or deterrent. The burden of proof is on the Government - it is not for us to prove a negative, that speculators do not harm the public interest, but for the Government to prove that they do. In introducing the proposal, Financial Secretary John Tsang made unfounded claims that "unscrupulous speculators may take advantage of the heated market sentiments to lure people into buying beyond their means". Yet, banks have strict limits on loan-to-value ratios, which we support, and are required to stress-test borrowers to ensure that their income can support their mortgage when rates rise. So there are plenty of safeguards. For buyers who do not need to borrow, it can hardly be said that they are investing "beyond their means" - it's their money. And note that he referred to "unscrupulous speculators" - apparently accepting that there are scrupulous speculators who are not causing any harm to others and are merely risking their own capital.

The Financial Secretary also claimed that "short-term speculative activities... threaten our economic and financial stability". This is far-fetched. Again, no evidence has been proffered to support this view. It is a baseless claim. The HKMA has established clear and prudent lending limits, and even reined in the HK Mortgage Corporation to limit the amount it will guarantee. So SSD has nothing to do with ensuring the stability of the banking system.

The Government also fails on the third count, because it has proposed a law which lacks focus and captures far more people than just "unscrupulous speculators" or "short-term speculators". An accidental death or loss of employment of the breadwinner in a family, for example, after the couple has just bought a home, could result in being unable to pay the mortgage and forced to sell. They were not speculators. A new homeowner who sees prices falling and wants to trade up to a larger flat or get out and cut his losses is not a speculator. The Government has made no effort whatsoever to limit the collateral damage by, for example, exempting people who are selling their home.

Another set of unintended victims are the home-renovation industry: those who buy properties, renovate them, and sell them again, helping the urban renewal process, and providing a secondary-market alternative to buying first-hand homes off-plan from developers. These renovators even install nice kitchens, and you can see them before you buy. Are these traders really speculators, any more than a mechanic who buys a second-hand car, fixes it up and sells it again? They are certainly risk-takers, but since when has risk-taking been harmful to society? Aren't we supposed to encourage entrepreneurialism in HK?

Far from being harmful to society, speculators provide liquidity. They sell almost as much as they buy, so they don't affect the supply-demand balance as much as first-time buyers. Traders also play a part in the price-discovery process - those who study a market full-time are better informed and more likely to know when to buy or sell and what is a fair price in any set of market conditions, bubble or not. Take them away, and you are left with people who only buy or sell a few times in a lifetime. If the only participants in a stock market were uninformed investors, would that make a safer market for investment?

A fairer, focused alternative

If the Government really wants to distort the economy by favouring one kind of business over another, then it could impose a higher rate of profits tax on property traders (and even developers) than on other businesses. We'd call that stupid, but we wouldn't call it a breach of the Basic Law. It would also be complicated, because a company may conduct other business at a different tax rate, so the allocation of overhead costs and the off-setting of losses from other activities (or vice versa) would be complex. Keep it simple.

And if the Government is concerned about securing profits tax revenue from property vendors who may disappear (leave HK or liquidate) after selling, then it could create a withholding system - it could require anyone who sells within 2 years and makes a gross profit (based on the simple difference between purchase price (including stamp duty) and sale price) to buy a Tax Reserve Certificate before the transaction is registered at the land registry. There would be a rebuttable presumption that a short-term sale was trading for profit rather than capital gain. If the seller could prove that she was selling a capital asset for capital gain (as Weson did) then she would get her TRC refunded. Of course, those who sell at a loss would not be charged.

"But it doesn't affect me"

There's an element of populism in the SSD proposal. For many who can't afford property, it is seen as "targeting evil" in some way. For the one third of the population who live in public rental housing, it certainly won't affect them. It perhaps seems "unfair" that some people have made a lot of money speculating on property - it always seems fair when they lose it on the downside though. That's just human nature and envy. Because speculators are more evident during bubbles, they are blamed for "causing" them, without any foundation. Bubbles are caused by excess of demand over supply, and record-low interest rates increasing affordability of mortgages and driving money into assets for fear of inflation.

For people who owned property before 20-Nov-2010, it won't affect them. For those who bought on or after 20-Nov-2010, many may feel confident that they won't need to sell in the next 2 years. And let's put our cards on the table - your editor David M Webb has only ever bought one property in HK, in 2006, which he still owns and lives in. So it won't affect him. But that doesn't make it right.

If the Government sets a precedent by enacting this law, it will be emboldened to intervene again and again, not just in the property sector, but elsewhere. Slowly but surely, the free-market foundations on which Hong Kong rests are crumbling. Don't forget that this is the same Government which waded into the stock market and bought up 15% of the free float of the Hang Seng Index in 1998. Throughout the Global Financial Crisis of 2008-2009, not a single government did that. Sure, they nationalised failing banks, but they didn't try to push up the entire stock market with taxpayers' money. The US Treasury didn't go out and buy the S&P500. The UK Government didn't buy the FTSE-100.

If the Government considers speculation as evil rather than entrepreneurial, then they may consider similar measures the next time our stock market bubbles up again, as it did in 2007. They might consider that investors should be "delivered from temptation" of speculation by imposing a 15% stamp duty on any sale of shares within 6 months. Would that be fair and constitutional? Not in our view, but it isn't so far-fetched. The other day, Ceajer Chan Ka Keung, Secretary for Financial Services, told the media that "the imposition of stamp duties curbs over-speculative activities because it costs punters" and that we don't want "the short-term buy and sell caused by high-frequency trading". He was talking about much shorter holding periods, but the perspective is chilling. When a government seeks to control and manipulate risk-taking activity through taxation, it is heading directly away from the fundamentals of economic activity.

A lesson from Singapore

Singapore has something of a reputation for state-controlled capitalism and intervention, and unlike HK's Basic Law, the Singapore Constitution does not actually contain a right to acquire, own or dispose of private property (including real estate). In 1996, near the height of the property bubble before the Asian financial crisis, Singapore imposed a "Seller's Stamp Duty" (at least they were honest about who pays it) on short-term resales in addition to the regular stamp duty. The Asian financial crisis started in Thailand on 2-Jul-1997. As soon as the bubble burst, in November 1997, the Singapore Government suspended the Seller's Stamp Duty indefinitely and it was later repealed in the 2003 budget.

But old habits die hard. On 19-Feb-2010, Singapore resurrected SSD, again at the same rate as regular stamp duty, up to 3% for resales within 1 year of purchase. Then on 30-Aug-2010 they extended it to 3 years, but with 2/3 of the rate in the second year (i.e. up to 2%) and one-third in the third year (up to 1%).

However, perhaps they felt that their interventionist crown was being stolen by HK when it went proposed 15% SSD on 19-Nov-2010, so now Singapore has gone one-up, by announcing on 13-Jan-2011 that Seller's Stamp Duty would be extended to 4 years and the rate raised from 3% to 16% for resales in the first year, declining to 12%, 8% and 4% for resales in years 2, 3 and 4 after purchase. Anything we can do, they can do more of.

The political reality though, is that SSD will not deter speculative activity much. If the market keeps on going up, then speculators don't mind holding the property, and the moment the bubble starts bursting, they know that, like Singapore did in Nov-1997, the HK Government will have to scrap the tax or it will hit far too many non-speculators, even if a victim hasn't already challenged the HK law as unconstitutional.