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To: <bc_02_10@legco.gov.hk>
From: "David M Webb"
Date: 12/14/2010 04:11PM
Subject: Submission to the Bills Committee on Stamp Duty (Amendment) (No. 2) Bill 2010

To the Bills Committee on Stamp Duty (Amendment) (No. 2) Bill 2010

Dear Members,

I believe that the proposed "Special Stamp Duty" (**SSD**) is misguided and misconceived. As the Government noted in its own response to the Council regarding a near-identical proposal from legislators in June:

> "The proposal is unfair to those who have genuine needs to sell their properties within the specified period of time, and will cause additional hardship to those in financial difficulties. In fact, not all property transactions generate profits. Those gaining profits from property speculation are already subject to profits tax. The additional stamp duty will be considered as a kind of double taxation."

Nothing in the fundamentals of law, economics or fairness has changed since June. If Legislators approve it now, they will be voting for the consequences outlined above, and in addition, running the risk of a judicial review on the grounds of constitutionality of this law. Despite the joint-and-several legal liability for payment, the economic impact of the SSD will fall on the seller, because a buyer can instead choose an equivalent property which has been held for more than 2 years. So the short-term seller must absorb the cost of SSD by lowering his price relative to similar properties.

So the SSD proposal amounts to a partial confiscation of the value of property for anyone who sells within 2 years. Article 105 of the Basic Law promises persons the right to acquire or dispose of property (including real estate) and implicitly that must mean without penalty. If SSD was set at 400%, the seller would have to cut his asking price to 20% of similar properties which had been held for more than 2 years and give the other 80% to the Government. The confiscation would be near-total. Any amount of confiscation is unacceptable. The SSD's objective is a punitive and deterrent measure against acquiring and disposing of property within a certain timeframe, not as a form of taxation, and certainly not a fair one. The profits tax regime already taxes those who are trading in properties, if they make a profit.

I attach a detailed briefing on why SSD is such a bad idea, giving examples of the unintended consequential victims. Please consider this e-mail and the attachment as my submission.

Regards

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Government criticises Stamp Duty proposal

26th November 2010

Yes, you read that right. Just five months ago, the Government told the Legislative Council why the Special Stamp Duty (**SSD**) which it proposed last Friday would be unfair, would cause additional hardship to those in financial difficulties, and would amount to double taxation. Nothing in the fundamentals of law and economics has changed since June when LegCo was debating an amendment to the Stamp Duty Ordinance to install the new 4.25% rate on transactions over $20m.

During the debate, legislators had asked whether an additional stamp duty could be introduced on short-term resales by "confirmors". A confirmor is someone who has agreed to buy a property and subsequently sells it to a second buyer before completing the purchase, the second transaction being known as a "sub-sale". Both transactions are already subject to stamp duty at the standard rates.

The Government's Secretary for Transport and Housing responded to LegCo in a letter dated 7-Jun-2010 (p5) as follows:

> "The proposal is unfair to those who have genuine needs to sell their properties within the specified period of time, and will cause additional hardship to those in financial difficulties. In fact, not all property transactions generate profits. Those gaining profits from property speculation are already subject to profits tax. The additional stamp duty will be considered as a kind of double taxation."

We agree entirely with those points. The letter also detailed how the Inland Revenue Department is already assessing profits tax on those individuals and companies which it believes are running a business of property trading, rather than investing in capital assets for capital gains.

So that should have been the end of it, but 5 months later, the Government seems to have ignored its own criticisms of the legislators' proposal, and is going ahead with it. Dr Jekyll, meet Mr Hyde.

Background

Last Friday, 19-Nov-2010, the HK Government announced a proposal, subject to legislation, to impose a "Special Stamp Duty" on properties acquired after that date sold within 2 years, as follows:

- 15% if the property is resold within 6 months
- 10% if the property is resold after 6 months but within 1 year;
- 5% if the property is resold after 1 year but within 2 years.

This is on top of regular stamp duty, which remains as follows:

From HK$	Stamp duty	Effective rate
$0	100	NA
2,000,000	$100+10% of excess	0.005%-1.50%
2,531,760	1.5%	1.5%
3,000,000	$45k+10% of excess	1.5%-2.25%
3,290,320	2.25%	2.25%
4,000,000	$90k+10% of excess	2.25%-3.00%
$4,428,570	3.00%	3.00%
$6,000,000	$180k+10% of excess	3.00%-3.75%
$6,720,000	3.75%	3.75%
$20,000,000	$750k+10% of excess	3.75%-4.25%
$21,739,120	4.25%	4.25%

Who would pay?

As with existing stamp duty, the obligation to pay SSD would fall "jointly and severally" on the buyer and seller. The land registry won't register the transaction unless someone has paid the stamp duty. However, in practice, prices are struck excluding stamp duty, which is then paid by the buyer, for the simple reason that it is cheaper than paying "stamp on the stamp". For example, if a home trades for $10m plus 3.75% stamp, the buyer pays a total of $10,375,000, which is cheaper than setting the price at $10,389,610 and having the seller pay $389,610 in stamp (at 3.75%) to get the same net proceeds of $10m.

So one complication of SSD is that a buyer has no immediate way to tell which homes are what we will call "short-term sales" (within 2 years), and which ones are long-term sales, not subject to the SSD. The date of the last transaction can be checked at the Land Registry, but that takes time, so buyers would have to be very careful not to sign provisional sale and purchase agreements without knowing how much to deduct from the price to allow for the SSD. For example, if our $10m home is being resold within 6 months, then the buyer will only be willing to pay $10.375m in total, so he will need to set the price at $8.737m, so that when he pays the total 18.75% stamp duty, the total will come to $10.375m. The seller is worse off by $1.263m, or 12.63%, than if he had owned the home for 2 years.

And that really underlines that this move will have no effect on home prices. A home is only worth a certain amount to a buyer, including transaction costs, and there will be plenty of similar homes on the market which have been held for more than 2 years. So any excess stamp duty comes out of the seller's pocket and into the Government's over-flowing coffers.

Proposal may contravene the Basic Law

As we detailed in our article of 2-Mar-2010, "HK's stamp duty addiction", stamp duty is a frictional tax, not based on GDP or profits, but simply on the movement of assets. It throws sand in the wheels of the economy, reduces turnover, and distorts the choice between renting and buying. Levying stamp duty at rates of up to 19.25%, as proposed, is not just frictional but is, to any reasonable person, confiscatory. The Government is basically saying to any purchaser of a home: if you sell it within 2 years, then part of it is ours. It is against the spirit of Article 105 of the Basic Law, which says:

> "The [HKSAR] shall, in accordance with law, protect the right of individuals and legal persons to the **acquisition**, use, **disposal** and inheritance of property..."

Surely it is implicit in any constitutional right that the exercise of that right should not carry a penalty. Your right to disposal is being restricted if there is a penalty for disposing of a property within the first 2 years of ownership. It cannot be argued that this is a legitimate form of taxation when it bears no relation to profit or loss, and when those who are trading for profit are already subject to profits tax. It is a punitive, irrational move against those who have put their money at risk by buying property. The sole purpose is to deter people from exercising their rights of disposal within 2 years, and to penalise them if they do.

Think about it: what if the SSD was 100%? That would force someone who needs to sell to cut his price to about 50% of the price of similar properties (held for more than 2 years), to absorb the SSD. How about 400%? Then he would have to cut his price to 20% of similar properties, and give the other 80% to the Government. So what makes it OK to take away 15% of your property on disposal?

Deceptive statistics

You might think, from the way the Government is screaming about speculators, that a large portion of properties are resold within 2 years. That's simply untrue. The Government's announcement stated that the number of resales within 24 months increased by 32% in the first 9 months of 2010, but did not give absolute figures. This is misleading and deceptive by omission of the raw numbers and by failure to compare them with the total number of transactions. But there is an evidence trail out there which exposes the deception. According to another letter to LegCo dated 25-May-2010 (p5), again from the Secretary for Transport and Housing:

> "Take 2009 as an example, over 90% of the property transactions valued more than $20 million did not involve resale within two years of purchase."

So the number of resales within 2 years above $20m was less than 10% of all transactions above $20m in all of 2009. The resale figures for transactions below $6.72m might be a bit higher, due to lower stamp duty rates below that price, but not by much. Another factor affects the Government's claim: the Government referred to the *number* of transactions, not the *proportion* of transactions. In the first 9 months of 2010, there were 103,709 residential sale and purchase agreements, 18.6% higher than the 87,471 in the same period of 2009, which included the global financial crisis. So if the *number* of those which were short-term sales has increased by 32%, then the *proportion* has only increased by about 11.3% (being 1.32/1.186-1). In other words, most of the increase was because the market was busier generally.

So that ballyhooed 32% figure probably just means that the proportion of resales above $20m has gone up from about 10% of transactions to about 11.1% of transactions, and that 89% of properties sold over $20m were owned by the same persons 2 years earlier, possibly including developers. Again, the figures for lower-value transactions, might be higher because of lower stamp rates, but not by much. Lets say 15% of all transactions at most are resales within 2 years.

That same Government letter to LegCo also contained a table (p2) of confirmor cases as a percentage of all transactions in each of the years from 2007 to 2009. In 2009, this ranged from 3.79% for transactions below \$3m to 1.92% for transactions above \$20m. Given the friction of stamp duty, it is not surprising that the percentage of resales is lower for properties with higher rates of stamp duty. In order to avoid a loss, the market value must increase enough to cover the transaction costs - so a property acquired for \$10m plus stamp must resell for \$10.375m plus legal fees, agency commissions and fees associated with any mortgage.

It is also unsurprising that after a run-up in prices, the volume of resales within 2 years increases. That doesn't mean that every one of those sellers was a "speculator", whatever that now-pejorative term means. It may simply mean that a home-owner now thinks we are in a property bubble and has an excessive amount of his net worth tied up in his home. He wants to get out and rent, or down-size, until the bubble bursts. Nobody should penalise him for that. Or it may mean that a first-time buyer has built up enough equity to put down a deposit on a larger flat for her growing family.

The Government's announcement also included an even more alarmist figure: the number of resales within 12 months in the first 9 months of 2010 "surged by an even more rapid 114%". Obviously sales within 12 months are a subset of sales within 24 months, so they can't have been more than 10% of transactions above \$20m in 2009, and probably much less. Similarly for cheaper homes, the proportion won't be much higher. Now, keep in mind that the figure for resales within 12 months in 2009 would be distorted by the low volume in the last few months of 2008 and the first few months of 2009, due to the global financial crisis, so it is not surprising that the *number* of resales in 2010 is much higher.

Similarly, the number of resales between 1 year and 2 years actually fell by 18% in the first 9 months of 2010. Of course. Same reason - not many flats changed hands during the financial crisis (Lehman collapsed in Sep-2008) so not many of those are now being resold. By comparison, volume in 2007 (and consequently 1-2-year resales in 2009) was higher. But the Financial Secretary leaps to the illogical conclusion that this indicates a "shift in speculative activities to a shorter horizon". It doesn't - it just indicates that the market was quiet during the financial crisis.

There's one final statistic in the Government's announcement: 84% of the short-term resales within 12 months in the first half of 2010 (why not take the 9 months - does this not suit the Government's argument?) were transactions below \$3m. Yes, but again, how many is that, exactly? What proportion of total sales under \$3m is it? Probably less than 10%.

What we can tell you is that in the whole market there were 65,629 sales in the first half of 2010, of which 41,669 sales were below \$3m, so 64% of all homes purchased were below \$3m. Given that stamp duty is a token \$100 up to \$2m and a relatively low 1.5% at \$3m, it is not surprising that turnover is higher among such homes. They are simply more investable, and there are more of them in the housing stock. Plus, it is only natural that most people try to trade up from smaller homes rather than down from larger ones as their income increases, or they get married or start a family. Smaller, starter homes have a naturally shorter holding period.

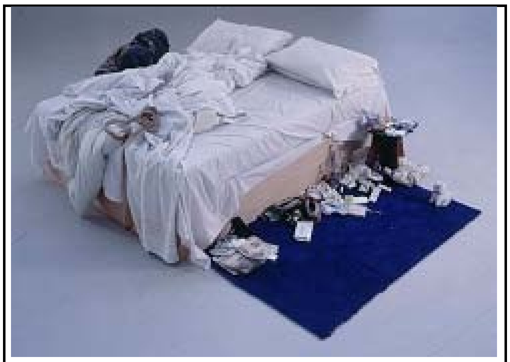
So who would it affect?

What the Government is proposing is the economic equivalent of bottom trawling in fishing. In its indiscriminate fishing net, apart from catching short-term investors, or what the Government now calls "speculators", the SSD would also catch homeowners who either wish to sell or are forced to sell, for whatever reason, for example:

- An owner who loses her job, and cannot pay the mortgage, may need to sell within 2 years of purchase
- A buyer who loses his job, and cannot get a mortgage to complete a home purchase, may need to sub-sell the property
- An owner who sees the market falling may wish to sell before the home drops into negative equity. If he has recently bought it, the Government will take away 15% of it, wiping out more of his equity. If he put down a deposit of 30% (the standard under mortgage rules) then the SSD will take half of that away from him. If he bought a guarantee from the mortgage corporation and only put down a 10% deposit (the minimum), then a 15% SSD hit will be 150% of his equity.
- Given the bubble, some people might buy a small starter home to get onto the ladder, and plan to trade up to a larger home when the bubble bursts. Now, they can't sell the starter home without punitive taxes, so they won't be able to trade up.

The IRD web site has an FAQ list which includes exemptions (Q11) for bankruptcy or involuntary winding-up, but not for foreclosure, nor does it cover voluntary sales by people in financial difficulties who are trying to *avoid* bankruptcy.

So when the bubble bursts, when the economy declines, and when people start losing their jobs, large numbers of recent homebuyers are either going to be charged punitive rates of stamp duty, making their losses much greater, or will be trapped in their homes, forced to wait at least 2 years and watch their losses mount. Politically, the Government would then be in a tight spot - having pushed the proposal into law, it would need to pass legislation to undo it again, with all the loss of face that entails.


Owner-occupied?

The proposed law is not retro-active, so it will only affect purchases made after 19-Nov-2010. That means that existing short-term owners will remain free to sell without punishment for doing so.

Of course, some legislators might think that the proposal could be modified to apply only to non-owner-occupied homes - but then that introduces a whole new bureaucratic problem of verifying whether or not the owner (or his close relative) is living in the property. At the least, a couple who buy two homes jointly could each designate one of them as their residence and fling a bit of dirty underwear on a bed to prove a point. Call it a trial separation. And maybe get a couple of flats for your adult children to live in too, and one for each set of grandparents. So trying to penalise investors at the same time as exempting owner-occupiers is fraught with difficulties, which is why the government hasn't suggested it.

Giving speculation a bad name

The Government seems to have adopted the word "speculator" as a pejorative term. This rather overlooks the fact that HK's success is built on the foundations of a free market, and anyone running a business is speculating on the value of his products or services. He buys raw materials, not certain of what his products will be worth, or he rents premises, not knowing whether he will generate enough revenue to pay the rent. He books a pop star for a concert, not knowing whether he will sell enough tickets. Not only is there nothing wrong with speculation, but nobody could run a business without it, and our economy would not function without it. It is just a fancy term for risk-taking, but the Government has apparently decided that "anyone minded to make quick profits" is evil. So tell that to the fishmonger who flips his fish for a quick profit.

As the Government noted in June, those who trade properties as a business will be subject to profits tax like any other business. There is no justification to charge them more than any other business, the standard rate of 16.5%, or 15% if they are unincorporated.

Financial Secretary John Tsang even claimed "unscrupulous speculators may take advantage of the heated market sentiments to lure people into buying beyond their means". How, exactly? It takes a willing buyer to buy a flat, and if they are borrowing from a bank, it takes a willing bank, with all the supervision of the HKMA, to lend the money. Rising markets attract speculators, but nobody has to be a speculator if they don't want to. Given their relatively small percentage of market volume, speculators are not causing the bubble, they are just a symptom of it.

Reducing liquidity, losing jobs in the sector

The SSD will not affect prices, but it will have a negative impact on liquidity. Imagine what the effect would be if we told investors in the stock market that if they sell within 2 years, then we will hit them with up to 15% stamp duty. A lot of stockbrokers would be looking for a job. The derivative warrant market would vanish. And with reduced liquidity in the property market, there will be less work for estate agents, conveyancing lawyers, and the related jobs in advertising that are linked to the volume of the secondary property market. Less work, fewer jobs.

Increased incentive for legal avoidance

The higher the tax on something, the greater the incentive to legally avoid it. Stamp duty really is a tax on the middle classes. Below $2m, you pay only $100. Above $100m, and properties are almost invariably owned by companies, incorporated in HK or overseas. If the owner is incorporated in HK and changes hands, then the stamp duty is 0.2%. If the owner is incorporated overseas in a place which does not have stamp duty (many places don't), or is itself owned by an offshore company, then you can just sell the offshore company and pay no stamp duty at all. The vendor might also be an offshore company, so that the HK person doesn't even take part in the transaction.

We explained this in more detail, with examples, in our previous article on stamp duty. We also explained several other reasons why people would incorporate their properties in our article on the Conduit Road controversy.

If SSD goes ahead, then expect more flats to be held by offshore companies. It makes sense to do this whether you are an investor or an owner-occupier, so that the home can be resold within 2 years without penalty. It also puts traders outside the scope of profits tax, since any gains made from selling the offshore company would be sourced offshore - in that sense it's no different to a HK person selling shares on the New York Stock Exchange.

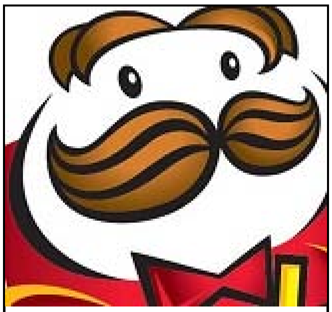
If the Government tells you that sales of companies which own property are currently rare, then they are bluffing, because they have no way of knowing how often it happens. What happens offshore, stays offshore. The only reason a buyer might prefer to buy the property rather than the company which owns it is to avoid hidden liabilities - but if the vendor is willing to give a guarantee, and a discount to avoid a much larger stamp duty, then the buyer might choose to buy the company. Also, companies can be maintained by reputable law firms using nominee directors, reducing the risk of any undisclosed liabilities, because the company will have a clean history. Rather like storing your vintage wine in a reputable wine vault.

The honest advice

What the Government should be saying to the public is this:

> "We think we are in a bubble. It's not something we can control, but we are increasing land supply to meet demand. That will take time to flow through. We are worried that you are going to get burnt. Don't buy property unless you are willing to take the risk. But we are not stopping you, and we are not going to make things worse if you lose money by slapping you with a "told you so" punitive stamp duty, nor are we going to tax you at a higher rate than any other business if you are trading for profit. Instead, we are going to recognise that stamp duty is an unfair imposition on economic activity, and abolish it. It's not like we need the money, and if we do in future, we'll tax profits and salaries based on their share of GDP."

In fact, different branches of Government are stating different views on the market level. Financial Secretary John Tsang, in his remarks, said that SSD is to "reduce the risk of asset bubbles forming", whereas the HK Monetary Authority, Norman Chan, said that newly-reduced loan-to-value limits were "to dampen the damage that would be inflicted by the bursting of the asset bubble". Yes, he said the asset bubble, the definite article, not just one that might emerge. John and Norman can't even get their line-to-take straight.


"Bubble, what bubble?"

Incidentally, Webb-site supports the announced higher equity requirements, the purpose of which is to protect the banking system and reduce the risk of it ever needing a taxpayer-funded bailout. Some things we do right in HK. We know that with a linked exchange rate, all the pressure from capital flows gets absorbed in asset prices, making them more volatile.

All that the HKMA is basically saying is that you can't borrow more money this year than you could last year against the same property, and because its value has gone up, the loan-to-value ratio must be lower. Unless, of course, you get a guarantee from the Mortgage Corporation, Hong Kong's own little state-backed interventionist Fannie or Freddie, in which case you can borrow 90% up to $6.12m. The HKMC is getting nervous too - the loan limit was reduced to $12m on 23-Oct-2009, then reduced to $7.2m on 13-Aug-2010, and now reduced to $6.12m on 19-Nov-2010.

No sunset clause

The Government claims the SSD is needed as an "extraordinary measure under exceptional circumstances". But if that is the case, then these exceptional circumstances should eventually disappear and so should SSD. However, if the SSD is intended to be temporary, then the Government isn't saying so. It is proposing to put this into a permanent law, the Stamp Duty Ordinance. Legislators, even the most populist and misguided ones who seem to think the SSD is a good idea, despite what they were told in June, should now be asking themselves why there is no expiry date on the SSD.

Including a sunset date of say 30-Jun-2012 (the end of Donald Tsang's administration) would at least allow the new Chief Executive not to be burdened by the mistakes of the old, and would allow the SSD to lapse into history unless it is extended. By then, the people of HK will have realised how stupid the idea was in the first place, as the Government admitted in its letter quoted at the beginning of this article.

Legislators shouldn't be supporting this proposal in the first place - exceptional times do not call for irrational measures, particularly ones which might breach the Basic Law and create so many unintended victims.