BY FAX AND BY E-MAIL
(2530 5921 / edr@fstb.gov.hk)

Our Ref.: C/TXG, M30586 20 October 2004

Principal Assistant Secretary for the Treasury (Revenue)
Treasury Branch,
Financial Services and the Treasury Bureau,
4th Floor, Central Government Offices,
Main Wing, Lower Albert Road,
Hong Kong.

Dear Sir,

Estate Duty Review Consultation Document

--- Please find attached the Hong Kong Institute of Certified Public Accountants' submission on the Estate Duty Review Consultation Document.

I hope that you will find our comments to be constructive. If you have any questions on our submission, please feel free to contact me on 2287 7084 or at peter@hkicpa.org.hk.

Yours faithfully,

Peter Tisman

PETER TISMAN
TECHNICAL DIRECTOR
(BUSINESS MEMBERS & SPECIALIST PRACTICES)

PMT/JT/ay
Encl.

Response from the Hong Kong Institute of Certified Public Accountants

Estate Duty Review Consultation Document

A. Summary of position

1. The Hong Kong Institute of Certified Public Accountants (HKICPA) advocates the abolition of estate duty. We have indicated in a number of our past budget submissions to the Financial Secretary that there are problems and inequities within the estate duty regime and we have come to the conclusion, taking all the relevant factors into consideration, that the best option would be to abolish it altogether.

2. Abolition could be carried out in one go, which we would favour, or in two to three stages. Were estate duty to be abolished in stages, complexities would be added during the transitional stage if, for example, exemptions were to be given on the basis of asset type or on the basis of non-domicile/non-residency. Nevertheless, if it was decided to phase out estate duty, we consider that the introduction of exemptions on bank accounts and listed securities during the transitional period, would benefit Hong Kong as an international financial centre. We also note that another option, which is not raised in the consultation document, would be to reduce the rates of estate duty in stages prior to total abolition, rather than, or in conjunction, with giving exemptions.

3. If abolition were to be carried out in stages, a clear timetable for final abolition should be given.

B. Detailed comments

4. We acknowledge that there are not only arguments against the retention of estate duty in Hong Kong. There are also arguments that would support its retention. Amongst the arguments for and against estate duty are the following:

For

(a) It provides a continuing source of revenue.
(b) The maintenance of any source of revenue is important, particularly in view of the fact that public expenditure has been exceeding revenue and there is evidence of a structural deficit.
(c) The Inland Revenue Department (IRD)'s figures suggest that estate duty has a relatively low cost of collection, i.e., it is a fairly efficient form of taxation.
(d) It has been suggested that it provides the IRD with the opportunity for a "final check" on tax compliance.
(e) In principle it is a fair tax as it is based on ability to pay.
(f) It provides employment in the financial services sector for specialists working in the field.

Against

(a) The revenue yield derived from estate duty has been consistently low and borne by a small group of taxpayers.
(b) As the only significant direct tax on capital in Hong Kong, it is an anomaly.
(c) In practice it does not catch the "super rich" but more usually those with moderate levels of wealth, which may have arisen from inflation in the value

of a single asset (e.g. immovable property). This is one reason why the tax in Hong Kong is described as an unfair tax.

(d) It can result in hardship for surviving relatives.

(e) It encourages the (re-)location of "Hong Kong" assets to offshore jurisdictions.

(f) It acts as a disincentive to the further development of Hong Kong as a financial centre and a "one-stop shop" for a comprehensive range of financial services and it inhibits inflows of capital from wealthy private individuals.

(g) The maintenance of estate duty runs counter to a growing international trend.

5. Some of the above points merit a more detailed consideration and are discussed below in the context of responding to the questions posed in the consultation paper.

(I) Whether the current estate duty regime should be retained?

Question (a)

6. We do not believe that the present regime should be retained. Although estate duty produces a stable source of revenue, the yield is low and not sufficient to justify its retention on this basis alone, given other problems with the regime. It is relatively easy to circumvent legally and the process of circumvention encourages the (re-)location of assets outside of Hong Kong and discourages capital inflows and the further development of private wealth management in Hong Kong. In practice, it has a very narrow base and does not effectively target and tax the wealthiest sector of the community, which was its purported aim when it was first introduced.

7. One option would be to rationalise the regime, make it more broad-based, close loopholes and address the various inequities and deficiencies in the regime. However, the HKICPA believes that this would be a major task, which could necessitate changing fundamental elements of Hong Kong's tax regime (e.g. departing from source as the basis of taxation) and that, given the mobility of capital in and out of Hong Kong and ease of movement of the wealthier sector of the community, it could be counter-productive. We also believe that this would be a retrograde step given the apparent trend away from reliance on estate duty and inheritance taxes internationally.

Question (b)

8. We do not think the regime should be retained.

Question (c)

9. Estate duty is a relevant factor in determining the amount of investment and capital flowing into Hong Kong. While there are many other important factors, such as the rate of investment return, general investment climate, the rule of law, political stability, proximity to the Mainland market, liquidity of markets, etc., the current estate duty regime encourages Hong Kong residents to locate assets outside of Hong Kong, and given that there are markets in the region that do not levy similar forms of taxes, or which base their taxes on the residency/domicile of the prospective tax payer, there are various other options available. It also discourages non-residents from locating assets in Hong Kong or retaining them here in the long term.

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

<u>Question (d)</u>

10. We would not support the concept of exemptions being given on the basis of non-Hong Kong residency or domicile. This would represent a fundamental change to the nature of Hong Kong's tax regime, even if the concept of residency/domicile were to be introduced alongside the source principle of taxation, and were such a change to be considered, it should be done in the context of the tax regime as a whole and not on an ad hoc basis.

<u>Question (e)</u>

11. See response to question (d) above. We also agree with the assessment in paragraph 22 of the consultation document that rules for determining residency/domicile can be difficult and complex. Exemption from estate duty in Hong Kong based on such criteria would introduce unnecessary complexity into the system.

<u>Question (f)</u>

12. While providing exemptions on this basis would attract more capital and investment from non-Hong Kong-domiciled/resident persons, the amount would be difficult to quantify. As indicated above, given the complexities of this approach, we doubt whether there would be general support for it.

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

<u>Question (g)</u>

13. We believe the estate duty should be abolished immediately in one go (see arguments in paragraphs 19 to 29). However, if the government decides to proceed with a phased abolition, introducing exemptions on the basis of asset types would be a reasonable option. As encouragement for the further development of Hong Kong's role as an international financial centre during the transition period of a phased abolition, we would agree that bank accounts and listed securities would be prime candidates for exemption.

14. Listed securities are a major target of investment, as Hong Kong has one of the largest and most actively traded markets in the region. It is also the principal "overseas" market for the listing of Mainland enterprises and when Mainland individual and corporate investors are able to invest more freely in overseas markets, Hong Kong is likely to be one of the main beneficiaries. Under the circumstances, exempting listed securities would add to the appeal of the Hong Kong stock markets and attract more funds here.

15. The above process would also encourage the development of the private banking and wealth management industries, which would be further enhanced by the exemption of bank accounts from estate duty. Studies have shown that, for example, the fund management industry tends to congregate where there is a critical mass of other financial service providers. The further development of private asset management would improve Hong Kong's capacity to provide a

comprehensive range of financial services and thus strengthen a sector that is one of the key drivers of Hong Kong's economy.

Question (h)

16. Exemptions for specific assets could theoretically lead to a flight of funds from other non-exempt asset types (e.g. immovable property), which could make the markets for those assets more volatile. Anti-avoidance provisions might need to be considered to discourage transfers in and out of certain types of assets simply to avoid estate duty. At the same time, it is noted that this would complicate the tax regime and, in the case of immovable property registered under individual names in Hong Kong, this is generally held for self use and it is doubtful, therefore, whether many transactions would occur for estate duty purposes. In any event, we reiterate that if exemptions were to be given for certain assets this should be as part of a phased abolition of estate duty with a definite time line for complete abolition.

17. Exemptions for listed securities and bank accounts would also significantly reduce the revenue yield from estate duty. In 2001/02 and 2002/03, bank deposits and listed securities together amounted to 44.7% and 38.5% of the composition of estates liable to estate duty (source: IRD annual report). If unlisted securities were to be added, the figures would increase to 63.1% and 67.6% respectively. With significantly reduced yields, estate duty could become a very inefficient form of taxation, unless the costs of collection could also be significantly reduced.

Question (i)

18. See response to question (g). There would be growth in employment in sectors such as private banking and fund management, which could be expected to more than compensate for any loss of employment in the estate planning and trust sectors. During the transitional phase towards abolition, there would, in any case, still be a demand for estate duty specialists. In the long run, advisers on trust structures could still be in demand because of the diversified objectives in setting up trusts.

(IV) Whether estate duty should be abolished?

Question (j)

19. The HKICPA considers that the argument for the retention of the estate duty regime are not as convincing as those against and, therefore, we support the abolition of estate duty. Estate duty is arguably one of the more glaring intrusions into the sanctity of private property rights and it needs to be justified on strong grounds.

Revenue Yield

20. The average revenue yield over the period 1999-2004 has been just over HK$1.5 billion per annum, representing an average of only 0.7% of total government revenue each year. As such, it is one of the lowest yielding taxes. In aggregate, for example, it amounts to only around 50% of the income generated from motor vehicle taxes. It produces a similar level of revenue to the amount that could be expected to be raised from a land and sea departure tax, at the levels previously proposed for that tax.

21. It is clear, therefore, that the amount of revenue raised is not a compelling argument for retaining estate duty, particularly if there are other sound reasons to consider abolishing it. Furthermore, we believe that abolition would attract more investment to Hong Kong and this in turn would ultimately result in other forms of revenue for the government (e.g., stamp duty on immovable property and securities transactions)

Deficit in public finances

22. Similar arguments apply to the suggestion that estate duty should be retained because of the fiscal deficits. Given the limited contribution of estate duty to total government revenue, the fact that there has been a deficit in public finances for the past few years is not a strong reason for retaining the tax. Furthermore, the government's Task Force on the Review of Public Finances came to the conclusion that the deficits are partly structural in nature. In order to deal with the structural shortfalls in revenue, it is necessary to identify sources of revenue that are broad-based and comparatively unaffected by changes in the general economic climate. Estate duty does not fit the bill.

Final check on compliance?

23. The suggestion, sometimes made, although not articulated in the consultation document, that estate duty provides a final opportunity to check a deceased's past compliance with his/her tax obligations is not a good argument. Other means, which do not involve levying additional taxes, could be used to fulfil the same purpose, e.g., requiring notification to the IRD as part of the process of obtaining probate or letters of administration.

Is estate duty a fair tax?

24. In principle, it could be argued, estate duty is not unfair because it falls upon those most able to pay it. It practice, however, the "super rich" are generally able to avoid it, quite legitimately, by setting up trust arrangements and ensuring that assets are not in Hong Kong and so not subject to the source-based regime that applies in Hong Kong. The numbers speak for themselves. Between 1999-2003, the average number of new cases examined per annum was 14,460. The number of dutiable cases, however, averaged only 318. The number of dutiable cases actually dropped steadily over the same period - from 354 in 1999/2000 to 298 in 2002/03. Relatively few of the very wealthy, therefore, are caught by the tax. Furthermore, the figures also show that over 60% of the dutiable cases were assessed at HK$2.5 million or less, which represents, in each of those cases, a total dutiable estate of less than HK$17 million. Such persons cannot be regarded as the "super rich" and, in practice, the bulk of the taxpayer's estate could, quite possibly, be made up of a single property. This may even be the principal family residence, as relief in respect of the matrimonial home applies only where ownership passes to the surviving spouse.

25. While clearly those assessed for estate duty are not impoverished, they are, as suggested above, few in number and, generally, not the wealthiest members of the community. The tax does not fall equally upon the very wealthy and it is fairly clear that the purpose for which it was introduced in 1915, that is, "to enable the whole community to benefit upon the death of persons who had grown very rich partly through the appreciation of assets and the progress of Hong Kong to which the whole community contributed" (consultation paper, paragraph 1), is no longer applicable, if it ever was.

26. The consultation paper notes that, in 2002/03, two estate duty cases involved assets worth over HK$1 billion. This statistic is used to reinforce the statement that “those who were charged estate duty clearly belong to the better-off segment of our society” (consultation document, paragraph 16). Without the availability of comparative figures for other years, it is difficult to put this reference to two very large estates in any meaningful context. However, the figures point to another anomaly, that is, that in 2002/03, two individuals seem to have contributed at least 20%-25% of all the estate duty revenue, which in total that year amounted to only HK$1.4 billion. This in itself casts doubt on the purpose, the usefulness and the fairness of estate duty in Hong Kong, which, as the figures suggest, must, in practice, have one of the narrowest bases of any type of taxation.

27. It should also be noted that estate duty is not a form of capital gains tax but a tax on capital. It could quite easily be the case, therefore, that, in order to pay the duty, the survivors of the deceased are obliged to sell securities, immovable and movable property at prices that represent a loss, rather than a gain, on the deceased’s original investment. They might also have to sell in a falling market. One of the inequitable elements of the estate duty regime is the fact that interest, at the rate of 4%, starts to accrue at the date of death. So while the survivors may be distraught and grieving the death of loved one, they will at the same time have to face an estate duty bill that is increasing daily.

28. Another objectionable aspect of estate duty is that it may entail taxation of assets, including bank deposits, which may already have been subject to taxation (e.g., in the form of income taxes on profits or salaries income, property tax on rental income, etc.).

International trend

29. While, as indicated in paragraph 7 above, one way of dealing with some of the inequities referred to above would be to extend the tax, make it more broad-based, less easily circumvented, etc., the HKICPA believes that this would be a retrograde step and one that would have a negative impact on Hong Kong’s status as a financial hub. While estate duty/inheritance taxes are still fairly common around the world, there is growing trend towards reform or abolition. It has been abolished in Australia, New Zealand, Canada, Malaysia, India, Italy and Macau. The US is also phasing it out. Major reforms have also taken place in Singapore.

<u>Question (k)</u>

30. For the reasons given in response to question (g) we believe that the abolition of estate duty would give a boost to the private banking and fund management industries. While there would, no doubt, be some reduction in the demand for estate duty planning, there would still be a call for advice to, for example, overseas-domiciled expatriates working in Hong Kong and Hong Kong permanent residents who retained assets and investment overseas. There would be a continuing demand for estate planning and for trustee companies, lawyers and accountants working in this field, given that tax is not the only consideration when people make arrangements in respect of their estates upon their death. In addition, the growth in the private banking/asset management industries, which would be encouraged to develop following the abolition of estate duty, would create new opportunities for professionals.

Question (l)

31. There are some people working in the financial services sector who focus primarily on Hong Kong estate duty work. No figures are available as to how many, although there are probably relatively few who deal exclusively with this area of work. In any event, any loss of employment resulting from the abolition of estate duty is likely to be more than compensated for by gains from the increase in private wealth management and related areas of work, the development of which in Hong Kong would be stimulated by the abolition of estate duty.

Question (m)

32. Useful research or information may be available from other jurisdictions, which have already undergone the process of abolishing estate duty/inheritance taxes.

Question (n)

33. We believe that the abolition of estate duty is one measure that would benefit the development of the asset management industry in Hong Kong.

34. Other tax-related measures that should be considered would include proceeding with effective legislation to exempt offshore funds from profits tax, on which a consultation exercise has already been conducted. The comments made during the consultation should be taken on board and the proposals amended accordingly.

35. Improving certainty and predictability in the tax system, through legislation or clearer rules of practice, is also important. Amongst the areas that now appear to be giving rise to ambiguity and uncertainty are the source/location of employment, offshore profits, and the taxation of unrealised gains/losses, following the decision in *Commissioner of Inland Revenue v Secan Ltd. and Ranon Ltd* [5 HKTC 266].

36. Other non-tax-related measures should also be considered. The private banking, fund management, and other relevant industries should be consulted on these.

Hong Kong Institute of Certified Public Accountants
20 October 2004