Appendix

Estate Duty Review
Consultation Document

Detailed response

We respond to the specific questions raised in the Consultation Document on Estate Duty Review as follows:-

Whether the current estate duty regime should be retained?

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

We strongly advocate the complete abolition of estate duty. It is an unfair and outdated tax which serves no useful purpose but acts as a hindrance to Hong Kong's development as the premier financial and asset management centre of the region.

Various social and economic objectives are usually quoted by governments as the reasons for the imposition of death taxes. The Consultation Document mentions two objectives for the introduction of estate duty in Hong Kong in 1915, namely "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 the progress of Hong Kong to which the whole community contributed."

However, examination of the facts and figures behind estate duty clearly reveals that the two stated objectives behind the introduction of the tax have not been fulfilled.

On the ability of estate duty to generate revenue, the table provided in paragraph 5 of the Consultation Document demonstrates that estate duty is not a revenue significant tax. On average, the revenue collected is only 0.7% of the total Government revenue in the past five years to 2003/04. Faced with the current persistent fiscal deficit problem, we agree that any stable source of revenue, however small the amount, should not be given up lightly. However, we consider it would be even more remiss if the economic benefits to be gained from the removal of estate duty are ignored. For example, abolition of estate duty would attract investments in Hong Kong real estate and Hong Kong listed shares which would result in more stamp duty revenue for the Government. Abolition would also make Hong Kong a more attractive centre for the location of trust and administrative services in Asia, which would lead to the further expansion of the financial sector and a consequential increase in profits tax and salaries tax collections.

The second stated objective of estate duty is to enable the whole community to benefit upon the death of *the very rich*. However, the figures disclosed in paragraph 16 of the Consultation Document demonstrate that this stated objective has not been fulfilled. According to statistics gathered by the Commissioner of Estate Duty, for the 2002/03 and 2003/04 assessment years, 69% and 47% respectively of the dutiable cases involved assets which were worth over $10 million, and 11% and 8% respectively of the cases involved assets which were worth over $50 million. In 2002/03, only two cases involved assets worth over $1 billion. In other words, the majority of the dutiable cases (69% in 2002/03 and 47% in 2003/04) have assets valued at between $10 million and $50 million. Clearly, those who were charged estate duty do not belong to the very rich of our society.

In response to a question raised by a member of the Legislative Council in July 2001, the Secretary for the Treasury provided the following information on the number of cases assessed to estate duty broken down by bands of $2.5 million each:-

	98/99	99/00	00/01
Duty Assessed	Number of Dutiable Cases		
$1 - $ 2,500,000	211	221	215
$2,500,001 - $5,000,000	68	73	58
$5,000,001 - $7,500,000	19	19	13
$7,500,001 - $10,000,000	6	15	8
$10,000,001 and above	22	26	24
Total number of Dutiable Cases	326	354	318

Of the total number of dutiable cases, more than 60% involved duty of less than $2.5 million, which means these estates had dutiable assets below $17 million. Again, this information indicates that the burden of estate duty is not falling on the very rich.

The reality is that through quite legal means, not least of which is the option of taking assets outside of Hong Kong, the richest in the community do not pay estate duty. It is a tax on the ill-informed, typically the middle class who have worked hard throughout their lives but have not sought proper tax advice.

The following table shows that of the total number of cases handled by the Inland Revenue Department ("IRD"), only a very small number is dutiable.

	99/00	00/01	01/02	02/03
New Cases	14,157	13,880	14,574	15,227
Cases finalised				
Dutiable	354	318	302	298
Exempt	13,889	13,246	14,399	15,047
	14,243	13,564	14,701	15,345

Source – IRD annual reports for 1999/2000 to 2002/2003

For example, of the 15,345 cases finalised in the assessment year 2002/03, only 298 were dutiable. A similar situation exists in the earlier years with a declining trend in the number being assessed. Paragraph 25 of the Consultation Document mentions that there were 258 dutiable cases assessed in the year ended 31 March

2004. This means that estate duty is a tax payable by merely 300 or less people each year!

Article 115 of the Basic Law stipulates that the Hong Kong Special Administrative Region shall pursue the policy of free trade and safeguard the free movement of goods, intangible assets and capital. However, estate duty as a tax on property located in Hong Kong that passes on death is a barrier to free trade, investment and movement of capital in Hong Kong and hence should be abolished.

(b) If you think the current estate duty regime should be retained, have you any suggestions on how the present regime, including its procedures, charging provisions, exemptions, exemption threshold, rates of duty, and interest and anti-avoidance provisions might be improved?

We strongly advocate the complete abolition of estate duty rather than tinkering with a tax system that is unfair, outdated and does not fulfil any of its stated objectives.

(c) *What factors do you think contribute to the investment and retention of capital in Hong Kong? To what extent does estate duty feature in this? How might adjusting the estate duty regime make a difference? Please try to quantify the effects of any proposed adjustment to the estate duty regime and explain the basis for your estimate.*

Many factors contribute to the investment and retention of capital in Hong Kong, including the rule of law, a stable and corruption-free government, quality of the workforce, standard of living, administrative ease in conducting business as well as taxation policy.

At present, estate duty is the only tax on capital in Hong Kong. This is clearly a barrier to the free flow of capital and is contrary to the objective of encouraging investment by not taxing investment income. In particular, estate duty is standing in the way of Hong Kong becoming the preferred centre for private investment and wealth management.

Estate duty drives wealth and people away from Hong Kong as estate duty planning invariably include divestment of control over Hong Kong based assets or their transfer from Hong Kong. On the other hand, if these assets remained in Hong Kong, they would add to economic growth, wealth creation and employment. For example, the abolition of estate duty would stimulate the real estate market in two ways. Firstly, local residents who have decided against investments in Hong Kong properties to avoid estate duty can now re-direct their investments to Hong Kong. Secondly, overseas investors from the Mainland, the region and other places would consider investing in the Hong Kong property market to take advantage of the absence of estate duty as well as capital gains tax.

The increasing wealth of Mainland Chinese, increasing demand from Europe to locate management of Asian based assets within Asia, and the need for investors and asset portfolio managers to retain assets in a given location are all major opportunities for the further expansion of Hong Kong's financial services sector. Hong Kong should aspire to become the preferred outlet for private investment and wealth management services in the region and look to capitalise on the growing demand of Mainland and other investors in these areas. Government has been working actively to promote investment, including proposals for investment immigration. Abolition of estate duty would provide a further attraction to potential investors.

Whether the estate duty regime should be adjusted through provision of exemption by reference to "domicile" or "residency" (proposal (a) in paragraph 11)?

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

We recommend the complete abolition of estate duty rather than just narrowing the tax incidence by providing exemptions based either on domicile or residency. The fundamental principle underlying taxation in Hong Kong is our territorial concept which has served Hong Kong well and hence should be retained. Introducing exemptions based on domicile or residency coupled with the existing territorial concept which taxes only properties situated in Hong Kong at the time of death would only add to confusion and complexity of the legislation.

(e) *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?*

As can be seen from overseas experience, rules for determining domicile and residency are generally complex. We therefore agree with the comments in the Consultation Document that the determination of "domicile/residency" of the deceased for estate duty purposes is a very difficult task, and is likely to be a major source of dispute if full or partial exemption from estate duty is tied to it. The best approach is to refrain from making the estate duty legislation more complex or unfair by introducing exemptions based on status of the deceased.

(f) *What effects, if any, on the asset management industry and the Hong Kong economy as a whole (eg. 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.*

As stated above, we believe that exemptions based on "domicile" or "residency" would cause confusion and dispute and hence we find it difficult to comment on their effects on the asset management industry and the Hong Kong economy as a whole.

Whether the estate duty regime should be adjusted through provision of exemption by reference to asset type (proposal (b) in paragraph 11)?

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

We believe that by far the best approach is to abolish estate duty in its entirety rather than to make piecemeal adjustments in the form of selective asset exemptions.

Furthermore, exemptions of the items mentioned in this question of the Consultation Document, namely bank deposits, listed securities and collective investment schemes, currently account for a substantial portion of the estates liable to estate duty. Accordingly, exemption of these items would substantially reduce the revenue collection from estate duty. The latest publicly available information on the composition of estates is contained in the IRD's 2002/03 annual report (see table below). In the year of assessment 2002/03, quoted shares and bank deposits account for 19.9% and 18.6% respectively of the composition of estates liable to estate duty. The figures for 2001/02 are 26.2% for quoted shares and 18.5% for bank deposits. This indicates that exemption of these items could result in a 40% to 50% reduction in the revenue collections.

Composition of Estates	01/02	02/03
	%	%
Immovable Properties	22.6	15.9
Quoted shares	26.2	19.9
Unquoted shares	18.4	29.1
Bank deposits	18.5	18.6
Others	14.3	16.5
	100	100

Source: IRD annual report 2002/03

Further, a specific item which could be said to be equally deserving of exemption is a deceased's principal place of residence. At present, the only relief available for residential properties is the matrimonial home relief whereby the matrimonial home is exempt from estate duty if ownership passes on death to the surviving spouse. If this relief is to be replaced by a more generic exemption for the principal place of residence of the deceased in Hong Kong, adding this item to the above list of specific asset exemptions could result in a drop of revenue collections by well over 50%.

Since estate duty currently accounts for on average only 0.7% of total Government revenue, we see little merit in introducing exemptions which would lead to a substantial reduction in the revenue take over a complete abolition of the tax.

(h) *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?*

Exemption of specific assets could lead to a substantial drop in revenue but may not necessarily result in a fall in the cost of collection. Paragraph 18 of the Consultation Document states that in the four assessment years from 1999/2000 to 2002/03, the cost of collecting estate duty ranged from 0.95% to 1.36%. The high end of this range already falls within the range for the cost of collecting other IRD taxes for the same period (ranged from 1.31% to 1.39%). If exemption of specific assets lead to a 50% drop in revenue, but the cost of collection remain unchanged, the cost as a percentage of revenue take could increase from 1.36% to 2.72%, making estate duty a very inefficient tax with a cost of collection well above the range of other IRD taxes.

(i) *What effects, if any, on the asset management industry and the Hong Kong economy as a whole (eg. 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.*

We recommend complete abolition of estate duty rather than making the tax more complicated by introducing exemption by reference to asset type.

Whether estate duty should be abolished (proposal (c) in paragraph 11)?

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

We strongly believe that estate duty should be abolished. It is an outdated, unfair and confusing tax. It contradicts the Government's initiatives in attracting investments in Hong Kong via CEPA or the investor migrant scheme. It acts as a hindrance to Hong Kong becoming an even more attractive centre for location of trust and administrative services, to retain and manage asset portfolios and to establish private holding companies in Asia. These opportunities are much coveted by Hong Kong's neighbours. Singapore has substantially reformed their estate duty legislation while Australia, Macau, India, Malaysia, and New Zealand have abolished the duty altogether. Hong Kong is falling behind in the race.

For these reasons, we urge the Government to take the necessary step of abolishing estate duty without further delay.

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

Our comments on the effects of abolition of estate duty on the asset management industry and the Hong Kong economy as a whole are set out in section (l) below. Personal asset management does not happen in a vacuum. Legal, accountancy and other professional expertise is required to fully appreciate the options and risks on offer. As the premier international corporate business and institutional financial service centre in the region, the SAR has the depth and breadth of experience and knowledgeable people to expand as Asia's personal financial jurisdiction of choice.

(l) *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, repatriation of capital from 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.*

Hong Kong's asset management industry – comprising asset management, advisory and private banking activities – was valued by the SFC at $2.95 trillion in 2003. The survey showed that 63% of assets managed in Hong Kong originate overseas, and 73% are invested in Asia, making Hong Kong by far the most international financial centre in the region. Of the 196 fund houses and banks surveyed, 24% have their regional headquarters in Hong Kong. In 2002, the finance and insurance sector employed over 152,000 people in the SAR.

The SAR is the asset management centre of choice for Mainland funds, and initiatives such as the investor migrant scheme support our belief that this role will only strengthen. The flow, moreover, goes both ways: Hong Kong is the management home to the bulk of the foreign assets invested in China. Among Hong Kong managed assets are $481 billion invested in Hong Kong and the Mainland, equal to 25% of combined PRC and Hong Kong GDP.

The base exists to move from institutional fund management to a stronger role in personal asset management, if the regulatory environment makes sense. Australia, Canada, Italy, New Zealand, Malaysia and other countries have abolished estate duty in recent years, and Singapore has revised its laws to benefit non-residents. For Hong Kong to position itself as the premier personal asset management centre in the Asian half of the world, similar regulatory rationalization is necessary.

The PRC holds the world's second largest stock of foreign exchange reserves, and is in the process of liberalizing – over several years – capital flows. As personal investment options broaden, Hong Kong will benefit from proximity, language and regulatory competitiveness. However, the more sophisticated investors become, the more important the regulatory environment will be. For Hong Kong to secure its role as the outward investment centre for the rest of China, the regulatory environment must evolve.

In the 1990s, financial sector employment rose from less than 10% of total employment to more than 13%. However, since then it has stagnated, barely keeping pace with overall growth in total employment. To take the industry to the next level, new products and services must be developed, and the rapid rise of wealth in the PRC is a strong indicator of the direction the SAR must move. Abolition of estate duty would go a long way in enhancing Hong Kong's position as the premier asset management centre in Asia.

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

We believe the best approach is for the Government to perform detailed economic modelling using different variables.

Other measures?

(n) *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?*

We believe that abolition of estate duty is a key measure in assisting Hong Kong to develop its role as the premier asset management centre for Asia. Therefore, other measures or changes must be adopted in conjunction with, but cannot be suitable alternatives to, the abolition of estate duty.

The following are other measures which we believe Hong Kong needs to consider in order to develop its role as the premier asset management centre for Asia:-

- A comprehensive review of the Companies Ordinance with the objective of making Hong Kong more attractive to international investors. For example, introduction of re-domicile provisions should be considered so as to facilitate the migration of overseas corporations to Hong Kong.

- A re-affirmation that the territorial concept remains as the key principle of taxation in Hong Kong. This concept has served Hong Kong well and has often been cited by overseas investors as a major incentive for investment in Hong Kong. However, recent changes in the tax legislation and in the practice of the Inland Revenue Department have caused doubts about the validity of the territorial principle. An example is the newly inserted Section 15(1)(ba) of the Inland Revenue Ordinance which introduced the principle of symmetry between the deductibility of an expense by the payer of a royalty and the taxability of the receipts in the hands of the payee. To achieve symmetry by taxing an entity that may conduct no business in Hong Kong is contrary to the territorial concept of taxation.

- The introduction of appropriate legislation to exempt offshore funds from Profits Tax. This will bring Hong Kong in line with other major international financial centres where offshore funds are generally not subject to tax. Further to the public consultation conducted on this issue earlier in the year, we recommend Government to work closely with the funds management industry to expedite finalisation of the legislative provisions.