HONG KONG ESTATE DUTY: A BLUEPRINT FOR REFORM?[1]

*Andrew Halkyard**

Taxation reform has dominated public debate in Hong Kong since the Financial Secretary, Sir Donald Tsang, announced in the early days of the new millennium that budget deficits in Hong Kong were 'systemic'. It is, therefore, particularly appropriate at this time to reflect upon the future role of estate duty in Hong Kong's overall system of taxation. In this context, it is submitted that, contrary to many voices raised in opposition, estate duty should have a future and the case for its abolition has not been adequately established. However, looking back over the past 80 years since the enactment of the Estate Duty Ordinance, there has been little attempt to change the now outdated legislation. Estate Duty is a tax in dire need of reform. The major problem areas reflected by the current law and practice of estate duty are identified and appropriate responses to meet them are suggested. These responses range from the prosaic (simplification in certain areas), to technical amendments (where the law appears unclear), to changes in the rate structure (to achieve greater horizontal equity). Detailed criticism is focused upon the controlled company provisions and it is suggested that they be radically changed in favour of general anti-avoidance criteria that reflect well-established practice. In conclusion, the argument is made for both systemic reform and simplification to make the ordinance more easily understood and more in line with modern Hong Kong conditions.

* Associate Professor, Faculty of Law, University of Hong Kong. This article is dedicated to my former colleague, co-author and friend, Professor Peter G Willoughby, who died at too young an age, on 25 January 2000. Among many accomplishments, Peter was the author of *Hong Kong Revenue Law: Estate Duty*, published by Matthew Bender. This was a breakthrough for Hong Kong legal publishing. Not only was it the first comprehensive text on taxation published in Hong Kong, it was also one of the earliest legal practitioners' texts written specifically for Hong Kong.

1 The genesis for this article is attributable to the author's research for the Joint Liaison Committee on Taxation ('JLCT'), which in May 1992 commenced a study on the future of estate duty. The constituent members of JLCT include the Law Society of Hong Kong, the Hong Kong Society of Accountants, the Hong Kong General Chamber of Commerce, the American Chamber of Commerce, the Hong Kong Association of Banks, the Capital Markets Association, the Taxation Institute of Hong Kong and the International Fiscal Association. JLCT meets monthly with the Commissioner of Inland Revenue to discuss technical changes to taxation laws, and any current issues involving interpretation of tax law and departmental practice. Although there is a formal agenda for meetings, in practice the discussion is often wide-ranging and forthright. The author is the technical adviser to JLCT and is grateful to acknowledge the assistance of all members of the Estate Duty Sub-Committee, particularly Peter Edwards (Convenor), Michael Ainslie, Ian Harris, Patrick Paul, Christine So, Stewart Smith, Daniel Wan, Peter Willoughby and Michael Olesnicky (Chair of JLCT). The views expressed in this article are, however, those of the author and should not be taken to be those of JLCT or of its members. The author also gratefully acknowledges the constructive and helpful comments on policy issues relating to wealth taxes provided by the reviewer for Hong Kong Law Journal.

Introduction

Hong Kong is committed to promoting free trade and safeguarding the free movement of goods and capital.[2] Accordingly, Hong Kong generally does not impose any barriers to investment and movement of capital; nor does it provide incentives or disincentives to encourage or discourage particular types of economic activity, as distinct from promoting economic activity generally.[3] Turning specifically to the Hong Kong Government's fiscal policy, it is well established that taxation should not operate as a disincentive to investment, whether foreign or domestic.

Given these commitments, and in today's troubled economic climate, it seems particularly appropriate to reflect upon the role of estate duty[4] in Hong Kong's overall system of taxation. Estate duty is a tax on property located in Hong Kong that passes upon death. It is Hong Kong's only direct tax on capital.[5] It could thus be argued that estate duty does act as a barrier to free trade, investment and movement of capital in Hong Kong. Indeed, it has long been contended that estate duty should be abolished.[6] This article critically examines these contentions and concludes that abolition of estate duty is not justified at this time. It is, however, a tax in dire need of reform. Various proposals will be suggested to achieve this end.

Empirical study

In order to make informed proposals as to the future of our current estate duty regime, basic information needed to be obtained, namely (1) what assets are typically dutiable? and (2) what is the make-up of a typical estate in terms of assets passing on death?

In response to queries on these matters, the Commissioner of Inland Revenue stated that a dutiable Hong Kong estate typically includes the following assets: immovable property (including the matrimonial home), listed shares, other investment assets (including unlisted shares), debts due to the

2 See Article 115 of the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China.

3 Hong Kong offers inherent incentives that promote overall economic growth in the Special Administrative Region. These include: low rates of tax, laissez faire regulation of business activity, proximity to and economic interdependence with the Mainland and an abundance of energetic and resourceful providers of labour and capital. See generally, Halkyard, 'The Hong Kong Tax Paradox: Or Why Jurassic Park Exists in the Pearl River Delta' (1998) 8 Revenue Law Journal 1.

4 See Estate Duty Ordinance (LHK, Cap 111), hereinafter referred to as the 'EDO'.

5 With the possible exception of stamp duty, which is arguably only nominally a tax on instruments rather than on transactions: see Stamp Duty Ordinance (LHK, Cap 117).

6 See, for example, the criticisms noted, but rejected, by the Financial Secretary in *The 1982/83 Budget Speech*, printed in Hong Kong Hansard, 24 February 1982, p 449.

deceased, bank deposits, gifts inter vivos and other property (including life insurance policies and personal effects).[7]

Abolition? Local and comparative perspectives

In the interests of promoting free trade and investment in Hong Kong, it could be argued that estate duty encourages the export of capital and the movement of Hong Kong dollars away from Hong Kong. To test this contention, it is necessary to examine whether there are any aspects of Hong Kong's estate duty laws that deter persons from holding assets in Hong Kong.

In late-1997, the Estate Duty Office conducted a survey to assess whether estate duty encouraged the transfer of assets out of Hong Kong.[8] The survey focused upon dutiable estates that had not been finalized. Ten percent of the 468 active cases identified were selected at random. From the information obtained, the Estate Duty Office concluded that where funds were transferred outside Hong Kong in the deceased's own name this was generally on a temporary basis. In most cases the funds were remitted back to Hong Kong to pay estate duty and interest.[9] Where funds were transferred offshore to relatives and third parties, the Estate Duty Office concluded this was generally for a specific purpose or in the nature of a gift. On this basis the Estate Duty Office considered that there was no indication that estate duty encouraged funds to be placed offshore either permanently or for a long period of time.

Perhaps the best way to verify the conclusions of the Estate Duty Office is to consider this issue from an estate planning perspective. Prima facie, it makes sense to keep many items of movable property, including chattels, bank deposits and other choses in action, outside Hong Kong.[10] However, the key assets in the Hong Kong context — local shares and immovable property — cannot be directly moved outside Hong Kong. Specifically, shares (and registered loan stock such as debentures) are located at the place where they can be dealt with. This is generally the place where the register is located.[11] For Hong Kong incorporated companies and offshore companies listed in Hong

7 Letter dated 19 August 1992 from the Commissioner of Inland Revenue to Michael Olesnicky, Chair of JLCT, a copy of which the author has on file. Full details of the figures supplied by the Commissioner are reprinted in the Appendix to this article. More recent, though not as detailed, figures can be found in the *Inland Revenue Department Annual Report 1998-99* (Hong Kong: Printing Department, 1999) Tables, p 26.

8 Letter dated 10 March 1998 from the Commissioner of Inland Revenue to Michael Olesnicky, Chair of JLCT, a copy of which the author has on file.

9 The Estate Duty Office surmised that these transfers 'were temporary and presumably for tax avoidance purposes'. It is not known on what basis the Estate Duty Office reached this conclusion, although it might be assumed that 'tax avoidance' refers to estate duty avoidance.

10 In light of EDO s 10(b) which exempts from duty all property situated outside Hong Kong as at the date of death.

11 See *Brassard v Smith* [1925] AC 371. See further, Willoughby and Halkyard, *Encyclopaedia of Hong Kong Taxation: Estate Duty* (vol 2) (Singapore: Butterworths, 1993) I [1652], point 14.

Kong, their share registers must be kept in Hong Kong.[12] Similarly, it is legally (and physically) impossible to move immovable property outside Hong Kong. Experience also indicates that persons will not cease investing in Hong Kong listed shares, registered securities and land and buildings simply to avoid payment of estate duty.[13]

Notwithstanding the above comments, Hong Kong shares, loan capital and immovable property can be metaphorically shifted outside Hong by holding such property through offshore companies and trusts. Without belaboring the point, it must follow that opportunities for the avoidance, or mitigation,[14] of estate duty are legion and the epithet describing estate duty as a 'voluntary tax' is well deserved. But all this seems to flow more from Hong Kong's adherence to a source-based principle of taxation,[15] which is, to say the least, porous. In the estate duty context this peculiar jurisdiction to tax does not encourage the movement of assets away from Hong Kong; rather, more systemically, it encourages the use of offshore structures to hold Hong Kong assets that would otherwise be potentially subject to duty.[16]

From a comparative perspective, it is noteworthy that, particularly in recent years, a vigorous debate has taken place in the United States upon the economic and social justifications for imposing taxes on wealth generally, and for continuing to impose estate tax specifically.[17] This has given rise to a very large body of literature, both theoretic and policy oriented.[18] At the risk of over-simplification, the case in favour of abolishing estate tax might be summarised as follows:[19]

> ... The estate tax is a bad tax. It raises little revenue. It does not redistribute wealth. It imposes large costs on the economy. And it is complicated and

12 See Companies Ordinance (LHK, Cap 32) s 103 (for Hong Kong incorporated companies) and Stock Exchange Listing Rules, r 19 (for offshore companies listed in Hong Kong). See further, Halkyard, 'Hong Kong Stock Restructuring Issues', The New Gazette (August 1994) p 56.

13 Recent evidence supporting this conclusion is found in the *Inland Revenue Department Annual Report 1997-98* (Hong Kong: Printing Department, 1998). During the property and share market boom in that year, stamp duty collections relating to transactions in Hong Kong immovable property and Hong Kong stock amounted to a staggering 21.2% of total taxation revenue collected.

14 See the contrasting definitions of these terms adopted by the Privy Council in *CIR (NZ) v Challenge Corp Ltd* [1987] AC 155.

15 This principle is reflected in the EDO by s 10(b) (see note 10 above), which exempts from duty all property situated outside Hong Kong as at the date of death.

16 See, most recently, *Shiu Wing Ltd v Commissioner of Estate Duty* [1999] 1 HKLRD 367 an estate duty avoidance case involving a complex offshore trust structure designed to hold Hong Kong assets.

17 See, for example, US Congress, *Present Law and Background Relating to Estate and Gift Taxes* (Washington: JCT, January 27, 1998), also cited in *Tax Notes* (February 9, 1998) p 706 (Doc. 98-4216) and Caron, McCouch and Burke, *Federal Wealth Transfer Tax Anthology* (Cincinnati: Anderson Publishing Co, 1998). These publications examine policy issues relating to the effect of wealth taxes on matters such as saving, investment and labour supply. They also examine the feasibility of alternative methods to tax wealth, apart from estate tax.

18 See generally, Bittker and Lokken, *Federal Taxation of Income, Estates and Gifts* (vol 5, 2nd ed; 1999 Cumulative Supplement, No 2 Text) (Boston: Warren Gorham & Lamont) pp 120-2 and S120-1 and S120-2 and sources cited therein.

19 Bartlett, 'The End of the Estate Tax?' Tax Notes (July 7, 1997) p 109.

unfair. It should be abolished. In recent years a number of countries have done exactly that. The United States should join them.

As in the United States, estate duty in Hong Kong raises relatively little revenue. However, it should be appreciated that the costs to Hong Kong of abolishing estate duty would still be significant. Specifically, over the past five years estate duty represents approximately 1.2 per cent of total government tax revenue.[20] In light of Hong Kong's low direct costs of collecting taxation, estate duty is undoubtedly revenue productive.[21] It is also fair comment that estate duty yields will probably increase in real terms when those who have created wealth in Hong Kong over the last 30 years die owning Hong Kong assets.

It is also true, as in the United States, that estate duty in Hong Kong is unnecessarily complex and imposes economic costs on those who must comply with its statutory strictures, as well as on those who seek to avoid it. It will be argued below that these matters are best countered by simplifying the charge to estate duty, rather than by abolishing it. Turning to the criticism that estate duty affects those with relatively modest wealth, it will be argued that the rates of duty should be changed to reflect a truly progressive system, rather than continuing with the current 'slab' system whereby there is essentially one rate for the whole estate. Tangentially, it will also be noted that estate duty in Hong Kong only applies where a person dies with a net assessable estate of slightly less than US$1,000,000. At this level, comparatively few Hong Kong estates are dutiable.[22]

One further argument raised by taxation policy theorists in the United States, and elsewhere, is that estate duty does virtually nothing to equalize the distribution of wealth.[23] This is largely because legal estate planning can virtually eliminate estate duty liability, even for the largest estates. The same conclusion seems valid in Hong Kong where, as noted above, estate duty is often dubbed a 'voluntary tax'. However, in the context of Hong Kong's political, economic and social conditions, it is rarely argued, and certainly not argued by Government, that taxation should be used as a primary tool to redistribute wealth. Any such policy might, in any event, be limited by Article 108 of Hong Kong's Basic Law that indicates Hong Kong should continue to practice a low tax policy.

More generally, Chapter 5 of the Basic Law, dealing with Hong Kong's economy and public finances, is consistent with the traditional requirements

20 See *Inland Revenue Department Annual Report 1998-99* (Hong Kong: Printing Department, 1999) Table, p 10.

21 See note 20 above, p 11 where it is stated that over the last four years the cost is less than one cent per dollar of tax collected.

22 See note 20 above, p 27 showing that of 12,807 and 13,832 cases finalised in 1997-98 and 1998-99, only 387 and 326 respectively were dutiable. Based on these figures the proportion of dutiable cases to total cases is only 2.67%.

23 See sources cited in the publications referred to at notes 17-19 above.

of Hong Kong's taxation policy. These were summarised by the Financial Secretary, Sir Philip Haddon-Cave, in his 1978-79 Budget Speech as follows:

> The *first* requirement is to generate sufficient recurrent revenue to finance a major part of a given level of total public expenditure … and to maintain our fiscal reserves at a satisfactory level. The *second* requirement is that the tax system is as neutral as possible as regards the internal cost/price structure and investment decisions. The *third* is that the laws governing the tax system are adapted from time to time to make them consistent with changing commercial practices. The *fourth* requirement is that each and every levy — be it direct or indirect — is simple and easy (and, therefore, inexpensive) to administer and does not encourage evasion, for a low and narrowly based tax system cannot afford to finance costly overheads. The *fifth* requirement is that the tax system is equitable as between different classes of taxpayers or potential taxpayers and between different income groups (and this means, *inter alia*, setting relatively high thresholds for personal taxation and generally ensuring that the system rests as lightly as possible on those at the lower end of the income spectrum, or leaves them virtually untouched). Exceptionally, and this is the *sixth* requirement, the tax system must be capable of being used to achieve non-fiscal objectives when necessary.[24]

Notwithstanding Haddon-Cave's requirements, it must be acknowledged that Hong Kong's pursuit of simplicity and efficiency in levying taxation has meant that matters of principle are sometimes ignored thus leading to unfairness. To the extent that this criticism is valid in the context of the charge to estate duty, this article seeks to offer suggestions for reform. In the meantime, it can only be noted that these unsatisfactory features are acknowledged, but generally tolerated in view of an overall preference for the simple, efficient and compliance friendly taxation system existing in Hong Kong.

On the basis of the study conducted by the Estate Duty Office as well as the analysis above, it is submitted that the case has not been made that estate duty undermines Hong Kong's attractions as a place for investment and carrying on business.[25] In this regard, it is also instructive to compare the experience of our regional neighbors and competitors. Estate duty has been repealed in recent years in countries as diverse as Australia, India, Malaysia, New Zealand and Canada (with the exception of Quebec). There is no estate duty imposed in

[24] Different formulations of these requirements have subsequently been consistently reiterated. The last major official public statement can be found in *The 1996-97 Budget Speech* (Hong Kong: Government Printer, 1996) para 47.

[25] Not surprisingly the Commissioner of Estate Duty agrees with this view. In his letter dated 10 March 1998 to JLCT, see note 8 above, the Commissioner stated: 'We cannot subscribe to the view that estate duty has encouraged the transfer of assets out of Hong Kong, or at any rate, permanently and in large quantities. The relocation of funds is mainly determined by such factors as the economy, infrastructure, tax system [and] exchange controls of the place in question.'

Indonesia, South Korea and Thailand, although it is still imposed in the United States, Singapore and Japan. But these selective examples of repeal and non-taxation do not show the full picture. With the exception of Malaysia, in all these countries capital is taxed in other ways, either specifically under a capital gains tax regime (Australia, Canada, India, Indonesia, Japan, South Korea and the United States) or, and often in addition thereto, under a broadly-based system of indirect tax such as a Goods and Services Tax (Australia, Canada, Indonesia, New Zealand, Japan, Singapore, South Korea and Thailand). In many instances, these more modern taxes — that are not levied in Hong Kong — were introduced as part of a package to reduce other levels of taxation on income.

Tangentially, estate duty also has an important role to play in assisting the Investigations Unit of the Inland Revenue Department ('the IRD'),[26] whose function is to uncover cases of tax evasion. A deceased person owning a large amount of property, the accumulation of which cannot be explained by profits tax or other records of income held by the IRD, is a prime candidate for detailed investigation.[27] Estate duty thus has a positive impact upon overall tax collection by the IRD.

It might be argued that the same tangential benefits may be achieved by requiring that a statement of Hong Kong assets should be served on the Commissioner by executors and personal representatives as a condition of obtaining probate or letters of administration and it is thus not necessary to levy estate duty. However, in view of all the advantages referred to above, it seems highly unlikely that the Hong Kong Government would (or should) be willing to give up this source of revenue at this time.[28]

Selective repeal: exemption for deposits with Hong Kong financial institutions?

If it is accepted that estate duty should not, and presently will not, be repealed, it is then necessary to consider a partial exemption for the most 'movable' type of asset, a deposit of money with a local financial institution. Any individual, resident or non-resident in Hong Kong, who holds money in a Hong Kong bank

[26] The IRD informed JLCT that approximately 10% of back duty cases arose from investigations commenced following enquiries raised during the assessment of estate duty liabilities on deceased estates.

[27] Understatements of profits and income by a taxpayer are often discovered when the executor files the Estate Duty Affidavit and the related accounts with the Estate Duty Office. See EDO s 14(6).

[28] It should also be appreciated that any abolition of estate duty may, as a practical matter, need to be revenue neutral. In other words, it would need to be replaced by increases in other taxes. Possibilities include the introduction of dividend withholding tax and/or capital gains tax (like estate duty, these taxes would typically affect high net worth individuals) or an increase in the standard rate (currently 15% in the 2000-2001 year of assessment) for high-income earners. Doubtless, business interests would oppose the former; and the latter would find no favour with many influential individual taxpayers.

account (whether in Hong Kong dollars or foreign currency) will have the account frozen on death and the estate must pay any estate duty chargeable. Even if estate duty is not chargeable because the deceased's Hong Kong assets do not exceed the estate duty threshold,[29] banks will invariably require probate procedures to be followed.[30] In the event, it could be argued that the burden of estate duty is a disincentive to invest in Hong Kong and therefore an exemption should be enacted for non-residents who hold bank deposits in Hong Kong, or at least non-Hong Kong dollar bank deposits, mirroring exemptions enacted in the United Kingdom[31] and Singapore.[32]

An informal study conducted by the Hong Kong Association of Banks[33] indicated that estate duty was not a major disincentive for depositors to hold deposits with financial institutions in Hong Kong. This would especially be the case in relation to Hong Kong dollar denominated deposits. Although any reduction or abolition of estate duty might cause an increase in Hong Kong dollar deposits, the study concluded that the overall effect on Hong Kong's banking system should be neutral because the relevant funds are returned to Hong Kong after being booked offshore. On the other hand, an exemption from estate duty for Hong Kong deposits denominated in foreign currency and held by non-residents may have a positive impact on the ability of banks to attract offshore deposits. But, even in this latter regard, the study produced no empirical evidence to show the extent to which an exemption from estate duty would benefit the Hong Kong economy.

Apparently, business groups, including the Hong Kong Association of Banks, have shown no real inclination to press Government to introduce any change in the estate duty treatment for deposits held with Hong Kong financial institutions. It can only be concluded, therefore, that even the limited case for partial exemption has not been made. A further reason to reject such a proposal is that it would discriminate against other assets held by both residents and non-residents and thus erode the source-based system of taxation operating in Hong Kong.

Does estate duty cause delay in obtaining probate?

Before concluding the submission in this article that estate duty should be neither abolished nor substantially repealed, it is necessary to deal with a

29 Currently $7,500,000. See EDO Part 24 of Schedule 1.

30 See EDO s 25, a provision requiring a bank to report to the Commissioner once it becomes aware of the death of a depositor. See further, Willoughby and Halkyard, note 11 above, I [3004].

31 See Inheritance Tax Act 1984, s 157 which, subject to certain conditions, exempts from inheritance tax foreign currency accounts held in the United Kingdom by non-residents.

32 See Estate Duty Act (Cap 96, 1997 Ed), s 12 which exempts from estate duty Asian Currency Unit deposits and balances with approved banks held in Singapore by any person who was neither resident nor domiciled in Singapore at the time of death.

33 Letters dated 26 October 1992 and 29 July 1997 from the Hong Kong Association of Bank's representative to Michael Olesnicky, Chair of JLCT, copies of which the author has on file.

commonly aired complaint. That is, estate duty, coupled with probate procedures, causes long delays in the administration of estates and results in assets being tied up for inordinately long periods. It has been further contended that these delays are not restricted to dutiable estates because in many other cases the Commissioner must be satisfied that no liability exists, for example, where estates are just below the minimum threshold for duty.[34]

The Commissioner's response to these criticisms is as follows:[35]

> In assessing the correctness of the affidavits lodged by the executors, a considerable amount of work (often involving enquiries with third parties) is required to verify the values of landed properties, unquoted shares etc. In addition, enquiries are necessary to ensure that all assets, particularly bank accounts, and inter-vivos gifts made three years before death, are included in the affidavits.

The issue of estate duty clearances is now covered by the Inland Revenue Department's performance pledge.[36] In 1996-97, 99% of the 6,705 simple and non-dutiable cases (not involving valuations of land and private company shares) were finalized within six weeks. Out of the 4,769 simple and non-dutiable cases (involving valuations of land or private company shares), 94% of them were finalized within six months. Of the remaining 850 complicated and dutiable cases, 86% were finalized within two years. Therefore, in the *majority* of cases, no undue delay occurs in the issue of estate duty clearances.

The Commissioner's response to the allegation that estate duty causes unnecessary delay in finalizing probate seems fair,[37] provided that the performance pledges relied upon by the Commissioner are themselves fair and

34 See note 29 above.

35 See note 8 above.

36 The estate duty performance pledges of the Inland Revenue Department for the year ending 31 March 2000 are set out in the departmental homepage at *http://www.info.gov.hk/ird/pp.htm#ed* and are as follows:

	Standard Response	*Performance Target*
Exempt and simple cases (neither requiring detailed investigation nor having a sworn value exceeding 60% of the exemption threshold)		
• Not involving landed properties, private company shares or interest in a business	Assessments or certificates of exemption issued within six weeks of receipt	First six weeks: 98%
• Involving landed properties, private company shares or interest in a business	Assessments or certificates of exemption issued within six weeks of receipt	First six months: 85% Next six months: 14%
Dutiable or complicated cases	Assessments or certificates of exemption issued within two years of receipt	First year: 55% Second year: 25% Third year: 10%

37 See however, Fok, 'Wait Reduction' Hong Kong Lawyer (May 1998) p 16 who notes anecdotal evidence that estate duty clearance can be relatively time consuming.

representative of good, speedy public service. In this regard, no criticism has apparently been directed at the utility and fairness of the pledges. It should be noted also that where a case cannot be finalized within a reasonable period of time (a typical case may involve protracted negotiation on valuation of land or shares), the executor upon production of a satisfactory guarantee to settle any outstanding duty and interest can apply for provisional estate duty clearance to enable early administration of the estate.[38] On the basis of the above analysis, it can therefore be concluded that the imposition of estate duty does not generally result in the assets of deceased estates being tied up for unreasonable periods of time. Again, the case has simply not been made that estate duty operates so unfairly or inappropriately that it should be repealed at this point in time.

Extended?

For the sake of completeness, it is useful to consider whether estate duty should be extended if neither abolition nor selective repeal were desirable. The reason behind this query is that, as stated above, estate duty is often referred to as a 'voluntary tax'. On this basis, it could be contended that the charge to estate duty is unacceptable and if estate duty were to continue it should ideally apply to those in similar economic circumstances.

As indicated previously, Hong Kong's adherence to a source-based system of taxation, rather than one based upon residence, makes extending the jurisdiction to tax a virtual impossibility. To reiterate, where, as under current law, Hong Kong assets can be held through offshore entities free of estate duty, it seems unreal to speak of extending the tax base without changing the very basis of Hong Kong's taxation system. In these circumstances, it appears inevitable that a different approach to reform will need to be adopted. It is submitted below that the correct focus should be on simplifying estate duty and reducing the inequities in existing legislation.

Simplification generally

If abolition or extension are not currently viable options, it would be hard to find anyone familiar with Hong Kong estate duty who would not think that it should be significantly simplified. One of Hong Kong's main regional competitors, Singapore, has done just this. It now imposes estate duty under a regime having the following features: a high threshold of duty, a low rate of duty

[38] This is a non-statutory concession granted to facilitate earlier administration of estates. See Estate Duty Form U3/SC/E46, reprinted in Willoughby and Halkyard, note 11 above, IV [23].

and substantial exemptions.[39] By way of contrast, even our staunchest supporters would not deny that the legislation enacted by the EDO is excessively complex, imposes a high maximum rate of duty, requires an understanding of archaic English case law and is redolent of a land and time with economic and social conditions far removed from modern day Hong Kong.

Various models could be suggested for Hong Kong to consider. One option is the Singapore-style simplification package. In any event, fundamental reform should proceed on the principle that simplification of estate duty should be designed to allow the administration of estates to be settled even more quickly than at present but yet not reduce revenue. Any shortfall in revenue resulting from simplification could be balanced by changes to the rate structure[40] or by a general denial of deductions which, interestingly, is a defining feature of a probate tax that has been suggested for Hong Kong as a replacement for estate duty.[41]

Most unfortunately, calls for simplification have met with the coldest of shoulders from Government. The official view seems to hark back to similar rejections for reform by the Financial Secretary in *The 1982/83 Budget Speech* who stated on 24 February 1982:

> But first I intend to use this opportunity to comment on certain criticisms of Estate Duty at large, which will also enable me to range more widely. It has been suggested that the Estate Duty legislation ought to be repealed because it is cumbersome and complex, its impact is easily avoided. ... The facts however are that the legislation is well understood by those who have to deal with it professionally, and by the officers of the department who administer it.[42]

In short, Government's approach seems to have been, and presumably still is, that so long as an arcane, nearly incomprehensible ordinance is understood reasonably well by professionals on both sides, then it is not necessary to substantially change it. This attitude is at best disingenuous; at worst it is a myopic adherence to the well-worn Hong Kong maxim: 'if it ain't broke, don't fix it'.

Notwithstanding the weight of the above criticisms, the fact remains that estate duty is not yet a particularly burdensome form of taxation nor does it

39 The Estate Duty Act (Cap 96, 1997 Ed) imposes duty on the net value of the estate up to S$12 million at the rate of 5% and thereafter at the rate of 10%. Exemptions include S$600,000 for a deceased's movable assets, an amount up to S$9 million for all dwelling houses (not restricted, as in Hong Kong, to one matrimonial home) as well as a whole range of exemptions available to non-residents. See generally, *Singapore Master Tax Guide Manual* (Singapore: CCH Asia, 1989) §4000 et seq.

40 Unless any shortfall was made up from other sources. See note 28 above.

41 See letter dated 2 December 1997 from JLCT to Donald Tsang, Financial Secretary, a copy of which is on file with the author.

42 Hong Kong Hansard, 24 February 1982, p 449.

seem to have inhibited Hong Kong's development as an international financial and service centre. Given the absence of any other form of direct taxation on wealth or capital, the extremes of wealth that exist in Hong Kong and the steady yield from estate duty, it seems unlikely that estate duty will be substantially changed in the foreseeable future.[43]

That is not to say that reform of estate duty should not be pursued. If this statement requires any bolstering, it should be enough to remind ourselves that the charging provisions, mainly contained in EDO section 6(1), are derived from the United Kingdom Finance Act 1894! But the first and most obvious candidate for reform, as will be argued below, is a comparative newcomer to the estate duty scene, the so-called controlled company provisions.[44]

Simplification of controlled company provisions

Of particular significance to the quest of simplifying the EDO is whether sections 34-45, anti-avoidance provisions deeming Hong Kong assets in a controlled company to pass on death, should be continued. The potential application of these provisions is extremely broad and fiendishly complex.[45] Yet they appear generally not to be enforced by the Estate Duty Office.[46] This gives the impression that (probably unfairly) the Estate Duty Office does not fully understand these provisions and (probably fairly) that there was a reluctance on the part of the Estate Duty Office to become involved in their complexity.

It does not appear appropriate that Hong Kong residents should be taxed by statute and untaxed by concession. In other words, if the law is not applied then there is good reason for repealing, or at least modifying, it. This is particularly so given the technical exposures arising under the controlled company provisions and the commercial problems of providing estate duty indemnities on a stock exchange listing or generally upon a sale and purchase of Hong Kong private company shares. In short, it seems wrong in principle that, in light of the potentially very wide scope of these provisions, many of the persons affected do not know in what circumstances, as a matter of law and practice, they should comply with the reporting obligations imposed by the Estate Duty Office.[47]

43 Compare Willoughby and Halkyard, note 11 above, V [1]-[3].

44 EDO ss 34-45 and Schedule 2.

45 See Horton, 'Hong Kong Estate Duty Legislation Relating to Controlled Companies' (1977) 7 HKLJ 186.

46 In his letter dated 10 March 1998 to JLCT, see note 8 above, the Commissioner stated that according to the records of the Estate Duty Office, only four cases in the years 1995-96 and 1996-97 out of 12,000 handled each year involved applying the controlled company provisions.

47 EDO s 42 imposes extensive obligations on a controlled company and its officers. Specifically, these persons must inform the Commissioner, within one month from the date of death of the deceased, that the deceased made a transfer of property to the company and that benefits accrued to the deceased from the company. Notwithstanding that heavy penalties, up to level 6 plus a further penalty of three times the estate duty payable upon the *whole* estate, can be imposed for failure to comply with s 42, the fact remains that the obligations are so broad that they are only honored in their breach.

In view of the real difficulties noted above, is repeal of these Byzantine provisions the appropriate response? Many estate duty practitioners would answer yes.[48] Others, however, would answer no and argue on the basis that, because the controlled company provisions have now been enacted for over forty years without causing serious problems, they should be retained.[49]

Predictably, the Commissioner's view is that the status quo should be maintained. In response to submissions made to the contrary by JLCT, he stated:[50]

> The controlled company provisions are admittedly complex, as [is] any other anti-avoidance tax legislation. However, we cannot accept that such provisions are uncertain either in their scope or in their enforcement. That the provisions have been sparingly invoked in the past years is conceivably due to the fact that the provisions have achieved their deterrent effects, that the IRD only applied the provisions to evasion cases,[51] that alternative charging heads have been used where available, and that people had apparently changed their way of running businesses, ie they tend to make more use of limited companies and hence their wealth are already under the umbrella of limited companies.

48 One of Hong Kong's best-known estate duty practitioners, Peter Edwards, strongly held this view. The following is a summary of various conversations held by the author with Mr Edwards from 1992 to 1995. Although he appreciated that abolition of the controlled company provisions would give rise to easy avoidance, Mr Edwards stressed that (1) in practice the provisions are rarely applied, (2) there is widespread ignorance of the existence of these provisions and (3) where persons concerned about the controlled company provisions approach professional advisers, other offshore estate planning (typically involving the use of trusts) can be implemented. In short, he took the view that it is relatively straightforward for a well-advised person to escape the potential application of the controlled company provisions. An unadvised, or poorly advised, person could, however, encounter all sorts of unexpected problems. On this basis, Mr Edwards thought that the existence of the provisions is no bar to avoidance because ignorance negates any *in terrorum* effect and, therefore, this does not constitute a valid reason for their retention.

49 Another well-known estate duty practitioner, Peter Willoughby, took a similar view in various discussions with the author, noting that s 35 had been enacted for many years without giving rise to many assessments. From the Commissioner's standpoint, Professor Willoughby speculated that keeping the estate duty advisers in some state of uncertainty as to the application of s 35 was part of its deterrent effect. Although he acknowledged that the main problem with its operation is uncertainty when advising upon a commercial corporate restructuring, he concluded that if proper records were kept, showing why the restructuring was necessary, in practice there was never any question that s 35 would be applied. Finally, Professor Willoughby took the view that if the controlled company provisions were abolished, there ought to be some *quid pro quo*, presumably in terms of alternative anti-avoidance legislation or another source of revenue to replace the estate duty forgone.

50 See note 8 above.

51 The Commissioner's policy in applying the controlled company provisions reflects the statement of the Financial Secretary who, when introducing the legislation to LegCo, stated that it would only be invoked 'where there was an element of evasion': see Hong Kong Hansard *1958*, p 310, quoted in Willoughby and Halkyard, note 11 above, at I [955]. It seems apparent, however, that in this context transfers which are contrived, artificial and undertaken purely for tax avoidance reasons, as well as those attempting to 'evade' estate duty, are subject to the application of the controlled company provisions. The provisions would not normally be applied to transfers which are undertaken for legitimate family or commercial reasons albeit with the least possible exposure to tax liability.

Usefully, the Commissioner then went on to state that he was prepared to issue a Practice Note on the interpretation and practice adopted by the Estate Duty Office in relation to the controlled company provisions.

In the context of considering the issues of certainty and complexity, it is relevant to note that where a transfer has been made to a controlled company, the company may apply under EDO Schedule 2 for an assurance that section 35 will not be applied by reason that such transfer was effected for commercial reasons and not with the purpose of avoiding estate duty.[52]

In summary, the Commissioner's response indicates that the substantive rules relating to the liability of controlled companies to pay estate duty are unlikely to be changed. In other words, whilst acknowledging that the rules are extremely broad, it will be up to the Estate Duty Office to decide in which cases they will and will not be enforced. In this regard, as noted above, the Estate Duty Office's broad policy is to enforce the controlled companies provisions only in cases involving the establishment of companies for the purpose of 'evading' estate duty.

With respect, the Commissioner's response does not adequately address the problems identified above. To reiterate, the legislation is way too complex, much wider than necessary to achieve its aims and is all too dependent upon the exercise of discretion by the Commissioner in circumstances where the legislation does not unambiguously provide for such discretion. Of particular importance in this regard are the compliance obligations imposed by EDO section 42 upon controlled companies and their officers to notify the Commissioner within one month upon the death of any person who transferred property to the company and where benefits accrued to the deceased from the company. In these cases, the general proposition enunciated by the Commissioner gives little guidance to companies and their officers as to whether they should file returns with the Estate Duty Office.

Notwithstanding these criticisms, the statement by the Commissioner that he was prepared to issue a Practice Note is welcome. At the very least, any Practice Note should confirm and justify that the Estate Duty Office's assessing policy in applying section 35 to only estate duty evasion cases is correct. Also, there should be a clear statement that the Estate Duty Office would not seek to impose penalties under the controlled companies provisions except in cases where companies and their directors fail to make the necessary filings only after being expressly required to do so by the Estate Duty Office. This would remove the compliance dilemma currently vexing many companies and their advisers.

Even those commentators who argue for retention of the controlled company provisions would generally agree that they are unnecessarily complicated and

52 In light of this provision, it could be argued that the Commissioner's policy set out at note 51 above has some legislative support. At the very least, it provides a degree of certainty for persons who have transferred property to a controlled company.

potentially so wide as to be unfair and not in the public interest. Given the complexity and the importance of commercial activities involving the use of companies in and for Hong Kong business, there seems no doubt that these provisions result in a great deal of unproductive effort being devoted by professional advisers to what are essentially commercial re-organizations and not tax avoidance schemes. In this context, it is therefore suggested that the following matters be considered for reform:

(1) The clearance procedure for transfers to a controlled company provided by EDO, paragraph 7 of Schedule 2 is retrospective only. This differs from the clearance procedure under the Inland Revenue Ordinance as set out in Departmental Interpretation & Practice Notes No 33: 'Advance Rulings'.[53] To maintain consistency, the estate duty clearance should be prospective in relation to proposed transfers. The provision for clearances would also be improved if amendments to section 35 were made so as to limit the type of transfers that are relevant to transfers of Hong Kong assets by the deceased or a connected person, rather than by any person.

(2) The statement made by the Financial Secretary in 1958 that the controlled company provisions would only be applied where there has been an attempt to 'evade'[54] estate duty is confusing. Evasion is normally taken to mean the evading by unlawful means of tax due. In contrast, *avoidance* has always been thought to mean lawful planning of family or commercial affairs so that the least amount of tax is payable. Recent case law developments indicate that there may be two kinds of avoidance, namely, that which is contrived, artificial and undertaken purely for tax avoidance reasons without any other purpose and that which is undertaken for legitimate family and commercial purposes albeit with regard to the least possible exposure to tax liability.[55] It would seem that in 1958, when the controlled company provisions were introduced, the Financial Secretary was also referring to the first category of avoidance and was not simply focusing upon fraudulent 'evasion'. In the circumstances, it would seem appropriate that the current Financial Secretary or the Commissioner should clarify what was meant or perhaps update the policy position so that the second category of tax avoidance will be excluded from the operation of the charge.

53 Even before the enactment of s 88A and Schedule 10 of the Inland Revenue Ordinance, which took effect on 1 April 1998 (DIPN No 33 relates to this legislation), advance clearances were available for the purposes of determining the application of the general anti-avoidance provision in the IRO, s 61A.

54 See note 51 above and related text.

55 See note 14 above and related text.

(3) The scope of section 35, which not only applies to transfers made by the deceased but to transfers made by anyone, anywhere, for any value and at any time and of assets which do not have to be Hong Kong assets, is extremely wide. For instance, section 35 can apply to a company from which the deceased has received benefits in the three years prior to death even though the transfer to the controlled company was made 30 years ago outside Hong Kong of foreign property, by a person who is neither resident nor domiciled in Hong Kong to a foreign company. Section 35(1) thus applies to a huge range of potential transfers, which may have nothing to do whatever with the deceased or Hong Kong. In the case of a group of companies, which includes offshore subsidiaries, it is in practice virtually impossible to identify all the transfers which might have taken place in order to get clearances under paragraph 7 of Schedule 2. The result is that in practice paragraph 7 is of very limited use. Therefore, if it were intended to be of use, it should be amended to ensure that in appropriate cases it is of practical value.

It is, of course, true that provisions which are anti-avoidance in nature should be wide enough to cover any possible loopholes in order to be effective and that any limitations of the scope will seriously affect the effectiveness of the provisions. It could thus be argued, as the Commissioner has done, that suggestions to (1) confine the definition of 'any person' making the transfer, (2) restrict the 'situs' of assets transferred to include only Hong Kong assets, and (3) limit the time of the transfer, would produce unintended loopholes. However, these arguments could be countered in either of two ways. First the controlled company provisions could be repealed in their entirety and replaced with a general anti-avoidance provision.[56] Alternatively, they could be redrafted in a much simpler and easily understood way, yet changed to incorporate more general anti-avoidance language, perhaps along the lines of a statutory formulation of *Furniss v Dawson*,[57] the leading United Kingdom case representing a judge-made attack on pre-ordained tax-driven transactions.

56 Such as that contained in Inland Revenue Ordinance (LHK, Cap 112), s 61A. This was not the view of JLCT, which noted that the EDO already contains very extensive anti-avoidance provisions, such as the 'associated operations' provisions in s 3. JLCT considered that the purposes of deceased persons making dispositions become very difficult to ascertain, particularly when transactions have taken place many years prior to death. It concluded that such an anti-avoidance provision would likely be productive of even greater delays in the administration of estates than at present and thus worsen what is seen as one of the worst aspects of estate duty. The counter argument to this is, of course, that a general anti-avoidance provision like s 61A focuses upon objective criteria, not subjective intention, and it is thus technically irrelevant that the deceased is no longer available to give evidence.

57 [1984] AC 474.

Remission of estate duty and the controlled company provisions

Section 27 of the EDO raises another technical issue relevant to the application of the controlled company provisions. Specifically, section 27 only permits the Commissioner to waive penalties and liability to interest on estate duty. It does not allow remission of the estate duty itself below the rate set out in the applicable Part of Schedule 1. On its face, therefore, section 27 contains a specific exclusion of any dispensing power in relation to estate duty that conflicts with the 1958 statement made by the then Financial Secretary as to the circumstances when the controlled company provisions would be applied.[58]

The Commissioner's response to this difficulty stretches the normal bounds of interpretation. In his letter to JLCT dated 10 March 1998,[59] he states that under section 20, the Secretary for the Treasury may remit the payment of any estate duty for which any equitable claim is made and proved to his satisfaction. He then noted that the remission power conferred by this section may be exercised in respect of a class of appropriate cases and the remission need not be in writing. The Commissioner takes the view that the pronouncement of the Financial Secretary in 1958 that the controlled company provisions would only be invoked where there was an element of evasion is already a legitimate remission of all cases in which no evasion of duty was involved. The Commissioner then proceeds to state that his only duty then is to examine each and every case in which assets are transferred to a controlled company to see whether it falls within the class qualifying for remission.

Given that the Commissioner has taken a very wide interpretation of what is essentially a dispensing power, it is highly unlikely that this will be the subject of complaint. However, a neater solution to this problem would be for the Secretary for the Treasury to confer upon the Commissioner a general dispensing authority under section 20 relating to cases where the charging provisions of section 35 will not be applied.

Small estates and exempt estates

An increase in the scope of the small estates procedure under EDO section 14A is a necessary reform.[60] This was limited to estates not exceeding $100,000 in value from 1972 until 1981 where no land, unquoted shares or business assets were involved. This threshold, long overdue for an increase, was eventually

58 See note 51 above.
59 See note 8 above.
60 Compare Fok, 'Wait Reduction' Hong Kong Lawyer (May 1998) p 16 which proposes relaxing the estate duty reporting procedures to speed up the administration of small estates and reduce the workload of the Estate Duty Office.

increased in 1981 to $400,000.[61] It has since remained unchanged. This limit should now be further increased to a level substantially exceeding $400,000. It is also unsatisfactory that the procedure should be excluded where the only land falling within the estate is a residential flat of modest value.

A further long overdue reform is to reduce the estate duty threshold below which no reporting of assets is required for estate duty purposes. Currently, that threshold is a miniscule $150,000, which is the amount up to which the estate can be administered by the Official Administrator.[62]

At the very least, the Commissioner should conduct a thorough review to see (1) how long is generally taken for settling a so-called small estate and obtaining probate and (2) whether these cases are subject to cursory review by the Assessor or whether they are looked at in some detail. This review would enable an informed decision to be made as to what should be a fair exemption level for both the small and exempt estates procedures described above.

Quick succession relief

The Commissioner has reported that from April 1990 to August 1992 out of a total of 812 dutiable cases, quick succession relief under EDO section 31 was only granted in four cases. The total duty involved relieved was $338,700. Records of the relief granted prior to April 1990 are no longer available.[63] This evidence indicates that quick succession relief could be extended to apply to all assets, rather than simply to business assets and immovable property as at present. However, the better argument appears to be that there is a good rationale for relieving estate duty on business assets and immovable property only because these are hard to 'break up' and the sale thereof to pay estate duty may cause particular hardship. On this analysis no change is recommended.

However, one provision that might be reviewed in light of previous inflationary trends is the proviso to section 31. This limits the value on which quick succession relief is calculated on the second death to the value of the property on the first death. There seems no reason for this restriction, which originated in 1914 before modern rates of inflation were known. Where asset values are decreasing, problems also arise because only the lower value of the asset on the second death is taken into account to minimise the double taxation that the relief is supposed to avoid. These anomalies are not only capricious in their effect but are also out of date and should be corrected.

61 See Ord No 29 of 1981, s 5.
62 See also Fok, note 60 above.
63 Letter from the Commissioner of Inland Revenue dated 19 August 1992 to Michael Olesnicky, Chair of JLCT, a copy of which the author has on file.

Rates of duty and indexation generally

The increase in the threshold for estate duty in 1990[64] was a substantial reform bringing most families outside the scope of the estate duty regime. Subsequently, after 1992 rates have generally been adjusted in line with the prevailing rate of inflation.[65] On this ground, there is no major cause for concern. However, other miscellaneous reliefs provided by the EDO, such as the inter vivos gift exemption of $200,000 contained in section 6(1)(c), ideally should be indexed so as to increase automatically in line with changes to the Consumer Price Index.

Looking specifically at the manner in which estate duty is charged,[66] a new scale of estate duty rates with no duty on the first slice and then duty at progressive rates on successive slices in a way similar to salaries tax is a necessary reform. This would replace the present 'slab' system under which, subject to the application of marginal relief, there is one rate for the whole estate. Such a change was made to United Kingdom estate duty in 1969[67] and was a great improvement. No difficulties need result from such a change although it would be necessary to find the average rate of duty for the estate as a whole in order to calculate duty attributable to particular assets. Any overall loss in revenue could be made good by adjusting the rates of duty at the upper end of the scale.

Jointly-owned property

The introduction of a three-year rule for section 6(1)(d), similar to that contained in section 6(1)(c) in relation to gifts, is another necessary reform. As the law now stands where a person transfers his or her own property into joint names, the whole is dutiable on the death of the transferor no matter how long after the transfer the death occurs. While a gift of half may have been intended, the Commissioner can apply section 6(1)(d) and claim duty on the whole whether or not three years has elapsed since the disposition. The strict law has been mitigated by a concession[68] which has the effect of equating the gift (section 6(1)(c)) and joint property (section 6(1)(d)) charging heads. However, this concession could be withdrawn by the Commissioner and ought to be reflected in the legislation.

64 See Ord No 31 of 1990, s 9 which raised the estate duty exemption limit from $2 million to $4 million.

65 In his letter dated 10 March 1998 to JLCT, see note 8 above, the Commissioner makes the interesting point that: 'Estate duty thresholds have been reviewed annually over the past years in the Budget exercise. The reviews are in fact more comprehensive than an indexing exercise as they covered not only consumer price indices, but also property price indices, stock indices, economic conditions, budgetary considerations, etc.'

66 Under the applicable Part of EDO Schedule 1, duty is charged at the appropriate rate to the *whole* of the dutiable estate, subject to marginal relief.

67 See Finance Act 1969, Schedule 17, Part I.

68 See letter dated 11 June 1979 from the Commissioner to The Law Society of Hong Kong, reprinted in Willoughby and Halkyard, note 11 above, III [8].

Surviving spouse exemption

Most commentators would agree that where the deceased's estate devolves to the surviving spouse, the inability of the surviving spouse to dispose of family assets until probate has been granted can cause great hardship. This could be seen to be oppressive where the delay is caused by the imposition of estate duty. Accordingly, there should be a complete exemption from estate duty in respect of property passing between spouses whether under a will or on intestacy (as is the case in the United Kingdom[69]). If this were accepted, the matrimonial home exemption under EDO section 10A could be repealed.

When this was pointed out to the Commissioner by the JLCT, his response was somewhat flinty:[70]

> Estate duty is levied by reference to the total value of the property passing on a death. It follows, as a point of principle, that the relationship between the deceased and the beneficiary is not relevant for the majority of assets (although special provisions do apply to the matrimonial home to alleviate possible hardship). A complete exemption for property passing between spouses would be contrary to the general principle of estate duty and defer its collection. This suggestion could not be supported.

This response is very much at odds with the 'family based' assessment adopted by the Inland Revenue Ordinance where not only is personal assessment available to married couples, but a whole raft of personal allowances and concessionary deductions are available to take into account the acknowledged interdependence and filial responsibilities accepted by Hong Kong families. The Commissioner's rejection of this proposal seems hardhearted and much too formalistic.

Technical corrections

There are many provisions of the EDO which are difficult to understand and for which greater certainty is desirable. Examples are numerous but include the provisions relating to the situs of specialty debts,[71] the provisions dealing with life settlements[72] and the provisions relating to exemption from estate duty for charitable inter vivos and testamentary gifts.[73]

69 See Inheritance Tax Act 1984, s 18.
70 See note 8 above.
71 See the tension between ss 6(1)(g) and 10(b).
72 See s 6(1)(b), a complex provision having some continuing effect despite its substantive repeal and replacement in 1959 by s 6(1)(h).
73 Compare the terms of ss 6(1)(c), 6(7) and 10(g).

Estate duty charge on gifted land

There are a number of conveyancing cases concerning charges imposed under EDO section 18 on gifted land. These cases, decided by the former High Court, are conflicting and there is currently no Court of Appeal decision to reconcile them.[74] In short, the Estate Duty Office is not required to register such charges and indeed, before a relevant person dies, it would not have any knowledge of its latent charge in any event. Section 66 of the Interpretation and General Clauses Ordinance[75] indicates that the Land Registration Ordinance[76] will not bind the government. Accordingly, purchasers of immovable property that has been the subject of an inter vivos gift within three years of purchase may be effectively liable to estate duty.[77] Paradoxically, this problem regularly manifests itself in a conveyancing context where the purchaser argues that, given the existence of this latent charge, the vendor's title is defective so as to justify the purchaser refusing to complete the transaction.

Section 18, by enabling the Commissioner to hold a charge over land to secure payment of duty, can impose great unfairness where a purchaser buys land in ignorance of that charge. Accordingly, the section 18 charge should apply either to the property (in the normal case) or to the proceeds of sale (in the event of a bona fide sale). In other words the charge should be overreached on a bona fide sale and attach to the proceeds of sale.[78]

Unfortunately, the Commissioner has not supported this submission. In his letter to JLCT dated 10 March 1998[79] he stated:

> This issue has been carefully considered on several occasions. It stems from the approach taken in the UK to shift the estate duty charge from the property itself to the proceeds of sale of the property (section 38 of the Finance Act 1957). However, this section was introduced to plug the then loophole of the 'disappearing trick' under which a property given by a donor before death 'disappeared' as at the date of death, such as by having debentures or redeemable preference shares redeemed prior to the death. Section 38 allows the onward tracing of the proceeds of any sale or redemption to determine the liability to estate duty. As such, it is more an anti-avoidance provision than a relief provision.

74 See Willoughby and Halkyard, note 11 above, I [2505] and II [965]-[968].

75 LHK, Cap 1.

76 LHK, Cap 128. The effect of these provisions is that the Commissioner is not obliged to register the charge at the Land Registry.

77 Although the proviso to s 18(1) contains an exception for a bona fide purchaser for value without notice, a purchaser will have constructive notice of the charge where there is a gift on the title within three years of the agreement for sale and purchase and actual notice where there is an earlier gift which the purchaser knows to be subject to a reservation in favour of the donor. See also Willoughby and Wilkinson, *Registration of Titles in Hong Kong* (Singapore: Butterworths, 1995) p 222.

78 It is understood that the Hong Kong Law Society's position has always been that the s 18 charge should attach to the proceeds of sale after disposal by the donee.

79 See note 8 above.

> In Hong Kong, estate duty is only payable on assets located here — no liability arises in respect of assets located elsewhere (section 10(b)). The suggestion will open up opportunities for exploitation of the concessions along the lines proposed. To illustrate the point: if A (who was close to death) gifted land to B who quickly sold it to C shortly prior to A's death, estate duty under the existing law is payable regardless of how B disposed of the proceeds of sale. This is because the dutiable gift remains the land itself. If, however, the charge is modified along the lines suggested, then the liability to duty would follow the sale proceeds. If the proceeds of the sale were placed in offshore deposits or used to acquire shares in offshore companies, then the liability to estate duty on the inter vivos gift of landed property would be extinguished.

With due respect, the Commissioner's response is not to the point. It is true that section 38 of the United Kingdom Finance Act 1957 is essentially an anti-avoidance provision to counter claims that duty is defeated where the gifted property 'disappears' between the gift and the death and is, in substance, replaced by some other asset.[80] It is also true that this provision dealt, albeit tangentially, with the very problem described above. But it dealt with this problem generally and certainly not specifically in the context of estate duty avoidance. *Green's Death Duties*[81] puts it is this way:

> The official view [of the UK Revenue] is that a purchaser is not protected from a 'latent charge' [such as where the property has been the subject of a gift inter vivos and the purchaser has notice of the facts]. But, in practice, the Revenue would seek to enforce such a charge only in exceptional circumstances, and ... the scope of the problem has been much reduced by s. 38 of the Finance Act 1957, whereby, on a sale, the 'latent charge' is usually transferred to some other property. (emphasis added)

It is clear therefore that the Commissioner's justification for not changing section 18 relies on the wrong assumption that the United Kingdom precedent sought to be adopted in Hong Kong should be considered solely in an anti-avoidance context. Not only is this an overly narrow interpretation, it simply does not address the conveyancing problems and unfairness highlighted by section 18 and the conflicting case law that has sought to interpret it.

In so far as the Commissioner's second justification is concerned, it seems to focus upon the wrong point. If the Commissioner is suggesting that recovery of duty may be more difficult because the proceeds of sale of the gifted

80 See generally, *Green's Death Duties* (London: Butterworths, 6th ed, 1967) p 145.
81 Ibid p 561.

property are outside Hong Kong, then this is undoubtedly correct. But this does not appear to be the Commissioner's main concern. Rather, he states 'that the liability to estate duty on the inter vivos gift [of land] would be extinguished.' This, of course, is simply incorrect and confuses liability to duty with the incidence of duty.

In conclusion, it is submitted that apart from possible increased problems of recovering estate duty on gifted property that has subsequently been sold, there has been no adequate response to the unfairness that section 18 may wreak on a purchaser and the opportunity has been lost to solve the conveyancing problems referred to above. This is a matter that should now be rectified.

Limitation on the Commissioner's right to assess and recover estate duty

Unlike the Inland Revenue Ordinance and the Stamp Duty Ordinance, the EDO contains no limitation on the right to recover estate duty. Assessments can be raised at any time without limit. This might be considered unsatisfactory because it inhibits the timely distribution of an estate. It might also be argued that it creates a positive disincentive for the Commissioner to settle awkward or difficult cases. Accordingly, it has been suggested that assessments in respect of any assets disclosed in an affidavit or corrective affidavit filed with the Commissioner must be raised within six years from the date of filing the affidavit or corrective affidavit (as the case may be) and ten years in the case of fraud.[82]

The Commissioner's rejection of this suggestion for change is mainly based upon compliance concerns. He states:[83]

> Of all our taxes, estate duty is the one that relies most heavily on the voluntary compliance for its administration and collection. This voluntary regime is supported by a mechanism which does not impose time limits on the making of assessments, which requires clearances before the assets can be administered, and which imposes interest from the date of death and levies heavier interest rates on affidavits filed outside the stipulated period. The absence of a time limitation is vital to the effective running of the voluntary system. On the other hand, if a time limit were to be imposed on the raising of assessments, the IRD could not be assured that details of the estate are *voluntarily* and *fully* reported within such time.

82 Compare IRO s 60.

83 See note 8 above. The Commissioner then goes on to note that it is not always the responsibility of the Estate Duty Office where a long lapse of time was taken to finalize a complex case. The Commissioner indicates his experience in more complex cases experience has shown that most of the executors or personal representatives adopt a reactive approach in dealing with the Estate Duty Office and they seldom take the initiative to conduct extensive enquiries into an estate's affairs in the first instance.

In the light of the performance pledges noted above, and their observance by the Inland Revenue Department, without more than anecdotal evidence it seems unfair to argue that the absence of a time limit for raising estate duty assessments creates a disincentive for the Commissioner to settle awkward or difficult cases. Accordingly, it does not currently appear justified to change the EDO to ensure that assessments must be raised only within a fixed period of time.

Estate duty appeals

When assessments are raised and disputes arise with the Estate Duty Office,[84] there should be a simple or summary procedure whereby the Commissioner can be required to state his opinion on a particular matter. The current appeals system, whereby appeals lie in the first instance to the Court of First Instance,[85] is expensive and a major impediment to executors challenging the views of the Estate Duty Office. It is not to the point to counter that there are very few estate duty cases on appeal and that it is thus not necessary to introduce any new appeals procedure. In this instance, the reason why there are so few appeals highlights the problem, rather than answers it.

Valuation issues

Currently, estate duty is levied on the principal value as at the date of death of the dutiable assets passing upon death.[86] This can cause hardship to the beneficiaries, particularly in a falling market and also where the assets, though valuable, are not easily sold or indeed easily valued. In the most serious of these cases, it is understood that the problem has sometimes been solved by an application for relief from estate duty under EDO section 20. The solution in the United Kingdom for estate duty and capital transfer tax was the right to substitute the arm's length sale price for "qualifying investments" within a set period from death.[87]

Given that the problem has been recognised in both jurisdictions, it now seems appropriate to deal with it. A fair solution would provide that duty on property passing on death should be calculated on the lower of market value as at the date of death or, in the case where an asset is sold within one year of death, the market value of that asset at the date of sale. If this suggestion were adopted, hardship would be avoided where estate duty has to be paid from the proceeds

84 These can arise quite often given the complexity and uncertainty of estate duty law.
85 See EDO s 22.
86 See EDO s 13(1).
87 See Finance Act 1975, Schedule 10, Part II. See now Inheritance Tax Act 1984, s 178(1).

of the sale of assets that have experienced a sudden drop in market values after death. In such circumstances, if estate duty had already been paid, the estate should be able to claim an appropriate refund of duty. Alternatively, if simplification and the speedy administration of estates were overriding factors, this one year proposal could be reduced to six months, which is the time limit for filing the estate duty affidavit and accounts with the Commissioner before additional interest charges start to apply.[88]

Conclusion

This article has endeavoured to analyse various themes relating to the future of estate duty in Hong Kong. First, it is concluded that, contrary to many voices raised in opposition, estate duty should have a future and the case for its abolition has not been adequately established. Second, looking back over the past 80 years since the enactment of the EDO, there has been little attempt to reform the now outdated legislation. By and large that legislation deals with legal relationships in vogue in the United Kingdom in the early days of the twentieth century, a place and time far removed from Hong Kong as it moves into the new millennium.

This article has also attempted to identify the major problem areas reflected by the current law and practice of estate duty. Appropriate responses to meet them have been suggested, ranging from the prosaic (simplification in certain areas), to technical amendments (where the law appears unclear), to changes in the rate structure (to achieve greater horizontal equity). Detailed criticism has focused upon the controlled company provisions and the suggestion put that they be radically changed in favour of more general anti-avoidance criteria which can reflect well-established practice.

Where appropriate, the healthy debate between the Commissioner and JLCT has been highlighted in this article, often in some detail. Although the Commissioner's response to suggested changes has generally been quite negative, the process of debate has been useful. To the extent that this article brings focus to the nature of disputes over estate duty reform in Hong Kong, that can only be a good thing. Paradoxically, the one major legislative 'reform', dealing with controlled companies, is overly complex and has a huge potential scope. In the circumstances, it seems churlish if Government were to continue to deny calls, not just for systemic reform, but also for simplification to make the EDO more easily understood and more in line with modern Hong Kong conditions.

88 See EDO s 12(4), (6) and (7).

APPENDIX

Estate Duty Information Supplied by the Commissioner of Estate Duty to JLCT

(1) Type of dutiable assets and amount of duty levied — based on 181 cases with value exceeding $5M finalised in 1991/92

Type of Dutiable Assets	Deposits in Banks	Deposits in Business	Debts due to the Deceased	Quoted Shares	Other Business Investments	Immovable Property	Gifts inter vivos	Other Property (Personal Chattels etc)	Total
Assessed value ($M)	526	12	24	758	360	664	443	3	2,790
Assessed duty ($M)	93.1	2.2	4.2	134	63.8	117.5	78.3	0.6	493.7
Percentage of duty	18.9%	0.4%	0.9%	27.1%	12.9%	23.8%	15.9%	0.1%	100%

(2) Make-up of a typical dutiable estate — from the same sample as (1)

No of Cases	Deposits in Bank	Deposits in Business	Debts due to Deceased	Quoted Shares	Other Business Investments	Immovable Property	Other Property including gifts inter vivos
23 cases	√			√		√	√
13 cases	√	√				√	√
11 cases	√		√			√	√
10 cases	√				√	√	√
10 cases	√			√	√	√	√
5 cases	√					√	√
72 cases Total							
Percentage of cases with each type of assets	87.3	16.6	9.3	50.8	35.9	70.2	81.2

The above table shows the typical combinations of assets of a dutiable estate. A typical dutiable estate normally has (a) bank deposits; (b) quoted shares and (c) landed properties, which accounted for 40% of the cases surveyed.

The liabilities are mainly funeral expenses; debts due to banks in the forms of mortgage loans and overdraft or debts due to private companies.