Estate and donations duties for Hong Kong

Philip Marcovici[1]

Estate duty in Hong Kong was abolished as of February 11, 2006. Now, more than ten years later, it is time for a return of not only estate duty to Hong Kong, but of a comprehensive accompanying donation tax.

In a 2015 speech entitled 'Lifting the Small Boats' delivered by Christine Lagarde, the Managing Director of the International Monetary Fund, Ms Lagarde emphasised that the theme of growing and excessive inequality is not only a matter of newspaper headlines, but is a growing problem for economic growth and development. It is not immoral to enjoy one's financial success, said Ms Lagarde, but it is a reality that poor and middle-class families have not been able to stay afloat through hard work and determination alone. Reducing excessive inequality, according to Christine Lagarde, is not just morally and politically correct, but is good economics, essential to the generation of higher, more inclusive and sustainable growth.

IMF research shows that if the income share of the poor and middle class is raised by one percentage point, GDP growth increases by as much as 0.38 percentage points over a period of five years. An increase in the income share of the wealthy by the same one percentage point results in a decrease of GDP growth by 0.08%, likely due to the lower fractional spending of income by the wealthy.

In Hong Kong, inequality is a sad reality, as it is in most of our world. Inequality has become one of the most important political issues of our age, giving rise to populist governments, and increasing risk of social unrest and instability.

For a wealthy community such as is Hong Kong, inequality is just not right, and needs to be addressed, and now. A new system of estate and donation duties will not eliminate inequality. But steps in the right direction need to be taken.

Government policies and action are critical

Before turning to the logic of why Hong Kong needs estate and donation duties, it is important to emphasise that taxation alone does not address inequality. The Hong Kong government needs to be creative and proactive in developing policies that address inequality in a real way.

Critical targets need to be set for ensuring access to education, healthcare and housing, and to addressing the sad state of the environment in Hong Kong. While there are economic arguments against governments hypothecating taxes (earmarking particular taxes for particular expenditures), consideration might be given to linking new estate and donation duties to specific programs oriented to addressing specific needs of our community, and to specifically address growing inequality. This might help create a sense of real action on the part of the Hong Kong government and a sense of purpose and meaning for those subject to the new estate and donation duty regime.

Why estate and donation duties?

Hong Kong has one of the most taxpayer friendly tax systems in the world, affording those

---

[1] Philip Marcovici is retired from the practice of law and consults with governments, financial institutions and global families in relation to tax, wealth management and other matters.

living, working and investing in Hong Kong the ability to accumulate wealth at a pace that is simply not possible in countries with high tax rates and a wide taxation base.

Top tax rates are well below 20% in relation to even the highest salaries and business profits. Further, Hong Kong taxation only applies in relation to Hong Kong source income, meaning that income sourced abroad is totally free of taxation in Hong Kong. And unlike many other jurisdictions, Hong Kong does not tax capital gains, even when realized, or dividends. Indirect taxation, such as a value added tax, does not, at least so far, apply on purchases of Hong Kong goods and services, something that contrasts with the approach of many other countries, particularly in Europe, where such indirect taxation contributes hugely to government revenues. Remarkably, even high cost luxury goods are completely free from sales taxes.

Governments need a broad revenue base, and Hong Kong is not excluded from this, despite historic success in generating revenue through land sales and enjoying significant budget surpluses. Hong Kong's ability to rely on a narrow base of taxation for the long term would be a risky policy decision for a forward looking government.

But apart from broadening the tax base, estate and donation duties would serve another very important need: they would introduce to Hong Kong a sense that government cares about inequality and about those in need, and that those who have benefited from the enormous opportunity of being connected to Hong Kong by residence, place of investment or otherwise are part of the collective effort to address the needs of our entire community.

Historically, estate duty contributed around HK$1 billion annually to government revenues, a relatively insignificant amount in view of current budget surpluses. There is little question, however, that a more comprehensive approach to the imposition of estate and donation duties would add meaningful revenue. Broadening the base of revenue for the Hong Kong government is important in view of the current narrow revenue base, and the reality that concentration on land sales and stamp duties associated with property transactions is not a safe, long-term way for government to fund the needs of Hong Kong and its aging population. Indirect taxation, such as value added taxes may be part of the future of Hong Kong's tax system, but such taxation is regressive. An estate and donation duty system would help balance an approach to indirect taxation, and possibly allow for lower rates and additional exemptions for necessities, helping to alleviate many of the negatives of indirect sales taxes.

But would imposing estate and donation duties be a technical nightmare?

Fair taxation needs to be simple and transparent taxation.

While there will be challenges in adopting the right approach to the imposition of estate and donation duties in Hong Kong, these challenges can be met given the many examples worldwide of such regimes that work, and Hong Kong's own experience with its historic estate duty and the many solid recommendations that had been made regarding its retention and reform. Among these is an excellent article by Andrew Halkyard, then Associate Professor in the Faculty of Law at the University of Hong Kong, entitled 'Hong Kong Estate Duty: A Blueprint for Reform', 30 Hong Kong L.J 47 2000.

While it is not the intention of this article to propose a detailed new law to implement Hong Kong estate and donation duties, there are a number of points that can be made regarding the relative ease with which such laws could be developed, and some of the global dynamics that would make it easier to ensure enforcement today than was the case more than ten years ago, when Hong Kong abolished estate duty. And it is interesting to note that Hong Kong's abolition of estate duty may not have been particularly well thought out.

Can estate and donation duties be imposed in a fair and effective way with an eye to ensuring that Hong Kong does not jeopardise its attractions as a wealth management centre and as an investment destination?

Hong Kong can be ambitious. A well-designed estate and donation duty system can raise revenue, be simple and fair. Hong Kong can also establish an estate and donation duty system that can be effective – a system that raises much more in the way of revenue than the cost of administration and otherwise, and which preserves the attractions of Hong Kong as a place to live and work, to invest and in which to conduct a wealth management business.

When Hong Kong's estate duties were abolished more than ten years ago, some of the arguments made reflected a view that having estate duties could be harmful to Hong Kong's objective of developing itself as a wealth management center. Relevant was that Singapore was also considering abolishing its estate duties, something it ultimately did. But Singapore, like many countries, is reconsidering that decision, and the debate in Singapore regarding what it takes to create a fairer society is in progress.

But more importantly, there really are few reasons to believe that having a well thought out estate and donation Duty regime would chill any efforts to further develop Hong Kong as a wealth management center and as an investment destination. More important to these objectives are other factors, as can be seen from how other successful wealth management locations have managed to combine the imposition of such taxes with significant attractions to the international community to make use of their locations for wealth management – and here the US, the UK and Switzerland would be but three examples. Exemptions can apply to encourage certain activity, and guidance from the experiences of other jurisdictions would be instructive for Hong Kong.

Similarly, on the attractiveness of Hong Kong as an investment destination, an effective, low rate estate and donation duty regime should not be viewed as a deterrent to investment. There are many global investment centers, including the UK and the US, that continue to attract significant foreign investment despite donation and inheritance taxes. Some exemptions are carefully targeted to apply; in some cases, the tax exposures are there and are part of what investors anticipate in relation to their investment.

Hong Kong would have many choices it can make in how its estate and donation duty is formulated so as to minimise any negative impact on choices investors make, or on its objective to compete as a meaningful wealth management center.

Information exchange, the Common Reporting Standard and more

In an article published in 1991 in Tax Notes International, the author of this article advocated Hong Kong developing a wide network of tax treaties, agreements on taxation between countries, facilitating and encouraging cross-border investment and addressing, among others, situations of double taxation and ensuring effective information exchange. The ideas expressed were based on the view that in the run up to the return of Hong Kong to China in 1997, Hong Kong would have been able to negotiate particularly beneficial treaties with other countries.

While the author received an open ear from the Hong Kong government at the time, many tax professionals, from accounting and law firms and elsewhere, spoke out against the initiative, fearing that Hong Kong entering into tax treaties would compromise Hong Kong's ability to maintain secrecy, and retain and attract foreign investors seeking, for good and bad reasons, to hide behind opaque Hong Kong structures and investments.

Today, Hong Kong is trying to catch up with others in the tax treaty arena, such as Singapore, and has a growing network of comprehensive tax treaties. But some of Hong Kong's treaties only deal with information exchange, Hong Kong having long lost its negotiating power in light of global tax transparency initiatives and the need Hong Kong has had to enter into a vast network of tax information exchange agreements. But the bottom line is that Hong Kong is now part of the global shift towards significant tax transparency.

The changing world has also resulted in the development and adoption by Hong Kong, and by many, many other jurisdictions, of new automatic information exchange rules. Among these features the Common Reporting Standard, developed by the OECD, and under which Hong Kong both automatically sends information to other countries regarding bank accounts maintained in Hong Kong, and receives such information from other countries in relation to residents of Hong Kong having interests in such accounts overseas. Impossible for many to have contemplated ten years ago, today beneficial ownership information is being exchanged automatically in relation to bank accounts held directly or indirectly, through trusts, foundations, offshore companies and other previously opaque structures.

But even more is happening in the world of growing tax transparency. Registers of ownership of companies and other investment vehicles; transparency on the ownership of real estate and other assets; and a growing range of tools based on technology and cooperation between governments is leading to a world where tax authorities, including those in Hong Kong, have and will have at their disposition the information they need to easily enforce their tax systems.

For Hong Kong to develop an estate and donation duty system is now a much easier task than it would have been even a few years ago.

Many Hong Kong investors are subject to donation and inheritance taxes in other countries – why should they not have home jurisdiction obligations?

Wealth owners in Hong Kong invest globally, and when they do, they become subject to taxation in other countries, which taxation is sometimes reduced or eliminated under tax treaties Hong Kong is a party to. In the income tax area, many countries impose withholding taxes on interest, dividends, rents and other payments, and in some cases other taxes, such as on capital gains and otherwise. Where a Hong Kong resident, normally defined for treaty purposes as an individual 'ordinarily resident in Hong Kong' is the investor and an appropriate tax treaty applies, the foreign tax exposure is often reduced, and sometimes eliminated.

Countries also have estate and gift tax treaties, something that Hong Kong does not have given that it does not tax either estates or gifts. A strategy under which Hong Kong would develop a new Hong Kong estate and donation duty would allow Hong Kong to develop such a network of treaties, ensuring that its revenue base is protected, but also helping to manage the tax exposures abroad of those resident in Hong Kong, adding to the many attractions of being a Hong Kong resident.

But why should a Hong Kong investor be subject to inheritance taxes at rates of up to 40% of the value of real estate investments in the UK but zero tax on the value of their real estate investments in Hong Kong? And in the case of the UK, the tax cannot be avoided by interposing a Hong Kong or other company between the investment and the beneficial individual owner.

Estate and donation duties and the Basic Law

The Basic Law is likely to come up in any debate regarding the imposition of new taxes, such as the development of a new estate and donation duty regime.

While there may be different views on the issue, the Basic Law, in the tax area, provides broad economic guidelines for governments of the HKSAR to follow. Unlike substantive rights, such as the right of abode, economic and taxation articles of the Basic Law should not be regarded as being immutable year by year. Rather, references to taxation should be viewed in a broader context that does not ignore changing economic needs and circumstance. The Hong Kong government should be freely able to decide on something like the imposition of an estate and donation duty, while adhering to the guidelines of the Basic Law, which provides for a sound long-term foundation of taxation and economic policy in Hong Kong.

The contrary view would be that the Basic Law entrenches an approach to taxation, and that references to taxation were specifically designed to fetter future governments. For example, BL 108 prescribes that Hong Kong shall continue to practice a low tax policy. Although this is clearly in line with previous policy and appears to generally meet with the approval of the Hong Kong public, it is highly debatable whether such a policy should be viewed as a mandatory provision in the laws of the HKSAR that would preclude residence based taxation (which already applies in areas such as Hong Kong's offshore funds legislation). A fairly low rate of duty imposed upon gifts and estates should not breach this provision, even if the jurisdiction to tax has changed to meet specific needs and policy goals.

The goals set out in Chapter V of the Basic Law dealing with the economy, such as maintaining a free port, balanced budgets, and low rates of taxation, are laudable as policy objectives. They also seem to have been supported by the public in Hong Kong, have been adhered to for many years and, subject to a stable economic environment, will no doubt continue to be pursued in the foreseeable future. However, given the increasing economic volatility of international business, and a challenging domestic economic and social environment, the ability of the Hong Kong government to pursue these goals successfully in the longer term, let alone on an annual basis, is questionable. To enshrine these policies in what is essentially the constitution of the HKSAR restricts the policy options of the government and should not be read in such a confining way. And, more importantly, the development of an estate and donation duty is not at all inconsistent with the notion of maintaining 'low rates of taxation'- in many respects, broadening the tax base is what will permit Hong Kong to continue to offer 'low rates of taxation,' while building a fairer society that is reflective of what Hong Kong can and should be.

One possible approach

The author of this article stands by to provide the Hong Kong government and others interested with more detailed, technical ideas on how a fair system of Hong Kong estate and donation duty could be developed, including how it can be enforced and implemented without compromising Hong Kong's attraction as an investment destination, a wealth management centre, a place for wealth owners to live and otherwise.

But would it not be fair if:

- Those ordinarily resident in Hong Kong were subject to an estate and donation duty with a top rate of 8% on the value of assets passing to other than a spouse or life partner on death or by way of donation?
- Those ordinarily resident in Hong Kong were exempt from the estate and donation duty on their principal place of residence if they are living in it full time and on the first HK$10,000,000 of other assets?

- The estate and donation duty had rates that start at 3% for donations and estates over HK$10,000,000, rise to 5% at HK$20,000,000 and apply at the full rate of 8% only for estates of over HK$30,000,000?
- The estate and donation duty applied to all worldwide asset values, with credits for gift and estate taxes actually paid in other countries, but with no other deductions?
- Those not ordinarily resident in Hong Kong were subject to the estate and donation duty only on their Hong Kong situs assets, with perhaps only bank deposits being exempt, as is the case in some other countries that impose such taxation on nonresidents?
- Collections from estate and donation duties were hypothecated (earmarked) and could be used by government only to support programs specifically designed to address inequality – education, healthcare, housing and the environment?
- No deductions were to apply – even for other charitable donations or otherwise – keeping the new system simple and free from abuse? With a low top rate of 8%, there would be little discouragement of additional contributions, whether to charity or as, possibly, voluntary additional payments to the government programs linked to the new tax.

It is time for a serious reconsideration of Hong Kong tax policy in relation to estate and donation duties, and for a meaningful move towards creating a fairer society.