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Hong Kong Tax Tips

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Contents of Volume 1

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This book is based on my work experience in IRD.

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On 2 November 2005, the Legislative Council passed the Revenue (Abolition of Estate Duty) Bill 2005 to abolish estate duty. The proposed abolition is to facilitate the development of Hong Kong as an asset management centre. With the abolition, Hong Kong can attract more local and overseas investors to hold assets here. That will facilitate the development of asset management services, create employment opportunities, and so make Hong Kong competitive as an international financial centre. Besides, the abolition can shorten the time taken for obtaining the grant of probate so as to ease the successor's cash flow problems. The Ordinance will commence operation on 11 February 2006. Estates of persons dying on 11 February 2006 or after will not be subject to estate duty. As for those deaths between 15 July 2005 and 10 February 2006, their estates (if greater than \$7,500,000) would be subject to a nominal duty of \$100.

The government spokesman said: "In the past, the assessment of estate duty and the application for grant of representation have been closely linked. These arrangements have indirectly safeguarded the interest of beneficiaries in the estate concerned. The Revenue (Abolition of Estate Duty) Ordinance enacted by the legislature today has incorporated comments and views from Legislative Council Members and organizations such as the Law Society of Hong Kong and the Hong Kong Association of Banks in order to provide a legal framework and associated measures that continue to safeguard the beneficiaries in the absence of estate duty assessment procedures."

To safeguard the beneficiaries after the abolition, the

government introduces a new scheme with the following features:

- *provisions for criminal offence to deter unlawful intermeddling of the estates*
- *requirements for the personal representative to prepare an inventory of the estate*
- *provisions to empower the Secretary for Home Affairs to authorize on application release of money from the deceased's bank account to meet funeral expenses or the maintenance of any dependants of the deceased*
- *provisions to facilitate inspection of the safe deposit box of the deceased by the personal representative and beneficiaries before issue of the grant*
- *a mechanism to exempt persons dealing with small estates from the intermeddling provisions.*

A new office will be set up about one year after the abolition of Estate Duty within the purview of The Secretary for Home Affairs to carry out the above functions. Before the operation of the new office and as a transitional measure, the Estate Duty Office will carry on discharging the functions as before.

Summary of the new law

Where a person died before 15 July 2005, the executor must obtain estate duty clearance before he can apply for probate. However, from 11 February 2006 onward, no estate duty clearance is required as all deceased persons' estate are exempt. So, the following estate duty notes only apply to persons who died before 15 July 2005. The chief reason for publishing the following notes here is that there are still a number of estate duty cases not yet processed or not yet

finalized. This is due to the delay of either the executor in filing the affidavit or the Estate Duty Office in finalizing the assessment. So, I hope with the publication of the following notes the executors of such deceased persons can understand better about estate duty so that they can pay less duty and have their cases finalized early.

5.0 Overview of Estate Duty

Estate Duty is imposed on the principal value of all property passing on the death of a person. The dutiable property includes not only all the property owned by him in his own name and in joint name with others, but also all property which he gave away during the three years before his death.

The Estate Duty Office of the Inland Revenue Department is responsible for collection of estate duty.

A person administering the deceased's estate is called an executor. Some tax professionals like to classify executors into three types: (a) executor: a person named in the deceased's will to act so, (b) administrator: a person, not named as an executor in the will, administering the estate according to the court's grant of Letters of Administration, and (c) personal representative: whether he is an executor or an administrator of the deceased's estate.

Before an executor applying for probate or letters of administration from court, he must first obtain estate-duty clearance from Estate Duty Office.

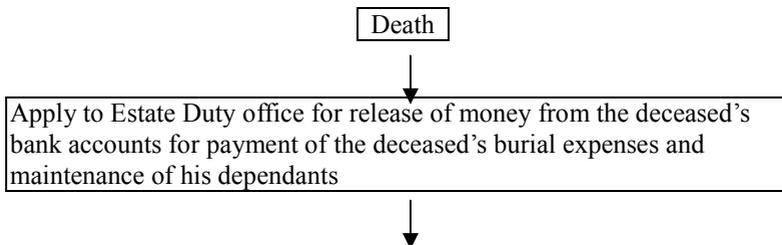
For a small estate without business or land property, the executor may file a Statement In Lieu Of Affidavit and then

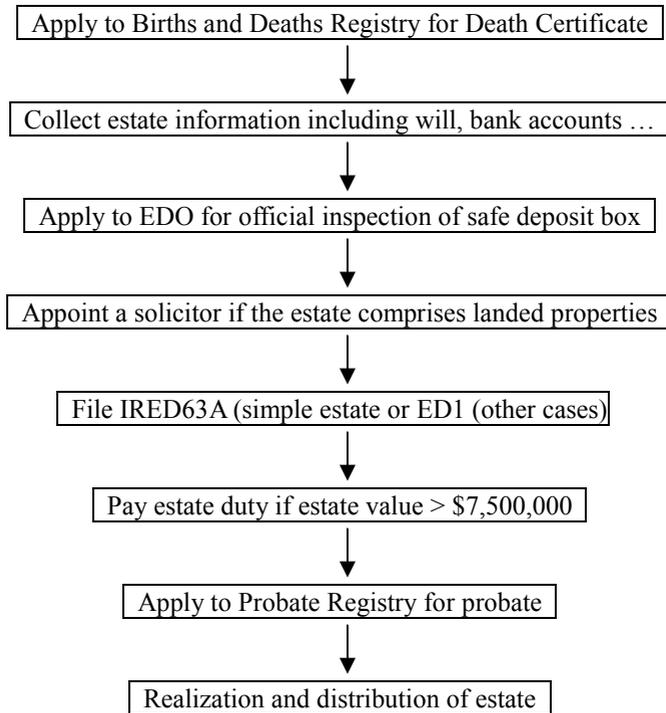
obtain a certificate of exemption under a simplified procedure. An estate is small if its value is below HK\$400,000.

For an exempt estate not meeting the simplified procedure, the executor should file an Affidavit for the Commissioner and certain documents relating to business valuation and property valuation and bank statements of the deceased covering the three years before his death. Then, the executor will get a certificate of exemption together with a schedule of property setting out all the property owned by the deceased. An exempt estate is one with a dutiable value below HK\$7,500,000.

For a dutiable estate (value over HK\$7,500,000), the executor should also file an Affidavit for Commissioner and certain documents relating to business valuation and property valuation and bank statements. To assess the duty payable, the estate will be thoroughly investigated and assessed. Then, an estate-duty assessment will be issued to the executor. After payment of the duty, a certificate of receipt of duty with a schedule of property setting out all the property owned by the deceased will be issued to the executor.

Below is a diagram showing the major steps in administering a deceased's estate.





5.1 Administration of the estate

If the deceased leaves a will, the executor named in the will can apply to Probate Registry for administering the estate. In other case, his relatives, in the order of spouse, children, parent, brother or sister, can apply for the administration.

What is estate duty clearance?

Before obtaining a grant of probate, the executor should get estate duty clearance from Estate Duty Office of Inland Revenue Department. If the estate has a value below \$400,000 and is without land properties, he can do this by himself. In that case, he should submit a Statement in lieu

of Affidavit to the office. If the estate has land properties or is complicated, he ought to consult a solicitor and file an affidavit with the office. If the dutiable value of the estate is below the exemption limit of \$7,500,000, the clearance will be in the form of a Certificate of Exemption. If it exceeds the exemption limit, the clearance will be in the form of a Certificate of Receipt of Estate Duty.

How to apply for the administration?

The executor can go to the Probate Registry to apply for a grant of probate for the will. If there is no will, the probate will be in the form of letters of administration. If the estate is simple and small (e.g. it has only few bank accounts with small balances), he can ask the Official Administrator to administer the estate in a summary manner without a grant of probate.

5.2 What assets are dutiable?

All property in Hong Kong passing upon the death of the deceased can be dutiable. Whether or not the deceased is a Hong Kong resident does not affect the charge.

Property includes movable property and immovable property, as well as their sales proceeds. It also includes money, goods, choses in action, land, buildings, shares, business, goodwill, copyrights, contractual rights, and actions for compensations or damages.

Property passing on the death includes:

- Property of which the deceased is competent to dispose.
- Property with a value exceeding \$200,000 which the deceased gave away absolutely within 3 years before

his death.

- Property given away in which the deceased kept a right to possession or enjoyment.
- Life interest or expectant interest enjoyed by the deceased.
- Interest in an estate of another deceased.
- Property held by the deceased as joint tenant or tenant in common with other person.

5.3 What assets are exempt?

Exempt property includes:

- Property situated outside Hong Kong.
- Property held by the deceased as trustee only.
- Property given away absolutely for at least three years before death.
- Property given to government or a recognized charitable organization.
- Property given away with a value below \$200,000.
- Property given away in consideration of marriage.
- Property given away as part of his normal expenditure.
- Property sold for full consideration.
- Property under a recognized retirement scheme.
- Matrimonial home passed to the surviving spouse.
- Life insurance proceeds.

5.4 Deductions

In computing the dutiable value, the funeral expenses subject to a limit of \$50,000 and the debts incurred for his own use or for his own benefit are deductible. But debts due to non-Hong Kong residents are not deductible unless they are subject to a charge on property in Hong Kong.

5.5 How to determine the dutiable value?

It is based on the open market value of the property as at the date of death.

Section 5 of Estate Duty Ordinance: Estate duty is payable on all property passing on the death of a deceased person (subject to other provisions of the Ordinance).

Section 6 defines "property passing on death" to include all property in which the deceased was competent to dispose immediately before death, certain gifts made by the deceased and certain interest owned or disposed of by the deceased in a trust or settlement.

5.6 Property passing

From case law, "property passing" means the changing of possession of beneficial interest in a property from one person to another.

A person is competent to dispose of a property if he can make it his own. If a person is competent to dispose of a property only in a particular event, he will not be competent to dispose it until that event occurs.

A general power of appointment owned by the deceased (usually according to a will or a trust deed) is a dutiable property. This is because by exercising that power, he can appoint himself to be the beneficial owner (even though he has not exercised that power before his death). However, a special power of appointment with which the deceased can appoint certain persons, excluding himself, to be the beneficial owner of a property is not a dutiable property.

In practice, almost all property owned by the deceased, including personal chattels or chose-in-possessions (such as antiques, paintings, jewels), real property (such as land and building) and chose-in-actions (such as shares, debts, copyrights), is property competent to be disposed by the deceased and therefore dutiable.

5.7 Trust, settled property and related exemptions

“Trust” is a big topic of law. If you have problems, I suggest you seek legal advice. Nevertheless, I would like to offer some guidance on its estate duty implications.

A “trust” is an equitable obligation imposing upon a person (called trustee) to deal with certain property (called trust property or settled property) for certain persons (called beneficiaries). There are various kinds of trust. The common topics concerning Estate Duty are set out below:

- Private trusts
- Presumption of resulting trusts
- Discretionary trusts

Where the deceased transferred his property to an approved charitable trust during his life time or on his death, the property is exempt from duty.

Private trusts comprise (a) express trusts and (b) implied trusts. An express trust is one expressly created by the settlor during his life through a trust deed, or on his death through a will, for a certain group of persons. The requirements for a valid trust are: (i) clear intention to set up a trust (ii) clear identification of the trust property and

(iii) clear identification of beneficiaries. An implied trust is set up either by presumed intention (resulting trust) or from the law of equity (constructive trust).

Estate Duty implications

Where the deceased has an interest in a trust, the interest (including a life interest) passing on his death is dutiable under Section 5.

Where the deceased is the settlor of a trust, the property he gave to the trust within 3 years before his death is dutiable as a gift under Section 6(1)(c). The three-year exemption will not apply if the deceased reserved an interest in the trust, for example he is one of the beneficiaries --- that means the property is dutiable even if it was made beyond 3 years before death.

Where the deceased has an interest in a trust and the interest is disposed of or ceased within 3 years before his death, the interest is dutiable under Section 6(1)(h).

Where the deceased has an interest in a trust, the interest (including a life interest) passing on his death is dutiable under Section 5 of Estate Duty Ordinance.

If the interest is a life interest in a landed property, for example a right to live in the property or a right to receive rental income until his death, then the entire property will be dutiable subject to the following exemptions:

- Section 30 - surviving spouse exemption: in the case of settled property, where estate duty has already been paid since the date of settlement on the death of one of the

parties to a marriage, it will not be dutiable again unless the life tenant was at the time of his death competent to dispose the property. This exemption applies in the following situation: A wife died after her husband and according to her late husband's will: she received rental income from a shop until her death and thereafter the beneficial ownership shop will absolutely pass to her son. Then, if estate duty had been paid in respect of the shop on the death of the husband, it is not be dutiable when the wife died.

- Section 6(6) – reversionary trusts exemption: a trust property is exempt from duty on the death of the life tenant during the life time of the settlor if the interest reverts to the settlor and the settlement creates no interest other than life interest.
- Section 33 exemption: in the case of settled property, where the interest of a person in a settlement fails or determines by reason of his death before it becomes an interest in possession, such interest is exempt from duty.

Where an interest in a trust is dutiable, it is necessary to determine what is the property passing on death --- it can be the asset in specie or a chose-in-action against the trust. In the former case, if the asset in specie is outside Hong Kong, no estate duty will arise. In the latter case, if the chose-in-action is enforceable outside Hong Kong, no estate duty will arise --- normally, in deciding the locality of a chose-in-action, it is usually necessary to look at the place of residence of the trustee.

Presumption of resulting trust

Even where no express direction is given by a settlor, a trust may be implied in law in certain circumstances. Examples of resulting trust are as follows.

- A father in his will put his property on trust for his son. But unfortunately, his son predeceases him. Then the trustee will hold the property as trustee in trust for the father after the death of the son. The trustee cannot take the property as his own in law of equity.
- A person bought landed property and paid off all the money consideration. He died before the execution of title deed. In law, the seller held the property in trust for the deceased buyer.
- A person deposited money from time to time into a bank account opened in name of his employee for payment of his petty business expenses. When the depositor died, the remaining bank balance was held in trust by the employee (as trustee) for the deceased.

The presumption of resulting trust should be distinguished from the presumption of advancement. The former is usually presumed between persons who are unrelated persons; whereas the latter is usually presumed between close relatives such as father and son. For example, if a person vested his property in name of his son, it will be presumed --- unless the contrary is shown --- that he intended to “advance” his son an absolute beneficial ownership of the property.

In the case *Cheung versus Commissioner of Estate Duty*

1988, the court reasoned that the presumption of advancement was weakening in modern circumstances where wives were less economically dependent on their husbands. As a result, the court applied the presumption of resulting trust.

Implications on estate duty

If a deceased person has an interest in a resulting trust, such interest is dutiable under Section 5 as a property passing on death. If he has no such interest (e.g. he is only a trustee), no estate duty arises on his death. If a deceased person advanced property to his close relative during his life time, the advancement is dutiable if it is made within three years before his death; it is not dutiable if it is made beyond three years before death. Where he reserved certain benefits in the property advanced, the three-year exemption will not apply --- that is to say the property is still dutiable even though it was made beyond 3 years before death.

Discretionary trust

A discretionary trust is one under which the trustee has an absolute discretion to apply the income and sometimes the capital for the benefit of a class of beneficiaries, with or without a power of accumulation.

Implications on estate duty

In general, the death of a beneficiary of a discretionary trust does not attract estate duty if the discretionary trust continues notwithstanding the death. This is because there is no property passing on death --- the deceased has no defined interest in the trust although a benefit may be said

to arise when the discretionary class of beneficiaries is getting smaller.

However, if after the death, there remains only one beneficiary, then it is clear that the discretionary trust has come to an end because the trustee is left with no discretion. He will have no choice but to apply the whole of the income for the remaining one beneficiary. In that case, there is a property passing on death and estate duty is leviable.

If the discretionary trust ceases by reason of a person's death, whether it is replaced by another discretionary trust, or by a non-discretionary trust, or by a vesting in beneficiaries absolutely, there will be a property passing under Section 5.

The absolute giving of property by a deceased settlor to a discretionary trust within three years of his death is dutiable as a gift. If the giving of property is made beyond three years before his death, it will be exempt. If the deceased is one of the beneficiaries, the three-year exemption will not apply because he reserves an interest in the trust.

5.8 Gifts inter vivos

“Gift inter vivos” means the gifts made by the deceased during life time. In general, all gifts with a value exceeding \$200,000 made within three years before death are dutiable. If the deceased reserved an interest in the gifted property, the three-year exemption will not apply --- in that case, the gifts are dutiable even they were made beyond three years before death.

The \$200,000 refers to the total amount of all gifts received

by the donee within the three years period. In other words, if a person received two cash gifts of \$150,000 each, the exemption will not apply because the total value of the gifts exceeds \$200,000 --- in that case, the amount dutiable is \$300,000 --- the exemption limit is not a deduction from the total dutiable value.

All gifts made in consideration of marriage are exempt from duty. As established from case law, a gift cannot be treated as being in consideration of marriage unless it is made (a) before or contemporaneously with the marriage, or (b) afterwards in pursuance of an agreement made before or contemporaneously with the marriage. To avoid future tax dispute, it is advisable to have a note or an agreement regarding the marriage gifts.

All gifts to approved charitable institutions are exempt from duty.

All gifts forming part of the deceased's normal expenditure are not dutiable. To satisfy this exemption and avoid future tax dispute, it is advisable for the person to make such gifts by way of many small odd sums (e.g. \$75,312, \$87,231 ... etc.) rather than by way a few unusual big round sums (e.g. \$1,000,000, \$2,000,000 ... etc.). This is because the former ones looks more like gifts of normal expenditure whereas the latter ones look more like big dutiable gifts.

If the gifted property remains unchanged in form when the donor dies, it will be the gifted property to be assessed and valued for estate duty as at the date of death. For example, if the gift was a pleasure boat and it sank before the donor died, no estate duty will arise because the gift did not exist at the time of death.

If the gift was money (may be cash or cheque or bank transfer), it was deemed to be passing immediately after the death. Therefore, estate duty is leviable even though the donee spent all the money or transferred it offshore before the donor's death.

It is the property itself subject to duty. Say, if the gift is a flat --- the rental income received by the donee before death will not be dutiable --- and the dutiable value of the flat will be based on conditions existing at the time of death --- if it is let out at the date of death, the dutypayer can ask for a discount from the valuation that is usually made on owner-occupier or vacant basis.

In the Sneddon case --- a sum of money was transferred to a trust for purchase of certain investments --- it was held that the subject matter of the gift was the money and not the investments purchased by that sum of money.

5.9 Joint property versus co-owned property

Joint properties are properties held by the deceased with other person and the deceased's beneficial ownership passes to such other person automatically on his death. The owners of such properties are usually called joint tenants.

Joint-owned properties should be distinguished from co-owned properties: although the co-owned properties are also held by the deceased with other persons, the deceased's beneficial ownership does not pass automatically to the other surviving owners on his death; instead it will pass according to his will or the rules of intestacy in case of no will. Co-owners are usually called tenants in common.

The taxation principle of joint properties versus co-owned properties usually concerns landed properties, although strictly speaking, it can extend to cover properties other than land and buildings.

For co-owned properties of which the deceased is a tenant in common, the property passing on death is the deceased's several share in the property according to the title documents. If the title documents do not stipulate the share of ownership, then the ownership will be shared equally between the tenants in common by virtue of the law of equity. If the deceased gives away his several share in a property within three years before death, the share will be liable to duty. Besides, if the deceased makes his sole-owned property a co-owned property, the loss in ownership will also be liable to duty. However, if these events occurred beyond three years before death, the three-year exemption will make them not dutiable unless the deceased retained interest in such gifts --- for example he continued to receive rent in respect of the share of ownership he gave away.

For joint properties of which the deceased is a joint tenant, normally his several share is assessed. For example, if the property is jointly owned by a father (deceased) and his son, then 50% of the property will be dutiable. However, if the deceased solely provided the purchase money of the property, then 100% of the property will be dutiable under Section 6(1)(d), subject to the following concession offered by the Revenue.

Section 6(1)(d) of Estate Duty Ordinance applies where the deceased having been the sole owner of property transferred it into joint names with another person or where

the deceased provided all the purchase money for the purchase of property which was by his direction conveyed to himself and another jointly. In such cases the entire property is dutiable irrespective of how long elapsed since the disposition was effected. To restrict the application of this section, the then Commissioner of Inland Revenue in a letter dated June 11 1979 to the Law Society of Hong Kong states:

“Whilst a claim under section 6(1)(d) may exist to duty on the entire joint property in which the deceased held an interest, by concession I am prepared to restrict the claim to duty on the deceased's severable share if it can be shown to my satisfaction that the other joint tenant was entitled to and in fact enjoyed one-half or more of the income (or other appropriate proportion if there were more than two joint tenants) during the whole of the three-year period before death and, in this connection, a wife who is a joint tenant is considered to have enjoyed one-half of the income where the property in question was the matrimonial home put by the husband into the joint names of himself and his wife. Your members are particularly asked to note the words which I have underlined.”

Although the deceased's beneficial ownership in a joint property passes to the surviving joint tenants automatically on death, estate duty clearance is still necessary even it is an exempt case --- the estate's total value is below \$7,500,000. This is because estate duty is a charge on the relevant property and without the clearance, any subsequent buyer cannot get a good title.

5.10 Location of property

Section 10(b) of Estate Duty Ordinance exempts overseas property from duty. As a result, only property located in Hong Kong is dutiable. The locality question concerns the property passing on death. If the property is a gift other than cash (e.g. a very expensive diamond ring), it will be exempt if it is not in Hong Kong when the donor dies. If the property was a cash gift and if the gift was effected in Hong Kong within 3 years before death, then it is dutiable even though the donee remitted the money overseas before death. The general rules for determining the locations of various assets are as follows:

Asset	General rule
Cash (bank notes, coins... etc.)	Physical location
Bank account	Location of the account – according to the bank's confirmation – foreign currency accounts opened in Hong Kong are dutiable.
Simple debt	Location of the debtor
Mortgage debt	Location of the security / mortgage
Judgment debt	Location of the court making the judgment
Landed property	Physical location
Personal chattels, machinery, ... etc.	Physical location
Public stock and shares	Location of the stock exchange / share register
Private shares	Location of share register
Bearer instruments (e.g. bonds)	Physical location

5.11 Valuation of property

Under Estate Duty, the assessable value of a property is called the principal value which is defined to be its open market value as at the date of death.

The open market value should be based on normal market conditions; it will not take into account the reduction caused by putting all the property concerned for sale in the market; nor will it be determined on a “forced sale” basis.

Because all dutiable gifts are deemed to be passing on death of the donor, their valuation are also based on the date of death, and not the date of gift. Furthermore, valuation of gifts should be on “capital” basis --- any income earned by the gift before death, or after the death, should be excluded from the principal value.

If the property's value has decreased as a result of the death (for example the business goodwill created by the deceased), the valuation should reflect such depreciation. In the circumstances, the dutypayer can ask for a discount, which may be in some cases quite substantial.

In the case *Man Kam Hung versus Commissioner of Estate Duty*, it was held that the principal value was neither the highest nor the lowest price which a competent valuer would recognize that the property would fetch if sold; but it was the most likely price, namely the mean price taking into account the risk factors.

The value of a life interest is based on the entire property concerned. But don't forget the Section 30 exemption

(applicable to certain settlements between spouses), Section 6(6) exemption (applicable to certain reversionary interest), Section 33 exemption (applicable to certain interest ceased before death), Section 31 relief (applicable to certain interest in business and property inherited from a dutiable estate), and Section 6(1)(d) concession (applicable to certain joint property) which may apply to exempt or reduce the dutiable value of a life interest.

There are three common methods of valuation: (a) by comparison to similar assets in the market (b) by capitalization of the income generated from the asset and (c) by considering the underlying assets and liabilities. The choice of the method depends on the nature as well as the size of the asset concerned.

Bank deposits

The dutiable value includes the accrued interest up to the date of death.

Landed properties

Normally, the valuation is made on owner-occupier or vacant basis. So, if the property was let out at the date of death, the dutypayer can ask for a discount from such valuation. For dutiable cases, the Revenue will ask Rating and Valuation Department to make a formal valuation which is normally based on a comparison with the then transaction prices of similar property. So, it is advisable for the dutypayer to query what are the comparables --- if the property's condition or view or location is worse than the comparables, the dutypayer can ask for a discount from the valuation.

Quoted shares

The valuation is based on the closing prices in the Stock Market as at the date of death. If there are no such prices, then the closing prices of the day immediately before or after will be taken. Normally, there are two closing prices: buyers' price and sellers' price. In practice, the valuation is the lower price plus one quarter of the difference.

Unquoted shares

If the shareholding is substantial (say it accounts for more than 50% of the total shareholding), the valuation will be based on the underlying assets and liabilities of the company concerned (this is called the asset backing method). The value per share is determined by the formula: $(\text{Total assets} - \text{Total liabilities} + \text{Goodwill}) / \text{Total number of shares}$. To determine the total assets, total liabilities and goodwill, the Revenue will usually ask for company accounts covering the last three years before death. Because the day of death does not generally fall on the accounting day, an adjustment will be made for any increase or decrease in net assets (i.e. profits or losses) from the accounting date to the date of death. Valuation of goodwill is usually contentious --- in practice the Revenue assess the excess of average profits for the last three years before death over a normal return (say 10%) on the capital employed (i.e. total net assets) as goodwill. If the death of the deceased affects the profitability of the company, the dutypayer can argue for smaller or even no goodwill.

If the shareholding is small, the valuation will usually be based on capitalization of the dividend for the last three

years before death. The value per share is determined by a formula: Average dividends per share for the last three years before death / Capitalization rate, say 8%. The capitalization rate is the normal expected rate of return from a similar investment. It is obvious that if this rate is set higher, the dutiable value of the shares will be lower. So, how much is the capitalization rate is frequently a dispute to be settled with the Revenue. In principle, the greater the risk of the business, the higher the rate of capitalization will be and the lower the dutiable value of the deceased's shares. So, if the business in question is of a special or risky nature, it is advisable for the dutypayer to argue for higher capitalization rate, that is small dutiable value of the shares.

In some cases, asset backing method is used for small shareholding --- for example: when the dividend capitalisation method cannot give a reasonable and fair valuation. If this method is used, a discount from the net asset value should be made for the minority shareholding of the deceased. The discount can be as large as 40% according to case law.

Unincorporated business

Valuation of sole-proprietor business is usually made on the above asset backing method similar to that for unquoted shares. It follows that the dutiable value equals to: Total assets – Total liabilities + Goodwill. The method for determining goodwill is same as that for unquoted shares. However, if the goodwill depends on the deceased's talent which could not be passed to the successor, the dutypayer can ask the Revenue to treat it as nil.

Valuation of partnership business (of which the deceased was a partner) is similar to that for sole-proprietor business although only the portion belonging to the deceased will be assessed.

Debts

Valuation of debts is usually based on the amount recoverable as at the date of death.

Personal chattels, antiques, paintings, jewels, etc

Normally, the Revenue will ask the executor to supply a professional valuer's report certifying their market value as the date of death.

5.12 Matrimonial home exemption

Section 10A(2) of Estate Duty Ordinance exempts matrimonial home from duty. The exemption applies if all the following conditions are satisfied:

- It was a property solely owned by the deceased or jointly owned by the deceased and his spouse.
- It was solely and exclusively used for residential purpose by the deceased and his spouse.
- It was devised or bequeathed by, or passed from, the deceased to his spouse.

If the deceased died without a will and is survived by his spouse, the third condition is deemed to be satisfied.

If the deceased had more than one property satisfying the above conditions, the executor could choose any one of

such properties for the exemption. Of course, it is advisable for him to choose the one with the highest value. Two adjoining flats connected to each other can qualify as one property for the exemption.

Important note

If the property is held jointly with children, the exemption will not apply. This is because the property will not be passed to the surviving spouse on death.

If the property is bequeathed by the deceased to his children before death or to his children on death by will, the exemption will not apply either.

5.13 Quick succession relief - Section 31 of EDO

If estate duty has been payable on the same leasehold property or business within 5 years before death of a deceased person, a tax relief will be given. The relief reduces the estate duty payable in respect of the same asset on the second death by the following ratios:

The period in which second death took place after the first death:	Percentage reduction in estate duty in respect of the same asset
one year	50%
two years	40%
three years	30%
four years	20%
five years	10%

No relief is granted if the second death takes place after 5 years of the first death.

If the dutiable value of the property on the second death exceeds that on the first death, the dutiable value on the second death will be substituted by that on the first death for computation of the relief.

Foo Ying v Commissioner of Estate Duty 3 HKTC 363

This case concerns whether Quick Succession Relief is applicable to a leasehold property in an unadministered estate. The first deceased died on 9 July 1982 and in his will 5/11 of his estate was devolved on to the second deceased who died on 28 October 1982. At the time of the second death, the first deceased's estate had not been administered. A leasehold property which had been assessed in the first deceased's estate was assessed again in the second deceased's estate. The issue was whether the Quick Succession Relief applied to the second deceased's estate. The Revenue argued that the second deceased's interest in the first deceased's estate was not the same leasehold property, but a chose-in-action for her share of the first deceased's estate, and this chose-in-action was different from the leasehold property to be assessed in the second deceased's estate. The Revenue's contention was rejected by the High Court. It was held that the word "leasehold property" should be accorded a wider meaning so that the "chose-in-action" comprising the leasehold property satisfied the "leasehold property" condition for the relief. In essence, the judge looked at the intent of the legislation: What mischief was to be remedied by the legislation?

An example showing computation of QSR

Mr. Chan died on 1 July 1998. The principal value of his estate was \$20,000,000 including a leasehold property with a principal value of \$10,000,000. Mrs. Chan died on 3 October 2000. The principal value of her estate was \$30,000,000 including the leasehold property inherited from Mr. Chan with a principal value of \$12,000,000.

Marginal relief applies to the estate duty payable in respect of the leasehold property on the death of Mrs. Chan.

<u>Estate duty payable by the executor of Mrs. Chan's estate</u>	\$
$\$30,000,000 * 15\%$	4,500,000
Less: Quick Succession relief	
Estate duty payable in respect of the leasehold property:	
$\$12,000,000 * 15\% = \$1,800,000$	
Reduction in estate duty – died within 3 years – reduction rate 30%	
$\$10,000,000$ (substitution value) * 15% * 30%	450,000

Duty payable	4,050,000
	=====

5.14 Controlled company provisions

Section 34 to 45 of Estate Duty Ordinance (called the controlled company provisions) are to counteract duty avoidance involving assets transferred to closely-related companies.

These sections will only be invoked in cases of blatant duty avoidance, according to the Estate Duty Office Practice Note No. 1. To read the practice note, please visit the IRD's website at <http://www.ird.gov.hk>

Below are some guidance notes on the topic.

What is a controlled company?

A controlled company is a private limited company under the control of not more than five persons.

How is duty avoided through a controlled company?

There are two common ways.

1. A limited company was set up overseas, usually in a tax haven country. Before his death, the deceased transferred a lot of his Hong Kong assets to this overseas company. Because he was no longer the owner of such assets when he died, such assets are not dutiable. Even though he held a number of shares in the overseas company, such shares are not dutiable --- because the share register was kept outside Hong Kong. Since the company was under his control, he could receive income generated from the Hong Kong assets in the form of dividends, director fee, benefits... etc. up to his death.
2. A limited company was set up in Hong Kong. Before his death, the deceased held only a few shares, or even no shares, in the company. But by his close relationship with the directors (who are normally his adult children) or by a covenant made with the

company, he maintained control or influence over the company and continued to receive income from the company up to his death. To avoid estate duty, he transferred a lot of his Hong Kong assets to the company. These assets will not be dutiable because they are no longer owned by the deceased at his death. Besides, very little (or no estate duty) will be payable in respect of the small shareholdings (or no shareholdings) when he dies.

Why controlled company provisions?

The spirit of exemption from estate duty is that if a person gives away absolutely his property beyond 3 years before death, the property is exempt from duty. But in the above two cases, the deceased does not make an absolute gift, and in fact he continues to control the assets through the controlled company and to receive income up to his death. If the duty avoided is substantial, the Revenue will invoke the provisions to assess the following “property passing on death” to duty.

What is assessed under the provisions?

Property passing on death = (Total benefits accrued to the deceased in the last three accounting years / Total net profits of the company in the last three accounting years) * The company's net assets in Hong Kong.

The benefits accrued to the deceased are widely defined to include various benefits and income, such as dividends, bonus, housing, director fee, reimbursement of expenses... etc.

5.15 Ramsay and Furniss principles

Apart from the controlled company provisions, there are no specific anti-avoidance measures in Estate Duty Ordinance. As such, the general anti-avoidance case law as established in United Kingdom and other common-law countries can apply. These anti-avoidance case law are known as “Ramsay principle” or “fiscal nullity principle”.

The principle was first introduced in the case *W. T. Ramsay Limited versus IRC* 1982 AC 300 and then extended in the case *Furniss v Dawson*. In the Ramsay case, the taxpayer "created" some short-lived transactions to make loss to counteract his profits. It was held that these artificial tax avoidance transactions which had no commercial reasons and were self-cancelling were held ineffective.

In the case *Furniss v Dawson* [1984] AC 474, the Dawson agreed to sell shares to a company called Wood Bastow. In order to avoid capital gains tax, Dawson set up a new company called Greenjacket which bought shares from them and then immediately sold the shares to Wood Bastow. Assessment of tax was made as if the shares had been sold directly by Dawson to Wood Bastow. In upholding the assessment, the court introduced a doctrine of fiscal nullity: to nullify those pre-ordained steps in a composite transaction which were inserted solely for tax avoidance purpose.

In the case *Shiu Wing Limited (and others) versus CED*, it was held that the Ramsay principle was applicable to Hong Kong estate duty, although the application of such principle could not work in that particular case to make the overseas gifts dutiable.

Shiu Wing Limited (and others) versus Commissioner of Estate Duty

When Mr. Pong Ten Un aged 85 was very ill suffering from cancer, he transferred, through a series of pre-ordained transactions, some shares of Hong Kong private companies and two pieces of land in Hong Kong to a trust for the benefit of his family. The trust was set up offshore and the transfer was structured as a sale involving offshore debts and movement of the consideration offshore. Just a few days after the completion of the arrangements, Mr. Pong died.

The Revenue invoked anti-avoidance case law such as Ramsay principle to assess the transfer was a gift.

The case was first heard by High Court and the ruling was against the Revenue. Then, the Revenue appealed to Court of Appeal and had the decision reversed. Then, the dutypayers appealed to Court of Final Appeal and it was held that although Ramsay principle was generally applicable to Hong Kong Estate Duty, the result of application of such law principles in that case was a gift outside Hong Kong and as such, the dutypayer's appeal was allowed. In its judgment, the Court of Final Appeal made reference to the principle established in *Furniss v. Dawson* as follows:

“First, there must be a pre-ordained series of transactions, or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end ... Secondly, there must be steps inserted which have

no commercial (business) purpose apart from the avoidance of a liability to tax. If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied.”

5.16 Who is to pay estate duty?

The basic principle is: Whoever controls or gets that part of the estate, he is liable to pay the related estate duty.

Below is a table of general guidance on the question.

Property concerned	Accountable person
Free estate (the part passing to the executor / administrator for administration)	Executor (or administrator in case of intestacy)
Gift made before death	Recipient of the gift
Joint properties	The surviving joint owner is primarily liable to pay duty whereas the executor is concurrently liable.
Property held in trust for the deceased	The trustee

5.17 How to reduce estate duty

First, take this advice: If the deceased's estate is big or is complicated or has land properties, you should consult a solicitor.

Beware of the penalties for intermeddling. Don't take possession of any part of the estate without the permission of the Estate Duty Commissioner. Where the deceased's dependants urgently requires money from the deceased's bank accounts for their daily expenditure or burial of the deceased before estate duty clearance, they can ask Estate Duty Office to issue a letter to the bank.

Where the deceased has a safe deposit box with a bank, the executor should inform Estate Duty Office as soon as possible to arrange for an inspection.

Where the deceased's estate is dutiable, late filing of affidavit may lead to penalties. Late filing means the filing of affidavit or account with Estate Duty Office is after one year from death.

Unpaid duty attracts interest from the date of death. Compared with the market interest rates, estate duty interest (4% per annum for the first 6 months after death and 8% per annum thereafter) is expensive. In law, duty becomes payable on filing of affidavit or within 6 months of death, whichever is the earlier. But take heed: interest accrues from the date of death, not from the expiry of 6 months after death. So, if the deceased has money in bank accounts, it is advisable for the executor to ask the Estate Duty Office to issue a letter to the bank to use the deceased's money to pay duty as early as possible.

Where the deceased's estate is complicated, Estate Duty Office may take a long time to finalize the case and then issue an assessment of duty. Hence, it is advisable for the executor to ask for provisional clearance of estate duty. With the provisional clearance documents, the executor can

apply for probate from court.

Normally, the Estate Duty Office will require security for the provisional clearance. To meet this requirement, the executor may offer to fully use all the deceased's bank accounts first, then if not enough, he can propose to make an equitable charge on the deceased's land properties or public shares, or if still not enough, he can propose a Bank Guarantee or an equitable charge on his own property.

Here are some tips to reduce estate duty:

1. Spend your wealth as your normal expenditure before you die.
2. Give away your wealth to a renowned charitable organization.
3. Give away your wealth absolutely to your spouse or your children as early as possible. Such gifts will escape duty if you survive three years after the gift.
4. Give away your wealth absolutely to a discretionary trust. Such gifts will escape duty if you survive three years after the gift.
5. Give away your wealth to your loved ones on their marriages. Such gifts are exempt from duty. It is advisable for you to write a note stating explicitly the gifts are in consideration of the marriages so as to avoid future tax dispute.
6. Put your matrimonial home in joint name with your spouse. This property will be exempt from duty if it is passed to your spouse on your death.
7. Put your money in joint bank accounts with your spouse or children. To avoid the Revenue's challenge under Section 6(1)(d) of Estate Duty Ordinance or under anti-avoidance law, it is advisable that the

initial fund of the joint bank accounts be equally shared by all the joint account holders.

Then, operate such accounts with many cash deposits and cash withdrawals by every account holder. Of course, in order to transfer money to your loved ones, you should contribute considerably more than the other account holders to the joint account. From case law, each account holder is entitled to withdraw money from his joint account and such withdrawal will not normally be regarded as gift. Because there are many cash deposits and cash withdrawals, the Revenue cannot use the "associated operations" under Section 3 or "Furniss" principle to assess the cash transfer as gift. Then, on your death, only your relevant share of the bank balance will be dutiable.

8. Put your land property in joint names (either under common tenancy or joint tenancy). Normally, only your relevant share of ownership will be dutiable on your death. But if you survive for less than 3 years after the transfer of ownership, the beneficial share ownership you give out will be dutiable as a gift under Section 6(1)(c). Caution: if the property is held by way of joint tenancy, the whole share may be dutiable under Section 6(1)(d) --- but there is a concession to restrict the dutiable share to the relevant share.
9. Put your money in offshore bank accounts. You can be do this with those local banks with overseas offices. But beware: the offshore bank accounts can lead to foreign estate duty and foreign succession law problems.
10. If you want to give money to your wife or children, don't give big sums (say \$500,000 or above) at one time. Give away many small odd sums frequently (say \$70,300, \$52,010 ...) so that they form part of

- your normal expenditure, rather than big cash gifts.
11. If you want to give big money to your wife or children, first transfer the money to an offshore bank account, then, withdraw the money to buy offshore public shares, then, hold the shares for some time before you transfer them to your loved ones. In such case, the gift is the offshore public shares and therefore exempt from duty. In fact, the Revenue has practical difficulty to trace the application of the application of the money of the offshore bank account and the disposal of the offshore public shares because they are done outside the Hong Kong's jurisdiction. Caution: the Revenue may use "associated operations" under Section 3 of Estate Duty Ordinance or the so-called "Furniss" principle to challenge the transactions as a local gift.
 12. If you have large-value land property, first have it mortgaged to a bank for cash, then, follow the steps under tip 11 to make the cash a offshore gift to your loved ones. Then, on your death, the dutiable value of the land property will be reduced considerably by the outstanding mortgage loan.
 13. If you want to hold a big sum of money to provide income to maintain your everyday expenditure, use the money to purchase an annuity from an overseas insurance company. The annuity will be exempt from duty on your death if it is made legally payable and enforceable outside Hong Kong (It is a simple debt). And you can receive a regular monthly income to pay off your daily expenditure as long as you live. This method can avoid the demerit of giving too much money to your children who spend it quickly; and besides, you will live at the mercy of your children because you have little, they have a lot. But beware:

the offshore annuity may lead to foreign estate duty and succession problems.

14. When you give away a property, don't reserve any right to its possession or enjoyment. Then, if you survive more than 3 years after the gift, it will be exempt.
15. Never use simplistic and blatant scheme to avoid estate duty. This is because the Revenue may take it to the court to disregard it as a sham. If the estate is very big, consult a solicitor.

5.18 Computation of estate duty

First, revalue various kinds of property passing on death (excluding exempt property) on the basis of "open market value as at the date of death". Then, add up all such values to get a total "principal value". From this principal value, deduct funeral expenses (restricted to \$50,000) and allowable debts. Then, determine the applicable duty rate according to the following table.

Total "principal value"	Duty rate
\$ 0 to \$7,500,000	Nil
\$7,500,100 to \$9,000,000	5%
\$9,000,100 to \$10,500,000	10%
Exceeding \$10,500,100	15%

Principal value is rounded up to the nearest hundred dollars. That means the principal value of \$7,500,031 is rounded up to \$7,500,100 for determination of the duty rate.

Estate duty payable = Principal value * Duty rate

The estate duty rate should apply to all parts of the estate, including free estate (that part of estate passes to the executor), joint property (that part of estate passed to the surviving joint tenant), gifts inter vivos (that part of estate already received by the donee but deemed to be passing on death). This rate will not apply to exempt property or a property held by the deceased as trustee only without any beneficial interest.

There is only one single rate of estate duty on any and all parts of the estate --- this is different from the graduated-rate system of Salaries Tax or Personal Assessment under which income of different rate-bands attracts different tax rates. So, if a principal value just exceeds a band limit, there will be a sudden increase in duty rate --- and this will make the net proceeds of the estate after payment of duty less than that of an estate just lower than the band limit. This is obviously absurd --- to overcome this absurdity, a marginal relief computation is introduced.

There is a special provision for the property in which the deceased never had an interest (for example a life insurance purchased by the deceased's children in respect of the deceased's life): such property forms a separate independent estate for determining the rate of estate duty. But this provision is seldom invoked in practice.

An illustration showing how estate duty is computed

A rich man died on 1 July 1997. He was survived by his wife, his son and daughter. He left no will. He had bank accounts of \$9,000,000 and a joint property with his wife (their residence) of \$10,000,000. He had another joint

property with his son of a total value of \$5,000,000. The purchase money was solely contributed by the deceased. He gave her daughter \$3,000,000 in February 1997 who deposited it into a fixed deposit with accrued interest \$150,000 up to the date of death. The total funeral expenses incurred was \$200,000. All values quoted here are open market values as at the date of death.

The estate duty payable is computed as follows:

<u>Property passing</u>	<u>Principal value</u>	<u>Duty thereon</u>	<u>Accountable person</u>
Free estate – bank accounts	\$9,000,000		
Less: funeral expenses	\$50,000		

	8,950,000	1,342,500	executor son /
Joint property with son	\$5,000,000	750,000	executor daughter
Gift to daughter	\$3,000,000	450,000	
	-----	-----	
Total	16,950,000	2,542,500	
	=====	=====	

With the principal value of \$16,950,000, the estate duty rate is 15%.

Notes for computation of duty

- Section 6(1)(d) applies to assess the entire joint property held with the son because the deceased provided the purchase money.

- The joint property with wife is exempt because of the matrimonial home exemption.
- The accrued interest on the cash gift is not dutiable.
- The maximum deduction of funeral expense is \$50,000.

Last Word

If a person dies on or after 11 February 2006, no estate duty clearance is required. Therefore, the notes concerning Estate Duty do not apply to such deceased person's estates; they only apply to persons dying before 11 February 2006. For this question, the date of death is the only decisive factor. As some executors do not administer the estate of a deceased until they want to sell or develop the estates many years later, the study of estate duty will go on even though estate duty is abolished in 2006.

Apart from Estate Duty, the notes in this chapter relating to administration and distribution of estates are still applicable to persons who dies after 11 February 2006.

If you have any questions about Estate Duty or administration of estates, I suggest you consult a solicitor.

Chapter 6 Accounting for tax requirement

- 6.0 Why accounting for tax requirement
- 6.1 Revenue versus capital nature
- 6.2 The double entry system
- 6.3 The year-end closing
- 6.4 Cash and bank accounts
- 6.5 Purchases of goods
- 6.6 Purchases ledger
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- 6.14 Bad debts and provision for bad debts
- 6.15 Purchase of plant and machinery
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- 6.18 Capital expenditure on information technology
- 6.19 Capital expenditure on patent etc.
- 6.20 Cash retail businesses
- 6.21 Trading business
- 6.22 Manufacturing businesses
- 6.23 Service-oriented businesses

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