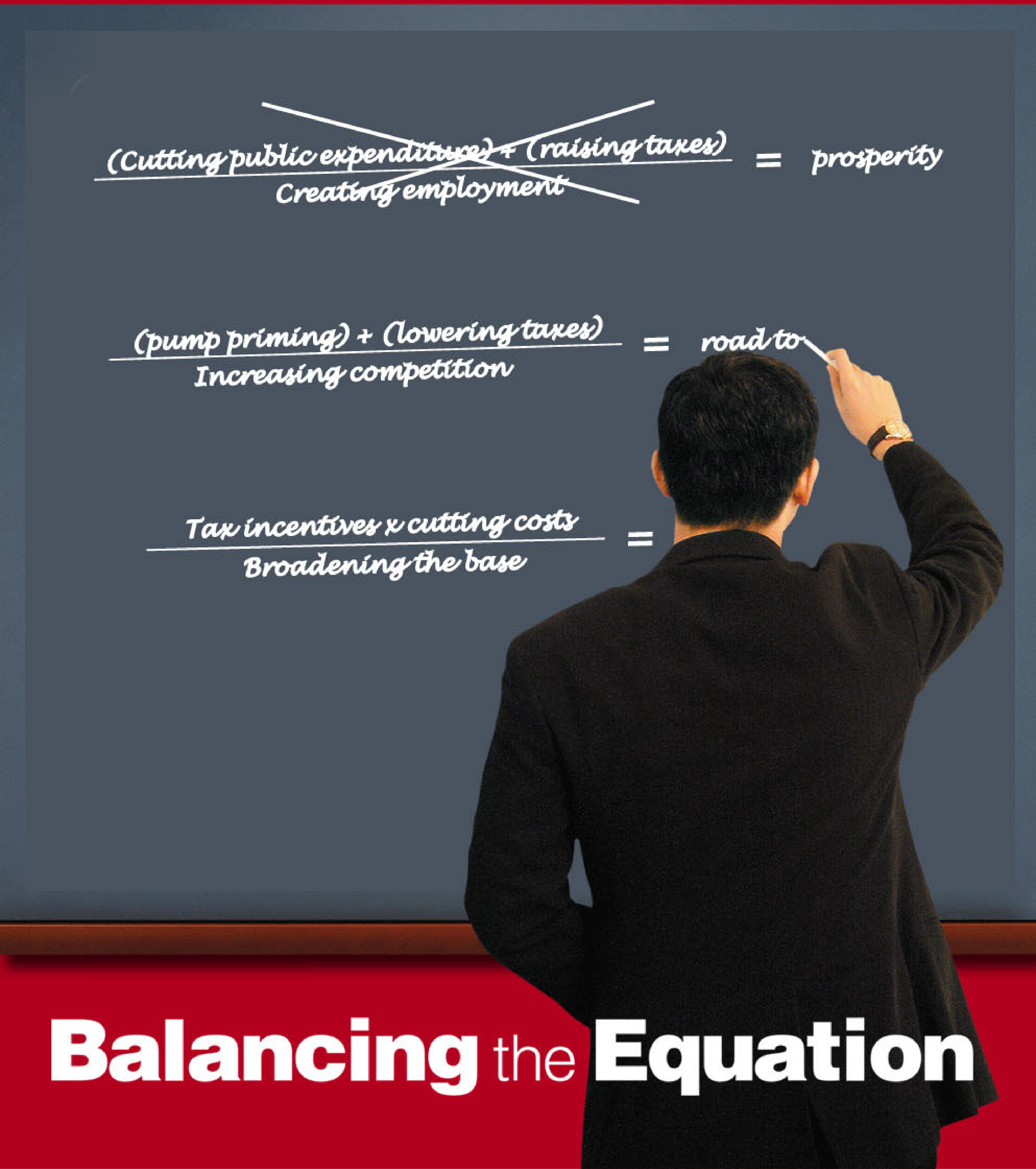
HKSA PROPOSALS FOR THE 2003/04 BUDGET

Hong Kong
Society of
Accountants



Balancing the Equation

BUDGET PROPOSALS 2003/04

"BALANCING THE EQUATION – Achieving Fiscal Equilibrium and a Fairer Society"

1. Overview

1.1. Introduction

Externally, the signals are mixed about the future direction of most major economies world-wide, although amongst Hong Kong's main trading partners, the Mainland's economy continues to grow at a rate of 7-8% annually. Hong Kong's domestic economy remains weak, with retail price deflation having entered into its fourth year, and various economic analysts have been sounding cautious notes on the performance of the domestic economy for both 2002 and 2003.

In the 2002 Budget Speech, the Financial Secretary (FS) projected a deficit of HK$45.2 billion in 2002/03 and he stated Hong Kong SAR Government ("the Government")'s intention to achieve fiscal balance by 2006/07. However, with lower than anticipated income from land sales and the deferral of any further sales of tranches of shares in the MTR Corporation Limited, these targets are looking increasingly difficult to attain, unless the state of the economy and financial markets improve substantially. The failure to keep the gap between income and expenditure in check at this time, particularly given the uncertain external environment, could have an adverse impact on investor confidence in Hong Kong and may potentially risk further speculative attacks against the currency in the future. In October 2002, one of the major credit-rating agencies downgraded its outlook for the Hong Kong dollar from stable to negative.

In our view, therefore, the Government needs to take positive action to address this situation through enhancing the business environment, dealing with deflation, controlling expenditure and increasing revenues.

Given the large size of the deficit and of public expenditure, it is critically important that the Government make major efforts to contain public expenditure. Each 1% reduction in expenditure would mean a saving of around HK$2.7 billion. Possible measures to reduce public expenditure would include, e.g. improving efficiency in the delivery of government services, varying the level of services, increasing private sector participation in the delivery of services and reducing the size of the civil service.

As it is unlikely that reductions in expenditure alone would be sufficient to address the deficit situation, the Government also needs to consider ways to raise more revenue. We offer some suggestions of possible revenue-raising measures in Part B of this submission.

While there is a need to address the deficit situation, the Society nevertheless considers that there still must be enough flexibility in the system to be able consider the merits of introducing limited specific tax concessions. These should be aimed at enhancing Hong Kong's attraction to investors as an international financial and commercial centre and springboard for entry into the Mainland and other markets in the region, and at encouraging more employment. Our proposals in this regard are contained in Part A of this submission. Part A also contains technical changes in respect of the tax treatment of certain matters and improve the clarity of rules relating to other matters.

1.2. Economic outlook

Hong Kong's economy, after turning around to a modest growth in the second quarter, picked up further in the third quarter of 2002. The growth impetus continued to come from the external sector. On a year-on-year comparison, GDP accelerated to 3.3% growth in real terms in the third quarter of 2002, from 0.8% growth in the second quarter.

However, consumer price deflation continued in the three months ended October 2002, with the Composite Consumer Price Index (CPI) falling by 3.5% over the same period a year earlier. For the 12 months ended October 2002, the Composite CPI was on average 3% lower than in the preceding 12-month period.

The unemployment rate fell to 7.2% in the period August - October 2002, down from 7.4% in July – September 2002. This translates to around 259,000 people out of work. However, the under-employment rate increased from 2.9% to 3.0% over the same periods.

The Mainland economy, meanwhile, continues to demonstrate a fundamental resilience, achieving growth of 8.1% on year in the third quarter of 2002. This should give some cause for optimism in terms of spin-off opportunities and benefits for Hong Kong provided the community can work together to successfully manage the changes and difficulties that Hong Kong currently faces.

However, given that Hong Kong is an open economy, we remain vulnerable to factors beyond our control, especially the performance of the economies of the United States and elsewhere, which impact on Hong Kong.

1.3. Fiscal position

As suggested above, the deficit in 2002/03 is now likely to be much higher than HK$45.2 billion estimated in the 2002 Budget with declining land sales and the deferral of further asset sales. Between April to September this year, the gap between income and expenditure reached HK$70.8 billion, compared with HK$60.7 billion for the same period in 2001 and HK$40.6 billion in 2000. This deficit increased by a further HK$1.6 billion between September and October 2002. Some analysts are now predicting a final deficit of between HK$65 billion and HK$80 billion, but the actual figure will depend to some extent on the timing of expenditure in relation to capital works, as well as the return on investments.

Fiscal reserves stood at HK$367.3 billion as at 31 October 2001. By 31 October 2002, they had fallen to HK$300.1 billion. Although, the current level of the reserves is due partly to the difference in timing between the main periods of public expenditure and income, if the final deficit is as high as is now being predicted this could bring down the reserve level to HK$250 - $260 billion by March 2004. At this level the reserves could fall below the revised target threshold set by the FS in his 2002 Budget Speech, i.e. the equivalent of 12 months of government expenditure, or around HK$254 billion, based on current estimated expenditure levels. This potential eventuality is of serious concern and points to the real need for positive action to be taken by the Government.

As at 30 October 2002, the foreign currency reserves held by the Exchange Fund stood at US$110.6 billion compared with US$113.1 billion at 30 October 2001. Hong Kong is currently the world's fifth (previously fourth) largest holder of foreign currency reserves, after Japan, Mainland China, Taiwan and Korea.

2. Detailed Proposals

Part A - Enhancing Employment/Business Opportunities Through the Tax System

2.1. Key features of the existing Hong Kong taxation system

The taxation system in Hong Kong has a unique combination of characteristics. Its key features which have helped to attract foreign investment to Hong Kong include the following:

1. The profits tax rates of 16% for corporations and 15% for unincorporated businesses remain relatively low compared with other jurisdictions.

2. The maximum salaries tax rate of 15% is also among the lowest in the world.

3. The territorial source principle of taxation means that non-Hong Kong sourced income will not be subject to Hong Kong tax except in the limited circumstances where it is deemed to be on-shore income.

4. There is no tax on capital gains and dividends.

5. Bank interest income is exempt from tax in most cases.

6. There is no import duty on most goods.

7. The tax legislation in Hong Kong is relatively simple and easy to comply with for both businesses and individuals. Employers in Hong Kong for example do not have any tax withholding obligations in respect of their employees except under limited circumstances.

Given the past success attributable to these cornerstones of the Hong Kong taxation system, great care must be taken to preserve these advantages as much as possible in the course of formulating solutions to address the dilemma which Hong Kong is currently facing.

2.2. Areas for review

Whilst the Hong Kong taxation system is relatively competitive vis-à-vis those of other jurisdictions, there is no room for complacency. Given that some of the neighbouring jurisdictions have been lowering their tax rates in recent years, a review of the taxation system in Hong Kong, and, in particular, the areas highlighted below, should be carried out with a view to enhancing the competitiveness of Hong Kong as an international financial and business centre.

2.2.1. Tax losses

Group Relief

We have advocated some form of group relief on various occasions in the past in order to avail ourselves of similar tax treatment to that provided in many developed tax jurisdictions around the world.

The existing law relating to the carrying forward of losses has the benefit of placing no overall time restriction on the absorption of previous years losses, although they must be set off as early as possible against subsequent years' profits until the losses are fully utilised. However, a corporation must remain in existence and undertake a profitable business in future if it is to be able to utilise the losses. In the context of a group of companies, firstly, it may well be the case that the group management does not wish to retain an unprofitable company and is therefore not able to take advantage of the facility to carry forward losses unless a potentially costly and inconvenient restructuring is undertaken. In some cases this will not be possible at all; secondly, the maximum economic benefit of being able to deduct losses incurred in a particular year may well not be achievable by having to carry them forward to future years, rather than being able to set them off against other group profits in the same year of assessment. As a corporate group will commonly be producing group accounts on a consolidated basis, it would also be reasonable for the tax regime to accord to the group a corresponding treatment in terms of its tax liabilities and benefits.

In the absence of full group relief we would advocate the introduction of arrangements to allow the transfers of losses within a group of companies in the event of the loss-making companies going into liquidation. For the definition of "group", section 45 of the Stamp Duty Ordinance (Cap. 117) could be adopted, namely the test of beneficial ownership of a minimum of 90% of the issued share capital. All relevant companies should be chargeable to profits tax in Hong Kong, although they need not be locally-incorporated. Procedures relating to notification, etc. would need to be formulated. We would propose that only losses occurring after the introduction of such relief and upon the liquidation of a company should qualify.

Loss carry-back

The ability to carry back losses for a given year of assessment against the assessable profits of a previous year would be a very useful benefit in this period of economic transition for Hong Kong. We have previously proposed an arrangement for loss carry-back, in particular for single companies upon cessation of business in Hong Kong, which, for the sake of administrative simplicity, could be limited to one year's carry-back only. We believe that such a measure would help to ensure equitable tax treatment for all companies by reducing the likelihood that an individual company is in practice required to pay more than the standard rate of profits tax over the life-time of the company. As such we would suggest that loss carry-back should be available to single companies regardless of whether or not group relief or arrangements for the group transfer of losses are introduced.

2.2.2. Uncertain/unfavourable tax treatments

a) *Financial services – extension of exemption for mutual fund corporations*

The existing exemption from profits tax for overseas mutual fund corporations and similar vehicles is restricted to those corporations that are widely-held and subject to the supervision of an acceptable overseas regulatory authority. Many overseas mutual fund corporations promoted by renowned overseas financial institutions for their overseas private clients are neither widely-held nor subject to regulatory supervision and as such do not fall within the exemption. Nonetheless, they are often self-regulated to high standards and have investment potential in hundreds of millions if not billions of US dollars. As they are not specifically exempt from Hong Kong tax there is a concern that by locating fund managers and/or investment advisers in Hong Kong, depending on their functions here, which very often cannot be predetermined with precision, the mutual fund corporation may be exposed to Hong Kong profits tax. While very often such exposure may be considered to be more technical than real, it nevertheless must be identified and formally advised to potential overseas investors in the Initial Offering Document for the fund. As a result of the uncertainty that this can create in the minds of investors, promoters of the funds are often deterred from locating the related fund management activities here.

In order to further encourage and promote the expansion of fund management activities in Hong Kong, we would recommend that the restricted exemption at present applying to mutual fund corporations and similar vehicles be expanded to embrace mutual fund corporations of the nature described above, subject to adequate safeguards against abuse being introduced.

In addition we believe units in all such mutual funds should be exempted from Hong Kong estate duty; as is now the case for such funds issued in the United Kingdom, Luxembourg and other major financial service centres.

b) *Intellectual property development*

Expenditure on the purchase of trademarks or copyrights is generally not tax deductible in Hong Kong. In order to encourage companies which wish to set up intellectual property (IP) development and/or licensing centres in Hong Kong, we suggest that:

- A deduction be allowed for the cost of acquisition of trademarks and copyrights;

- the scope of section 16(2)(e) of the Inland Revenue Ordinance (IRO) (Cap.112) be extended to allow for deduction of the interest expenses incurred in financing the acquisition of trademarks and copyrights; and

- tax credits be allowed for any foreign tax paid on the royalty income concerned.

c) *Trading in Hong Kong and manufacturing arrangements outside Hong Kong*

Many manufacturers in Hong Kong have relocated their manufacturing base to the Mainland over the past two decades. For these manufacturers, Hong Kong may serve as a sales and/or finance centre.

Typically, these Hong Kong manufacturers may have entered into a processing or assembly arrangements with a Mainland entity. Under a processing and assembly agreement, the Mainland factory owner agrees to provide processing and/or assembly services to the Hong Kong manufacturer at the factory premises in the Mainland in exchange for a processing fee. The factory owner typically undertakes to provide the factory premises, utilities and labour. The Hong Kong manufacturer, on the other hand, typically agrees to supply everything else necessary to the production of the finished goods, such as raw materials, designs, plant and machinery, training, production and management skills. Normally, the purchase of raw materials, as well as the development of design and technical know-how are carried out in Hong Kong. Finished products are normally exported to the Hong Kong manufacturer who sells them, with negotiations and sales transactions principally conducted in Hong Kong. All processing fees and manufacturing expenses will be absorbed in calculating the income from the subsequent sales.

According to the revised Inland Revenue Department (IRD) Departmental Interpretation and Practice Notes (DIPN) No.21, where the Hong Kong manufacturer retains the management and control of the offshore processing operations, a 50/50 apportionment basis applies to income earned by the Hong Kong manufacturer on the sale of goods. This concession offers a simple approach to resolving the question of whether the manufacturing operations in the Mainland should or should not be considered to be more immediately responsible for the generation of sales income. The IRD limits the application of this concession to certain specific legal forms of processing arrangements. In practice however for reasons other than tax considerations, the actual form of the arrangement between the Hong Kong company and the Mainland manufacturer may sometimes vary from the standard arrangement. Quite commonly, for example, it will be another group company rather than the Hong Kong entity that has a processing agreement with the Mainland entity. Sometimes also manufacturers choose to set up their factories in the Mainland by way of, for example, wholly owned foreign enterprises. In these cases the trading profits of the Hong Kong trading vehicle will be fully assessable to profits tax in Hong Kong.

With improved banking facilities and telecommunication systems in the Mainland, the need for manufacturers to maintain a sales and/or finance office in Hong Kong has been diminishing over the years. This, coupled with increasing competition from neighbouring jurisdictions by way of favourable tax legislation introduced in the late 1990s, means that Hong Kong is facing a real threat of losing its status as a centre for the sales/finance office function. If the sales/finance functions cease to be undertaken in Hong Kong this will also be likely to have a negative impact on the local logistics industry.

We suggest, therefore, that the IRD should be prepared to be more flexible in relation to the issue of processing agreements in the Mainland and, rather than disallowing apportionment merely on the basis that the parties involved have not adopted a specific legal form, should consider whether in substance, in respect of the Hong Kong entity, a particular arrangement can essentially be regarded as a processing agreement or an offshore manufacturing arrangement. If this is the substance of the set-up then we would suggest that the Hong Kong entity involved should be eligible for a 50/50 apportionment of profits tax. This would also take into account the changing practice in the Mainland where in practice it has been getting increasingly difficult to set up processing agreements in the form envisaged by DIPN No.21.

For more certainty and clarity, consideration should be given to amending the legislation to give effect to the above.

d) Charitable donations

Not surprisingly charities have found it particularly difficult to raise funds in the present economic downturn. In order to provide an incentive for greater contributions to be made by those who can afford to donate, and to encourage the development of a more socially-conscious community, we would reiterate our previous proposal to increase the present ceiling for allowable deductions from 10% to 20% of assessable profits/income. If circumstances allow, consideration should also be given to ultimately abolishing all limits on the amount of deductions allowed, in respect of profits tax and salaries tax, for donations made to charities recognised in Hong Kong.

2.3. Fiscal measures to improve the business environment and employment prospects

With the primary objective of improving the business environment and employment prospects in Hong Kong, we set out below some suggestions for measures that may be taken.

2.3.1. <u>Jobs for the unemployed</u>

We propose that employers should be able to claim a tax deduction of 200% (rather than 100%) of the first- and second-year costs of employing persons who have been certified by the Labour Department or other appropriate authority as having been unemployed for over one year. In order for an employer to be able to obtain this concession, there must be a net increase in employment by that employer. Measures should also be introduced to discourage employers from dismissing staff recruited under this programme after the second year and taking on new workers, in order to take advantage of the benefits without offering long-term employment opportunities. Therefore, consideration could also be given to allowing a more limited tax break during the third year of a relevant worker's employment with that employer.

2.3.2. Business opportunities

- *Regional headquarters/offices*

  We continue to propose that a 100% profits tax exemption should be granted to regional headquarters/offices in respect of management and consultancy income derived from associated entities overseas. (The term "associated entities overseas" will need to be suitably defined, e.g. beneficial ownership of at least 50% of the share capital by the group).

- *Retaining local manufacturing – 50% tax exemption for manufacturing in Hong Kong*

  Much of Hong Kong's manufacturing has moved across the border primarily because of lower costs. The tax system effectively recognises this trend through the 50/50 apportionment concession for processing agreements. However, this arrangement may also have the unintended side effect of reinforcing the migration of manufacturing activities while, at the same time, we are trying to retain a body of higher-value-added manufacturing in Hong Kong and to encourage other forms of manufacturing such as hi-tech, and environmentally-friendly product manufacturers to set up here.

  Under the circumstances, we believe that there is a case for offering a concessionary 50% tax exemption on profits for manufacturing of goods in Hong Kong which are primarily for export. Such businesses have similar characteristics to those involved in processing arrangements and it is undesirable that they should regard themselves as being somehow disadvantaged by remaining in Hong Kong rather than transferring part of their business to the Mainland.

  There may be an argument for going even further than this. The rates of unemployment and under-employment remain at relatively high levels. Recognising that manufacturing industries can offer significant employment opportunities to a range of workers, e.g. the low-skilled sector, and that a substantial number of unskilled Mainland immigrants enter Hong Kong to settle every year, we would suggest that serious thought be given to extending the concession proposed above to all manufacturing in Hong Kong, at least for a period of, say, five years, after which time the position can be reviewed.

- *Research and development*

  To encourage innovation and invention in Hong Kong, we suggest that the tax deduction of 100% of the expenditure on scientific research currently allowed to approved institutions be increased to 150%.

Currently, an initial allowance of 20% is available for capital expenditure in relation to buildings and structures used for scientific research. An annual allowance of 4% of the original capital expenditure is also given. We suggest that the initial allowance be increased to 25% and the annual allowance be also increased to 25% for three years.

- *Environmentally-friendly business/industry*

In his 2001 Policy Address, the Chief Executive said that the Hong Kong community must keep up its efforts in environmental protection. The Society proposes that tax incentives should therefore be granted to investment and spending on environmental protection equipment, machinery or systems (e.g. 100% depreciation allowances and/or additional investment allowances, inclusion in the prescribed fixed assets, reductions in first registration tax for more environmentally-friendly vehicles).

2.3.3. Individual concessions/self-improvement

- *Deduction for education expenses*

The existing HK$40,000 deduction for self-education expenses should be increased to HK$60,000 to encourage salaries tax payers to attend approved courses, including relevant undergraduate, postgraduate and professional training, and language courses. In order to allow persons with no or insufficient taxable income to benefit or fully benefit from this deduction it should be allowed to be carried forward until such time as they can offset it fully against their taxable income up to a maximum period of three years from the time the relevant self-education expenses were incurred.

In line with the Government's policy to promote continuing education of the workforce, this proposed increase in the level of deduction for education expenses should be an exception to any reduction in personal allowances and deductions (see sections 2.6 and 2.7 below).

- *Child allowance/dependent brother and sister allowance*

Currently the child allowance/dependent brother or sister allowance may be claimed in respect of a person in full-time education where that person is not above 25 years old. In order to not to discourage older persons from continuing to improve their skill and knowledge base, particularly as Hong Kong endeavours to move up the "value chain", we would suggest that this age limit be abolished. This would also be consistent with the Government's policy of life-long learning.

2.4. Other proposals

2.4.1. Concessions in relation to maintenance/child support payments

The spirit of allowances, for Hong Kong salaries tax purposes, is to provide tax relief to taxpayers who maintain their dependant(s) during a year of assessment on the condition that no other individuals are claiming the relevant allowance(s) in respect of the same dependant(s) for the same year of assessment.

However, there are no provisions in the IRO granting an allowance in lieu of a married person's allowance to a divorced/separated person who is legally liable to support his former spouse. Although the Commissioner of Inland Revenue has a discretion under the section 32(3) of the IRO to apportion the single parent allowance, this is subject to a claimant having the "sole or predominant care of a child" and under subsection 2(b) it is stated that a person cannot claim the allowance "by reason only that that person made contributions to the maintenance and education of the child".

In this connection, we would suggest that amendment be made to the current legislation, possibly through expanding the scope of the existing provisions, in order to provide an entitlement to some form of tax relief for taxpayers who are required to (a) make payments to maintain a former spouse and/or (b) give financial support to a child under the custody of a former spouse. In the case of (b) this should apply even where the taxpayer making the payments may not be able to demonstrate that he or she has sole or predominant care of the child. The additional allowances to be granted shall be limited to the actual payments made by the taxpayer up to the level of a married person's allowance.

2.4.2. The need for rules regarding restricted share benefit schemes

In general, under a restricted share benefit scheme, an employee is granted the right to receive shares of a corporation ("restricted stock") (usually the employer or the employer's related companies). Such shares are generally not able to be sold or otherwise dealt with and the employees' right to these shares could in certain circumstances lapse. The employee, however, may be paid dividends on the restricted stock.

Under the current legislation in Hong Kong, there are specific provisions under the IRO which make clear the position in relation to the taxation of benefits received from employee share option schemes but there are no specific provisions with regards to restricted share benefit schemes.

It is important that clear rules or provisions relevant to the taxation of the restricted share benefits are made. This may be achieved by the expansion of the scope of the specific provisions on share option benefits to also include the restricted share benefits. Alternatively, the issuance of a DIPN relevant to employee-restricted share benefits may also help.

Part B – Tackling the Deficit

2.5. The need to take positive action

With a deficit of HK$72.4 billion between April to October 2002, it will be difficult for the Government to achieve its fiscal targets if the state of the world economy remains weak and the structural element of the deficit is not dealt with effectively. We therefore believe, that in order to maintain international credibility in the financial system, and to dispel certain perceptions regarding over-reliance on growth in economic activity as the core solution, the Government needs a comprehensive and transparent agenda to tackle the deficit, .

Questions have been asked over the past few years whether the deficits that have currently being sustained are essentially cyclical or structural in nature. If they are merely cyclical then it could be argued that the best course of action would be to allow deficits to occur in the short-term, regardless of any specific targets set for the level of the fiscal reserves, rather than risk action that could lead to greater unemployment and a heavier financial burden for the working community as a result of, for example, cutting costs and/or increasing taxation.

The Task Force on Review of Public Finances which was charged with looking into this matter published its findings in February 2002. As the FS reported in the 2002 Budget, the Task Force "was of the view that, were the prevailing revenue and expenditure policies to continue, the Government would face ongoing and persistent fiscal deficits" leading to a depletion of the fiscal reserves by 2008/09. While questions were raised about some of the assumptions made by the Task Force in reaching this conclusion, certain factors influencing the overall fiscal position seem to be unequivocal.

It can hardly be doubted for example that significant changes have taken place in the property market in Hong Kong since 1997 which have had a major impact on the revenues achievable from land premiums. There appears to be a general consensus that these changes are not merely short-term and cyclical in nature. In any event it is doubtful whether it would be in Hong Kong's long-term interests as to see property prices return to the inflated levels of 1997. Similarly, in relation to the investment return on the reserves, as the level of the reserves reduces the investment income accruing from them will also diminish. This is currently being exacerbated by the low interest environment prevailing throughout most of the world, which is likely to continue for some time. The potential amount of any income from the sale of government assets, such as shares in the MTR Corporation Limited, will also be considerably less than originally anticipated as long as financial markets and confidence in the economy remain weak.

Under the circumstances, and given the importance of maintaining international confidence in Hong Kong, the need to demonstrate resolve and capability in the prudent management of the financial system and the currency, is clear. This includes being seen to take measures to tackle the deficit, including taking positive action to contain the level of public expenditure as a proportion of the overall economy, despite the difficulties currently being faced in the domestic market. This in turn requires taking a critical look at the various areas of public expenditure, including the cost in relation to the provision of existing services, any plans for new services or expansions of existing services as well as capital expenditure projects. The review should consider the need for, the timing of, and the role that the private sector could play in, such activities and projects. However, the extent to which public expenditure may be reduced is also limited by the need to avoid causing the economy to contract further and thus any cost-cutting should as far as possible be targeted towards the "fat" that still exists in the system. In this regard, although staff costs constitute a major element of government expenditure, it must also be recognised that imposing substantial across-the-board reductions in salaries, for example, would inevitably have an adverse effect on overall consumer spending.

As improvements in the external economy cannot be relied upon to occur in the short-term, and as it is unlikely that reductions in expenditure would be sufficient in themselves to address the deficit, the Government should in addition be looking at ways to broaden the tax base or increase revenues under the existing tax base. This would also be consistent with the Basic Law (Article 107) requirement for the Government to "follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product".

As measures to broaden the tax base might take a considerable time for implementation, the Government should, while preparing for the introduction of such measures, also consider other revenue-raising measures which may be implemented in a much shorter timeframe.

2.6. Options for increasing revenue through taxation

One area where the Government can focus on raising more revenue, even with stagnant economic growth, is through taxation. For example in 2000/01 a total of HK$100.4 billion was raised through taxation administered by the IRD. This comprised 60% of the Government's General Revenue. Of this, HK$73.8 billion was raised from profits, salaries and property tax, and taxation under personal assessment.

We believe that, all sectors of the Hong Kong community, i.e. corporations, unincorporated businesses and individuals should bear their fair share of any increase in the tax burden. In the longer-term broadening the very narrow tax base generally should be the preferred way forward. However, this may not be possible in the immediate term. The various options to increase revenue that we believe the Government should consider for implementation, either as long term or short term measures, include the following:

- The introduction of a goods and services tax or similar turnover tax.
- A reduction in personal allowances and deductions under salaries tax.
- The imposition of a temporary surcharge on profits, salaries and property tax payers, for two years, at a rate of, say, 10% based on their actual tax liability.
- An increase in government rates.
- A comprehensive review of government fees and levies on the basis of the "user pays" principle.
- An increase in resources and efforts towards conducting tax investigations and audits.

2.7. Broadening the tax base

2.7.1. Introduction of a goods and services tax or turnover tax

We note that the Government has indicated that a broad-based consumption tax or goods and services tax (GST) will not be implemented whilst the economy remains in its current depressed state due to the perceived financial hardships involved in the introduction of such a tax.

However one of the advantages of a broad-based consumption tax is to stabilise the Government's revenue and also to ensure that the tax burden is borne by a wider sector of the population. We suggest that the Government continues to carry out preparatory work with a view to introducing a broad-based consumption tax or GST at an appropriate time in the future.

The Society has broadly endorsed the strategy of introducing a GST at an appropriate time (see the Society's submission to the Advisory Committee on New Broad-based Taxes ("Advisory Committee") dated 29 October 2001), if it is deemed necessary to identify additional sources of revenue, as a means of stabilising government revenue and extending the tax net to those persons using facilities in Hong Kong who might not otherwise contribute to the cost of those facilities.

2.7.2. Reducing personal allowances and deductions

The Advisory Committee considered, inter alia, reducing the level of personal allowances and deductions, and concluded that this would be an effective, and easily understood, measure to raise additional revenue. At the same time this would bring more employees back into the tax net, thus encouraging social responsibility and requiring some element of contribution to the community. We concur with these observations. We suggest that the level of personal allowances and deductions in Hong Kong should be reduced, to be more in line with those in other countries.

Reducing personal allowances and deductions by around 16%-17%, which would, for example, result in a single person's personal allowance being reduced to HK$90,000 from the existing HK$108,000, could raise an additional tax revenue of approximately HK$4-5 billion per annum. Such a reduction would appear to be reasonable given that, using 1994 as the base year, the Composite CPI increased by 10.61% between 1994-2002, whereas e.g. a single person's personal allowances increased by 50% during the same period, as indicated in Appendix 1.

The effect of reducing personal allowances and deductions by around 16.7% generally, excluding self-education expenses (for the reasons given above), is illustrated in Appendices 2 and 3.

2.8. Increasing revenue under the existing tax base

2.8.1. A Temporary Surcharge

We have suggested the measures above which would, if implemented, have the effect of broadening the tax base and thereby increasing and helping to stabilise government revenues. However, if the Government believes it is not appropriate to implement such measures now, and certainly the introduction of a GST would take some time even if work were to commence now, it still faces the question of how to tackle the deficit, and retain international credibility.

In the absence of the immediate adoption of any other measures to broaden the tax base, tax revenue can be increased by raising the tax burden for existing taxpayers or introducing new taxes. Our preference would be to adopt the former in order to broadly maintain the simplicity of our tax system. As for the latter category, the Government could push forward with the Boundary Facilities Improvement Tax which appears to have the support of the community at large. In such circumstances, we believe there would also be some merit in imposing, as a short term measure, say for two years, a temporary surcharge (TS) on all profits, salaries and property tax payers, and persons electing for taxation under personal assessment.

There is an historical precedent, in 1975, for imposing a surcharge on corporations subject to profits tax as a temporary measure, just as there is a precedent for the temporary reduction or rebate of tax at the time of a significant budget surplus, as occurred in the year of assessment 1997/98, when an across-the-board rebate of 10% of the tax liability arising was refunded to all taxpayers.

Whilst a surcharge could be easily introduced in the case of profits tax and property tax, the position for salaries tax is potentially more complicated if it needs to be considered in conjunction with any reduction in personal allowances and deductions. We believe, if personal allowances and deductions were to be reduced, that the TS should not apply to taxpayers who are currently paying salaries tax at progressive rates. Otherwise, such taxpayers would face a double burden.

Imposing a TS would have the advantage that the standard rate of profits and salaries taxes in Hong Kong would remain unchanged, and this would help to clarify and emphasise, both to Hong Kong taxpayers and to international investors, that the surcharge is intended to be no more than a short-term temporary measure, and that the Government is taking active steps to balance the deficit, therefore maintaining Hong Kong's competitive position. Additionally this would be a relatively simple measure for the IRD to implement with minimal additional cost.

Numerical examples demonstrating the possible impact of a TS are set out in the Appendix 4.

Based on the total revenue for profits, salaries and property taxes in the year of assessment 2000/01, of HK$73.8 billion, a 10% TS could immediately increase revenue by 10% of that, i.e. HK$7.4 billion, all other things being equal.

As indicated above, it would appear that a reduction of personal allowances and deductions by 16%-17% would raise salaries taxation revenues by HK$4–5 billion per year; the impact on taxation under personal assessment has not been calculated. Based on the 2000/01 figure for salaries, profits and property taxes assessed (excluding the amount attributable to progressive rate salaries tax payers) which total HK$53.2 billion, a TS of 10% would raise about HK$5.3 billion per annum.

Accordingly, we believe that a TS should be levied fairly across the board on all payers of profits, salaries and property tax. However, if personal allowances and deductions were to be reduced significantly, TS should not apply to taxpayers who are currently paying salaries tax at progressive rates.

2.8.2. Increase in government rates

Another possible broadly-based measure to bring in more revenue would be an increase in government rates. This has the advantage that there would be very little additional cost to the Government in collecting the additional revenue, as the mechanism for raising and collecting rates is already in existence, and it could be implemented quickly. A 1% increase in government rates would raise additional revenue of approximately HK$2.5 billion based on the 2001/02 estimated income from this source.

2.8.3 A comprehensive review of government charges based on the “user pays” principle

The Society believes that the Government should consider further the implementation of the concept of the "user pays" in relation to levies and charges, and review the level of government levies and charges which are directly attributable to the level of consumption by users. In this respect we note that the FS did not increase government levies and charges in his last Budget.

However, while it is appropriate in principle that users should pay a market or fair rate, and not a discounted rate for a service or facility, implementation of this should be subject to the provision of a “safety net” for the low paid and, more broadly, in the current economic climate, subject also to there being no major adverse impact on the economy and the livelihood of Hong Kong citizens.

2.8.4 An increase in resources and efforts to conduct tax investigations and audits

The Government should step up its efforts to recover taxes which should have been paid in the first place by conducting tax investigations and audits. The IRD has been able to recover back tax and penalties in excess of HK$2 billion per annum for the past few years. With the allocation of more resources, it is hoped that the revenue collection would be increased accordingly.

2.9. Conclusion

Recently, Hong Kong's economy has been in recession – prices are declining and unemployment rates have risen to historically high levels. If these were the only problems to be tackled, the Government could adopt an expansionary fiscal policy by reducing tax rates and increasing public expenditure. In effect, it has been doing this given the deficits experienced in recent years and the increase in public expenditure as a proportion of the economy. However, the Hong Kong fiscal reserves, stood at HK$300.1 billion at 31 October 2002 (compared with HK$444 billion in March 2000) and if the present trend continues they will be exhausted within a few years' time.

Under the circumstances, we believe the Government must be resolute in controlling the level of public expenditure. In addition, the Government has to consider and implement, in a transparent manner, some or all of the revenue-raising measures outlined above.

The Government has indicated that it will not pursue a broad-based consumption tax or GST in the immediate future. We would, therefore, favour the implementation of, for example, a TS and/or a reduction in personal allowances and deductions, as short-term revenue-raising measures.

The Society believes that all sectors of the Hong Kong community i.e. corporations, unincorporated businesses and individuals should contribute towards tackling the deficit, especially the structural part of the deficit. The adoption of the measures proposed above could help to achieve fiscal equilibrium and a fairer society.

Hong Kong Society of Accountants
9 December 2002

Appendix 1

Composite Consumer Price Index/Level of Personal Allowances and Deductions (1994-October 2002)

Year	Composite CPI (%)	CPI with a base of 100 attributed to 1994's figure	Level of personal allowances (for a single person) if linked to changes in the CPI	Actual personal allowances (for a single person)	Year of assessment
			HK$	HK$	
1994	8.8	100.00	72,000	72,000	(1994/95)
1995	9.1	109.10	78,552	79,000	(1995/96)
1996	6.3	115.97	83,498	90,000	(1996/97)
1997	5.8	122.70	88,344	100,000	(1997/98)
1998	2.8	126.13	90,813	108,000	(1998/99)
1999	-4.0	121.09	87,184	108,000	(1999/00)
2000	-3.8	116.49	83,872	108,000	(2000/01)
2001	-1.6	114.62	82,526	108,000	(2001/02)
2002 (3 months ended October 2002)	-3.5 (over a year earlier)	110.61	79,639	108,000	(2002/03)

Appendix 2

Salaries Tax – 2003/04 Budget Proposals

Personal Allowances

Personal Allowances		**Present**	**Proposed**
		2002/03	2003/04
		HK$	HK$
Personal allowance	(single)	108,000	90,000
	(married)	216,000	180,000
Single parent allowance		108,000	90,000
Child allowances:			
1st child		30,000	25,000
2nd child		30,000	25,000
3rd to 9th child (each)		15,000	12,500
Dependent parent allowance		30,000	25,000
Additional dependent parent allowance		30,000	25,000
Dependent grandparent allowance		30,000	25,000
Additional dependent grandparent allowance		30,000	25,000
Disabled dependant allowance		60,000	50,000
Dependent sibling allowance		30,000	25,000

Appendix 3

Annual Income Levels Below Which No Salaries Tax Is Payable

	Present	Proposed	Reduction
	($)	**($)**	**%**
No dependent parent / grandparent			
Single	108,001	90,001	-16.66
Married	216,001	180,001	-16.66
Married + 1 child	246,001	205,001	-16.66
Married + 2 children	276,001	230,001	-16.66
Married + 3 children	291,001	242,501	-16.66
No dependent parent / grandparent and having incurred mortgage interest of $100,000 for residence			
Single	208,001	190,001	-8.65
Married	316,001	280,001	-11.39
Married + 1 child	346,001	305,001	-11.85
Married + 2 children	376,001	330,001	-12.23
Married + 3 children	391,001	342,501	-12.40
Including two dependent parents / grandparents			
Single	168,001	140,001	-16.66
Married	276,001	230,001	-16.66
Married + 1 child	306,001	255,001	-16.66
Married + 2 children	336,001	280,001	-16.66
Married + 3 children	351,001	292,501	-16.66

Appendix 4

Introduction of a Temporary Surcharge (TS) - Numerical Examples

We use the following numerical examples to demonstrate the possible impact of a TS on three single taxpayers in respect of salaries tax, with A and B subject to progressive rates whilst C is subject to the standard rate. It is also assumed that a TS of 10 % will apply to the tax liability calculated where applicable.

Example I – TS on all salaries tax payers with no reduction in personal allowances

	A	B	C
	HK$	HK$	HK$
Assessable Income	360,000	1,000,000	1,500,000
Less: Personal Allowance	108,000	108,000	N/A
Net Chargeable Income	252,000	892,000	1,500,000
Tax at progressive rates	32,340	141,140	
Tax at Standard Rate			225,000
TS	3,234	14,114	22,500
Total Tax Payable	35,574	155,254	247,500
Increase in Payment	3,234	14,114	22,500

Example II – TS on standard rate taxpayers with a reduction in personal allowances

	A	B	C
	HK$	HK$	HK$
Assessable Income	360,000	1,000,000	1,500,000
Less: Personal Allowance	90,000	90,000	N/A
Net Chargeable Income	270,000	910,000	1,500,000
Tax at progressive rates	35,400	144,200	
Tax at Standard Rate			225,000
TS	N/A	N/A	22,500
Total Tax Payable	35,400	144,200	247,500
Increase in Payment	3,060	3,060	22,500