



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

TAX

PUBLIC EXPENDITURE

REVENUE

In FOCUS - The Core Strengths of Hong Kong's Tax System

Budget Proposals 2005 / 06

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IN FOCUS – THE CORE STRENGTHS OF HONG KONG'S TAX SYSTEM

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BUDGET PROPOSALS 2005/06

A. OVERVIEW

With Hong Kong's economy showing signs of recovery we believe it is time to focus on the Hong Kong tax system and its impact on the Hong Kong economy in the 21st century. Hong Kong has long prided itself on having a straightforward and easily understood low tax system, which has provided a level playing field for economic growth. It is generally recognised that the certainty that this tax system has provided in the past has been a significant factor in encouraging inward investment into Hong Kong and facilitating economic growth for businesses operating in Hong Kong.

Hong Kong is one of the few jurisdictions with a territorial system of taxation and whilst this has both advantages and disadvantages, it has generally been considered that the advantages outweigh the disadvantages and, coupled with the low rates of tax imposed, the tax system in Hong Kong has been attractive to both domestic and international entrepreneurs and conducive to Hong Kong's economic development.

However one of the weaknesses of the Hong Kong system is the narrowness of its tax base, and the significant increases in personal allowances that were granted to salaries tax payers in the 1990s resulted in Hong Kong being left with an even narrower tax base. This was recognised by the Advisory Committee on New Broad-based Taxes, established by the Financial Secretary (FS) as a result of Hong Kong's continuing budget deficits, which reported to the Government on 1 March 2002.

In February 2002, the Task Force on the Review of Public Finances reported to the government and indicated that Hong Kong faced structural fiscal problems and consequently there was a need to address the basis of the current tax system. Based on government forecasts in the 2004/05 Budget, reiterated in the consultation documents on the 2005/06 Budget, fiscal reserves will reduce by a further 24% of the March 1998 level, or 39% of the March 2004 level, in the coming five years to 2008/09, with the projected reserves falling to around \$167.3b by 31 March 2009. This would be equivalent to only eight months of government expenditure compared with the level of reserves as at 31 March 1998 which stood at the equivalent of twenty-eight months of expenditure. Whilst there may be no immediate need to raise additional revenue in view of the improved economic conditions in Hong Kong, provided expenditure is kept in check, there is still an urgent need for the government to review its sources of revenue, taking into account the narrowness of the tax base and to ensure longer-term control over growth in its expenditure.

Furthermore, in recent years, there has been a perception amongst taxpayers that there is increasing uncertainty regarding the effectiveness of the Inland Revenue Ordinance (Cap. 112)("IRO") and in the application of that Ordinance by the Inland Revenue Department ("IRD") and the courts. Whether this perception is correct or is incorrect is perhaps less relevant than the fact that it exists. This perception is a problem that affects Hong Kong's competitiveness as a regional business hub and that should be addressed. Failure to do so would result in the erosion of the very simplicity and certainty of our system of taxation, which have encouraged inward investment into Hong Kong.

Our submission is entitled "In FOCUS – the Core Strengths of Hong Kong's Tax System" and it identifies ways in which we believe the system should be re-examined and can be improved to reinforce the positive trend in the economy. We also comment on the need to retain the revenue generated through our tax system through savings and greater efficiency in government expenditure. Our FOCUS is directed at the following facets of the system:

- F - Fundamentals
- O - Opportunities
- C - Community
- U - Understanding
- S - Savings

We draw attention, in particular, to the need to address the areas of uncertainty in Section B4 of our detailed proposals. These include the question of legislating for uncertainty in the areas of profits tax and salaries tax and the need to clarify the position regarding the IRD's policy of "assess first/audit later", which has led to uncertainty and some anxiety amongst taxpayers, who, in some cases have been unable to treat their tax affairs for each year as finalised until the six-year time bar period has elapsed.

We also refer to the impact of the decision in *Commissioner of Inland Revenue v Secan Ltd. and Ranon Ltd.* [(2000) 5 HKTC 266] ("*Secan*") which, taken to its logical conclusion, suggests that, in some respects, in setting tax policy, the Hong Kong Government has deferred to the International Accounting Standards Board, the body that sets international accounting standards. That body dictates disclosure items in the audited accounts of companies and, therefore, in view of the decision in *Secan*, it will, effectively, also be deciding how profits and losses are to be taxed in Hong Kong, unless the situation is remedied.

These factors, together with the opportunities that are discussed in Section B2, suggest that there is a need for a review of the IRO and the introduction of legislative changes to remove this uncertainty.

We also refer to the concept of "user pays", which can assist the community by placing more of the financial responsibility for the provision of services on those persons who use those services. We have identified in section B2 a number of areas where we believe the current tax system can be improved and thus enhance Hong Kong's status internationally. We have also included sections on goods and services tax ("GST") and estate duty, which are areas currently under review by the government.

1.1 Economic Outlook

Hong Kong's economy picked up with GDP increasing by 7.2% in real terms in the third quarter of 2004 compared with a year earlier. This followed a 12.1% increase in the second quarter, which represented the fastest growth since the first quarter of 2000. The government is maintaining its revised forecast of 7.5% growth for the year, released in August 2004, compared with a figure of 6% quoted in the 2004/05 Budget Speech. The growth impetus continued to come from the external sector. However, with rising oil prices and somewhat slower growth than expected in the United States, some forecasts are predicting a slight decrease in the overall figure for 2004 to around 7%.

Following a continuous downtrend since November 1998, overall consumer prices, measured in terms of the Composite Consumer Price Index (CPI(C)), has reverted to a slight year-on-year increase since July 2004. For the third quarter, the CPI(C) rose by an average of 0.8% over the same period a year earlier, reversing the 0.9% decline in the second quarter. While this was due partly to the effect of a low base of comparison in 2003, the increase in the CPI(C) reflected the combined influence of improved economic conditions, sustained consumer demand and rising import prices in recent months. However, it is noted that month-to-month, the rate of increase appears to be dropping, from 0.8% in August to 0.2% in October 2004, and the government is now projecting an overall figure for the year of -0.3%, compared with a forecast of 0% in August and -1% in the 2004/05 Budget Speech.

The unemployment rate fell to 6.7% in the period of August-October 2004, down from 6.8% in July-September 2004. This translates to around 240,000 people out of work. The under-employment rate held stable at 3.2% between the period of July-September 2004 and August-October 2004.

While Hong Kong's open economy is constantly vulnerable to factors beyond our control, especially the performance of the economies of the United States (US), the Mainland and Europe, and the impact of world events, such as the current high level of, and volatility in, oil prices, which could adversely affect the growth of the world's major economies, the signs at present are positive. The US recovery appears to be solidly based with growth recorded at 3.7% in the third quarter (according to advance estimates). The Mainland economy, meanwhile, continues to demonstrate a fundamental strength, achieving growth of 9.5% in the third quarter of 2004.

1.2 Fiscal Position

The overall deficit in 2004/05 is now likely to be lower than HK\$42.6b estimated in the 2004 Budget, with the improved state of the economy and consequently the increasing amount of revenue to be collected. This was illustrated clearly by a land auction held on 14 October 2004, which generated a record amount of income for the government. At HK\$14.12b, it surpassed the budget estimate of HK\$12 billion for the whole year. Nevertheless, as the government is officially still quoting a projected operating deficit of HK\$46.6b in 2004/05 and consolidated

deficit of HK42.6b (in its consultation materials for the 2005/06 Budget), some of figures contained in this submission are still predicated on the official forecasts. For the first six months of the fiscal year, the gap between income and expenditure reached HK\$22.7b, compared with HK\$74.3b for the same period in 2003 and HK\$70.8b in 2002.

Fiscal reserves stood at HK\$252.6b on 30 September 2004, compared with HK\$234.4b as at 31 October 2003. Based on government forecasts in the 2004/05 Budget and the consultation documents on the 2005/06 Budget, the projected reserves will fall to around \$167.3b by 31 March 2009 (see above). Despite a promising rate of economic recovery, operating revenue still appears to be falling short of fully matching operating expenditure. Windfalls from volatile sources of revenue, such as land premium, cannot be relied upon to solve the mismatch between operating expenditure and operating revenue. This points to the real need to address the ongoing mismatch between revenue and expenditure in order to ensure long-term confidence and stability in Hong Kong's economy.

As at 30 October 2004, the foreign currency reserves held by the Exchange Fund stood at US\$119.5 billion compared with US\$112.4 billion at 30 October 2003. Hong Kong is currently the world's sixth largest holder of foreign currency reserves, after Japan, Mainland China, Taiwan, Korea and India.

1.3 Structural Deficit

In February 2002, the Task Force on Review of Public Finances identified changes that had occurred on the revenue and expenditure side of the budget and concluded that Hong Kong was facing a structural fiscal problem. On the expenditure side, the cumulative growth of government expenditure in nominal terms started to outstrip growth in the economy from 1993-94 and the gap widened from 1997-98 onwards. This, coupled with the aging of the Hong Kong population, which meant that there would be increasing demands for social security payments, prompted the Secretary for the Treasury to state: "the directions indicate that the continuation of current revenue and expenditure policy is not an option". The Task Force recommended that the first priority was to control the growth of government expenditure. On the revenue side the Task Force recommended that the government should consider the recommendations of the Advisory Committee on New Broad-based Taxes ("Advisory Committee"), which was to report (and subsequently did report) shortly afterwards.

It seems clear, therefore, that Hong Kong should continue to address the structural fiscal deficit and to ensure that its taxation system is able to generate the revenues that are required, whilst at the same time maintaining control over government expenditure to ensure that revenues raised are utilised effectively for the benefit of the Hong Kong community.

1.4 Summary of Proposals

Fundamentals

1. A decision should be made and announced on introducing a goods and services tax (GST). A consultation paper should be released as soon as possible so that a consensus can be reached at an early stage on the appropriate design of a GST system in Hong Kong.
2. Pending the introduction of GST, if it is necessary to raise additional revenue, the options of a further review of certain personal allowances, a moderate increase in rates on tenements and the introduction of the previously-proposed Boundary Facilities Improvement Tax should be considered.
3. To address the acute uncertainties that have arisen following the Court of Final Appeal decision in *CIR v Secan Ltd and Ranon Ltd.*, consideration should be given to amending the Inland Revenue Ordinance (IRO) to establish that there is no necessary connection between accounting and tax treatment in relation to corporate profits.
4. A one-time tax amnesty should be introduced covering all open years of assessment (i.e., the six years prior to the year in which it is introduced) to improve tax compliance in the future and provide a one-off increase in revenues with very little cost to the government in terms of additional facilities.

Opportunities

5. Various measures should be introduced to enhance Hong Kong's competitiveness as a location for regional offices and group companies, such as the following concessions:
 - Full profits tax exemption to regional headquarters/offices in Hong Kong in respect of management consultancy income derived by the Hong Kong entity from associated entities overseas.
 - Exemption of interest income received by regional offices from loans made in Hong Kong to their overseas associates.
 - Group relief.
 - Loss incurred in the current year of assessment should be permitted to be offset against the assessable profits of one previous year.
6. Given the international trend towards lowering the rate of direct taxes, the profits tax rates in Hong Kong should be reduced at the earliest opportunity. In particular, the "temporary surcharge" on the corporate profits tax rate should be removed at the time of introduction of a GST, or in 2008/09, when the budget is forecast to go into surplus again, whichever occurs first.

7. To improve the competitive environment for the local manufacturing sector, and provide employment opportunities, a 50% profits tax reduction should be granted to local manufacturers of goods, for a limited period of, say, five years.
8. Freeing up land in the Border Closed Area separating Shenzhen and Hong Kong has the potential to generate significant economic benefits to Hong Kong. We would suggest that, as a start, the government should clearly state its position in relation to the future of this area.
9. A unilateral tax credit should be given for the amount of foreign withholding tax paid (in jurisdictions with no double taxation agreement with Hong Kong) on income sourced in Hong Kong, of up to a maximum of 50% of the amount of Hong Kong profits tax payable on such income.
10. Consistent with the Institute's recent submission on the subject, we advocate abolishing estate duty in one go, but if the government opts for a phased approach, exemptions on bank accounts and listed securities should be given, and a clear timetable provided for final abolition.
11. A capital gains tax should not be introduced in Hong Kong as it will be unlikely to result in an overall gain to Hong Kong and will discourage investment.
12. Worldwide taxation should not be introduced in Hong Kong, as it would necessitate a complex system of tax credits together with double taxation agreements. It would also be inconsistent with the source principle of taxation.

Community

13. The duty on alcoholic beverages in Hong Kong provides a stable source of revenue and we doubt whether abolishing the duty on alcoholic beverages would encourage wine tourism in Hong Kong, particularly given the competition from wine-producing countries in the region, or stimulate Hong Kong's development as a regional hub for wine products. Under the circumstances, we do not see the need for any change at present.
14. A detailed review of the level of duties and fees levied by the government should be undertaken and, as far as possible, the "user pays" principle should be adopted, as long as the government is willing to be accountable for the services that it provides and to examine whether and how services could be delivered more efficiently.
15. Fiscal measures, including environmental taxes and tax incentives, should be considered as a way of promoting and improving environmental protection.
16. Employees should not be taxed on any redundancy/severance payments from their employers of up to twice the statutory limits.

17. In relation to (16) above, where an employee's salary has been reduced because of business conditions and the employer subsequently pays a long-service/severance payment based on the previous higher salary, the difference between the payment based on the final salary and the actual payment made by the employer should also be deductible by the employer.
18. An extra deduction of 50% on the salary costs of employing unemployed persons (who have been actively seeking working for one year or more) should be granted to employers in the year of assessment 2005/06.
19. Government ground rent, like rates, should be deductible against property tax to better reflect the actual expenses borne by landlords.
20. Students should be allowed to claim a deduction for the interest they pay on their student loans from the government for a period of, say, five years, after they begin work, with the students being able to elect in which five years they wish to claim the expense.
21. Self-education expenses should be able to be carried forward for up to three years so that they may be claimed when the taxpayer is generating income subject to salaries tax.
22. To further encourage charitable donations, the following measures should be introduced:
 - The present ceiling for allowable deductions should be increased from 25% to 50% of assessable profits/income, with a view to removing the ceiling altogether as a long term objective.
 - Any donations that cannot be claimed against tax in the relevant year should be able to be carried forward.
 - The term "approved charitable donation" should be defined for the purposes of the IRO to include donations in kind, provided the goods are valued by a qualified third party.
23. To improve the arts and cultural environment in Hong Kong, and encourage more private sector support, consideration should be given to allowing corporate sponsors of "approved" events and activities to claim deductions of 150% of actual expenditure.

Understanding

24. Clarity, certainty and consistency application of tax laws and tax administration have been fundamental to Hong Kong's reputation as a place to do business. We therefore propose that:
 - Consideration should be given to following the approach adopted by other jurisdictions by publishing the IRD assessors' manual.
 - Given the reliance of Hong Kong's tax system on the principle of source of profits, legislation should be introduced to clarify the position regarding offshore profits, particularly in the case of manufacturing and trading profits.

- The government should encourage voluntary disclosure of errors and omissions in tax filings by imposing penalties based primarily on financial restitution, and not imposing punitive penalties and/or prosecution on those making full voluntary disclosure.
- The IRO should be amended to include tests to determine the major source of income that are subject to profits tax.
- The IRO should be amended to clarify the tests or rules for determining whether an individual has a Hong Kong-source employment.
- The legal basis of the “assess first audit later (AFAL)” approach now adopted by the IRD needs to be clarified. The AFAL has led to increased uncertainty amongst taxpayers, because their tax affairs may not be concluded for any particular year of assessment until the expiry of the statutory time limit of six years.
- To provide greater certainty to businesses and to counteract the negative effect of the AFAL, the time for re-opening tax affairs under the IRO should be shortened from six years to three or four years, which would be in line with a number of other jurisdictions.

Savings

25. Since the government is continuing to face a shortfall of operating revenue over operating expenditure, it should critically review the various areas of public expenditure.
26. Consideration should be given to out-sourcing where appropriate, and also to expanding the matching scheme, which has been successful in engaging more private sector support for universities, in relation to other community activities funded by the government.
27. As health expenditure is expected to continue to grow in the future, it is critically important to determine how to maintain a financially sustainable public health care system over the longer term.
28. To help to develop Hong Kong into a regional centre of excellence for tertiary education, and better utilise the fixed cost facilities in the tertiary education system in Hong Kong, consideration should be given to offering tertiary education programmes to overseas students, either in or outside Hong Kong, having regard to, amongst other things, the full costs of providing those services.
29. To enhance the efficient use of resources and the delivery of public services, further studies should be carried out to identify suitable public services for privatisation, which may include postal services and water supplies.
30. With a view to cutting capital expenditure, the government should encourage more private participation in major capital projects.

B. DETAILED PROPOSALS

B.1 FUNDAMENTALS

1.1 Hong Kong's Narrow Tax Base

On 1 March 2002, the Advisory Committee presented its report to the FS. The report considered various options but recommended a GST as an option that would broaden the tax base and generate approximately \$6 billion annually for each percentage point at which GST was levied.

In its report the Advisory Committee stated:

"Of all the options surveyed by the Advisory Committee [GST] is the only one that fits the primary criteria of being broadly-based and highly revenue-productive even when the tax is set at a level which, when compared with other economies, is low."

"... the aging of the population will place an upward pressure on social security expenditure and medical and health services. The Advisory Committee has noted that many other mature taxation jurisdictions have all implemented GST (or a variant of it) to reform their tax system in the face of aging populations. With changing demographics, increasing community expectations for government services and the adverse effects on direct tax revenues of cyclical downturns in the economy, it has become increasingly untenable for governments to continue their heavy reliance on income taxes as the predominant revenue source... Taxing private domestic consumption provides an alternative form of revenue that is considerably better shielded from economic and demographic changes within the community (pp. 22-23)."

We would also propose that the focus should now be on broadening the tax base in Hong Kong, rather than looking to increases in direct taxes as the primary source of any future requirements for additional revenue.

1.2 Preparing for a Goods and Services Tax

The issue of the introduction of a GST in Hong Kong has been under discussion for some time. We note that, in the 2004-05 budget, the FS confirmed that the government had set up an internal committee to conduct a detailed study on the implementation of a GST and subsequently a research team from the International Monetary Fund held discussions in Hong Kong to seek views on implementation issues. Recently, the FS has indicated that a GST would not be brought in until at least 2009. We would urge the government to make a decision on the introduction of a GST and announce its decision in the coming Budget Speech, so as to provide a clear direction on the issue and, as appropriate, to enable the community as a whole to move on to the next stage of working together to ensure a smooth introduction. As part of this process, we also urge the government to release a consultation paper as soon as possible so that a consensus can be reached at an early stage on the appropriate design of a GST system for Hong Kong.

Given the differences between Hong Kong's economy and other economies that are sometimes quoted as examples of existing GST systems, it will be important for a successful and, as far as possible trouble-free implementation, for the government to conduct more detailed economic and fiscal modelling and forecasting and to thoroughly test the proposed GST system. The objective would be to evaluate the revenue and other implications of introducing the system, so as to avoid any significant unforeseen effects that could have an adverse impact on its smooth implementation.

We set out in Appendices 1 and 1.1 a more detailed discussion on the introduction of a GST and the relevant technical considerations. The following are amongst our key recommendations:

General points

- GST in Hong Kong should be kept simple to enhance certainty;
- exemptions and zero-rated items should be kept to a minimum;
- appropriate compensatory measures should be built into the system, including allowances for lower-income groups and students;
- reductions in direct taxes should be introduced in parallel; and
- to provide medium to long-term predictability, the government should consider giving an undertaking not to increase the initial rate of a GST for 5-10 years;

Other key design features

- GST in Hong Kong should be a credit-invoice type;
- a single positive rate of, we suggest, below 5%, should be adopted;
- the destination principle should be adopted but, for practical reasons, consideration should be given to excluding goods in transit;
- consideration should be given to zero-rating exports (including tourist purchases);
- financial services should be taxed, where explicit fees are charged (except for exported services);
- residential rental payments should be exempt in order to maintain parity with owner-occupied residential buildings;
- to enhance cost-effectiveness, in view of the substantial number of small businesses in Hong Kong, the registration threshold should be set fairly high at, say, HK\$5 million turnover, with an option to register below that level.

1.3 Broad Based Tax Measures

The Advisory Committee recognised the need for Hong Kong to change the composition of its revenue-raising activities with a shift away from direct taxes towards a GST. However, recognising that the introduction of GST could take some time, the Advisory Committee made three recommendations of possible measures to broaden Hong Kong's narrow tax base in the short term, i.e. increasing rates on tenements, reducing personal allowances and introducing the previously-proposed Boundary Facilities Improvement Tax.

a. To increase rates on tenements

The Advisory Committee did not recommend increased rates be used as a long-term revenue measure to cover the fiscal needs of the government. However given that the implementation of a GST may require a long lead time, the Advisory Committee considered that "a moderate increase in rates in the interim is an option, should the state of government finances so demand". The Institute has previously suggested that consideration could be given to an increase in rates as a short-term revenue-raising measure, if additional revenue is required pending the conclusion of its research into a GST and, as appropriate, subsequent preparatory work for implementation.

b. Personal Allowances

The Advisory Committee concluded that, by international standards, personal allowances given to salaries taxpayers and other concessionary deductions are high in Hong Kong. They also contribute to the narrow salaries tax base. A reduction in personal allowances would bring new taxpayers into the tax base. The Advisory Committee proposed that the then existing level of personal allowances be reduced with a view to broadening the tax base. We note that, over the past two years, the FS has already adopted this proposal by reducing the basic personal allowance and the married person's allowance in the last two years. However we also note that, contrary to this trend, there has been a significant increase in child allowances for the third and subsequent children. We therefore suggest that a further review of specific personal allowances be undertaken by reference to the adoption of a base year, with relevant allowances adjusted in line with the changes in the economy from that time.

c. Boundary Facilities Improvement Tax

The Advisory Committee considered that a land and sea departure tax (subsequently called the Boundary Facilities Improvement Tax) would provide a steady source of revenue for the public purse. Although legislation to introduce such a tax was put forward by the government and subsequently withdrawn, in our view the proposed Boundary Facilities Improvement Tax would have advantages, as identified clearly by the Advisory Committee. We, therefore, propose that the option of introducing this form of tax should be re-examined by the government.

1.4 Government Policy regarding Profits Tax – The Need to Legislate to Counter the Decision in the *Secan* Case

The decision of the Court of Final Appeal in *Secan* has had an impact upon the policy of the IRD and the interpretation of the IRO. This was recognised by the IRD in the Departmental Interpretation and Practice Notes No. 40 "Profits Tax Prepaid or Deferred Revenue Expenses" ("DIPN 40") issued in October 2002.

Prior to the *Secan* decision, the IRD "generally accepted that if an expense would typically be paid in advance the prepayment would be allowed as a deduction on the basis that the expense has been incurred".

In relation to the facts of the case, the judgment in *Secan* indicated that assessable profits must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the IRO (See Appendix 2 for further references to the case).

Essentially the IRD has referred to the *Secan* decision as authority to adopt the approach of determining the assessable profits or allowable losses of a company based on the accounting disclosure or treatment of such items in the company's audited accounts. A number of problems have occurred in this area, not the least of which relates to the adoption of International Accounting Standards (IAS) (or International Financial reporting Standards (IFRS), as all new standards are called) in Hong Kong, which, under the principle of "fair value accounting", require the recognition of certain profits and losses in audited accounts that may be unrealised and may continue to be unrealised for an indefinite period.

Although, in the past, unrealised losses reflected in the profit and loss account may have been able to be set off against the taxpayer's tax liabilities, the situation is different following *Secan*, because if, ultimately, an unrealised loss turns into an actual gain it can still be taxed at that time, whereas with unrealised profits, tax may be charged but it is quite possible that if, eventually, those profits turn into actual losses, the losses might not be able to be used because the taxpayer might already have ceased business at that time. The requirement to pay tax on unrealised gains, therefore, may affect the financial health of a business and may even be a contributing factor in its failure. The overall economic impact could be greater still, given the potential knock-on effect on creditors of that business.

Under the circumstances, we recommend that the government introduces legislation to address the existing uncertainty that has arisen following *Secan* decision and the IRD's application of it.

We also recommend that when Hong Kong adopts an IFRS in future a review of its impact on the IRO be undertaken and, if necessary, specific amendments to the IRO should be introduced to maintain the integrity of Hong Kong's tax system.

1.5 Improving the Levels of Tax Compliance – Implementing a Tax Amnesty

One of the strengths of the Hong Kong tax system has been that its legislation has been relatively straightforward and easy to understand. From time to time contentious areas have arisen in interpretation of the tax law and, in the past, clarification has been obtained either by reference to court decisions, the use of Departmental Interpretation and Practice Notes or, when necessary, changes to the legislation. This approach has enabled taxpayers to have greater confidence in their dealings with the IRD and has encouraged full disclosure in compliance

matters and the belief amongst taxpayers that their affairs will be dealt with on a consistent basis.

However, in recent years, there has been a perception amongst taxpayers that there is no longer a consistent approach adopted in the enforcement of certain provisions of the IRO, particularly with regard to source of profits and source of employment income.

One of the adverse consequences of an entrenched perception of this kind is that taxpayers are less willing to make a full disclosure of their tax affairs and are also less willing to approach the revenue authorities to correct past errors, where these come to light, as there is a fear that severe penalty action will be taken against them, even if this is a case of voluntary disclosure to correct genuine errors. We believe that this phenomenon is beginning to occur in Hong Kong.

Some jurisdictions have countered this problem by improving the consistency of approach in the interpretation of their revenue legislation and also provided increased certainty in the legislation itself. Some jurisdictions have also taken the opportunity to review their legislation to offer a tax amnesty to delinquent taxpayers to bring their tax affairs up to date without the fear of undue penalties, but with the expectation of increased penalties once the amnesty period has expired.

We have recently seen a tax amnesty being offered by the tax authorities in Mainland China on individual income tax, which has been extended past its original deadline of 30 June 2004.

We, therefore, consider that in conjunction with provision of greater certainty regarding the introduction of new legislation and clarification of existing procedures of enforcement, that Hong Kong should consider introducing a tax amnesty, covering all open years of assessment, that is, the six years immediately prior to the year of assessment in which it is introduced. This would have the advantage of providing a one-time increase in revenues with very little cost to the government in terms of additional facilities. It should be made clear any amnesty would be a one-time amnesty that would not be repeated, and it would be coupled with increased penalties for future omissions.

We set out in Appendix 3 our detailed proposals on this matter.

1.6 Voluntary Disclosures Subsequent to an Amnesty

In considering increased penalties after such an amnesty, however, we stress that there should be provision for taxpayers who have made genuine mistakes, and who make a full voluntary disclosure of their mistakes, to be subject to lower penalties, based primarily on economic restitution, rather than punitive penalties.

B.2 OPPORTUNITIES

2.1 Regional Base

2.1.1 Tax exemption for management fees from overseas associates

In order to enhance Hong Kong's status as regional base for multinational companies we propose that a full exemption from profits tax should be granted to regional headquarters/offices in Hong Kong in respect of management consultancy income derived by the Hong Kong entity from associated entities overseas. This would encourage the establishment of regional headquarters in Hong Kong, which could then recharge their expenses to associated entities in the region and receive that income free of tax in Hong Kong.

It is recognised that anti-avoidance provisions would be required to prevent abuse of this relief. Such provisions could, for example, limit the concession to transactions with "associated entities overseas", defined by reference to the common beneficial ownership of at least 50% in each of the companies that charges/pays the management or consultancy fees.

2.1.2 Tax exemption for interest received on loans to overseas associates

Currently section 15(1)(f) of the IRO deems the interest derived by a corporation on loans made to its overseas associates to be subject to profits tax if the provision of credit is made in Hong Kong. While it may not be a problem in practice for group companies to arrange the provision of inter-company credit to be made outside of Hong Kong, we believe that if the interest received by regional offices from loans made in Hong Kong to their overseas associates were to be exempted from profits tax, this would provide an incentive for international businesses to establish their treasury function in Hong Kong. This in turn would benefit the further development of the financial services sector in Hong Kong.

Similar accompanying anti-avoidance provisions to those referred to above may also need to be considered.

2.2 Group Relief

Corporations often organise themselves into holding companies, subsidiary and associated companies to reflect the structure of their business and to limit liabilities. Under Hong Kong tax system each company within a group is considered a separate legal entity and is currently taxed separately. Companies within a group are not allowed to offset the tax losses of one company against the taxable profits of another. As a result the setting up of separate companies within the group can effectively raise the tax rate for the whole group where one or more group companies have taxation losses.

This offset of losses by companies within the same group, commonly known as "group relief", is common in many developed tax jurisdictions and we have, in previous submissions, advocated some form of group relief should be introduced in Hong Kong.

We note that with effect for the Year of Assessment 2003 the Singapore Government has introduced a loss transfer system of group relief in Singapore. The Singaporean authorities have adopted a definition of a group as consisting of a Singapore incorporated parent company and all of its Singapore incorporated subsidiaries. Two Singapore incorporated companies would be members of the same group if one is 75% owned by the other or both are 75% owned by another Singapore incorporated company. The Singapore incorporated companies must have the same accounting period to qualify for group relief.

As Singapore operates its taxes on a territorial basis similar to that in Hong Kong we consider that the adoption of group relief in Singapore demonstrates that such arrangement is workable under a territorial system.

The need for group relief has become more apparent following the decision in *Secan* with its clear implications that unrealised profits can be subject to profits tax, although those gains may not be finally received until a later period or even not received at all. An example of this would be an unrealised gain on a hedging arrangement. As indicated in Appendix 2, the suggestion that unrealised gains should be taxed is contrary to the accepted principles of taxation law in Hong Kong and if legislation to minimise the more unfavourable implications of the decision in *Secan* is not introduced, then there will be inequality in the tax system. The adoption of group relief in Hong Kong may enable such unrealised gains to be offset by losses incurred by other group companies.

As in previous submissions, we propose that, if full group relief is not introduced, arrangements should be introduced to allow the transfers of losses within a group of companies in the event of the loss-making companies going into liquidation. 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.

2.3 Utilisation of Tax Losses

Loss carry-back

The present law (Section 19D of the IRO)

1. The present law is simple and straight-forward and imposes no time restriction for the absorption of losses.
2. If the loss is not fully deducted it is carried forward, without time restriction, to be deducted against the assessable profits of the corporation in future years of assessment.
3. There is no choice for the corporate taxpayer to select the particular year of assessment in which a loss carried forward may be absorbed.

Inequitable tax treatment

The economic benefit of the losses incurred in a year of assessment is lost if the loss has to be carried forward to a future year for offset. This is particularly damaging in the case of cessation of business and rising cost of doing business in Hong Kong.

As discussed in section B 1.4 above, following the decision in *Secan*, the IRD takes the view that unrealised gains in investments that are required to be reflected in the profit and loss account are taxable. This is so, even though ultimately no gain may be realised at all. In principle, unrealised losses would also be able to be set off against other profits or carried forward. However, in the situation where a business does not have other profits and fails to make a profit in subsequent years before ceasing business altogether, it will not be able to set off the unrealised losses even though it may previously have been taxed on its unrealised gains. This appears to a situation that is likely to arise more often following the *Secan* decision and it seems to be inequitable.

Proposal

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, say, one year's carry-back only. We believe that such a measure would help to ensure that 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 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.

In order to counter trafficking of losses, appropriate anti-avoidance measures would need to be introduced.

Loss carry-back is adopted by most countries that have advanced taxation systems. The most notable of these are Germany, Japan, the United States and the Netherlands.

In the Netherlands, a company may set off its losses against its taxable profits for the three preceding years.

In Germany, a net operating loss is automatically set off against the non-distributed pre-tax income (including capital gains) of the previous year, up to a maximum amount of €511,500 (assessment year 2003).

2.4 Incentives

The objectives of business tax incentives are defined in terms of economic growth, stability, and structural changes in regional development, sectoral orientation and asset composition. Tax

incentives are technically efficient if they actually induce desirable changes with minimum cost. Most countries and territories in the Asia-Pacific region have their own tax incentive policies. Some have concluded that for the betterment of their economic development, they should provide certain incentives and tax preference treatments for some encouraged industries - Singapore and South Korea are two examples where this policy has achieved some success. In view of the keen competition in the region, we would suggest Hong Kong should review the existing incentive programmes of its neighbouring competitors to ensure that we remain aware of the competitive challenges and able to respond to them, as appropriate, by adjusting Hong Kong's system in ways that best meet Hong Kong's needs and enable Hong Kong to build on its own particular strengths.

Research findings show that attributes of corporation tax system such as tax rates, transparency and predictability can influence the international location of investment that is particularly sensitive to the host-country tax rates. We therefore propose that the government, within the current financial constraints, should consider following the international trend of lowering the profits tax rate in the long run in order to make Hong Kong even more competitive within the region. As indicated above, we believe that the introduction of a GST would be an opportune time to make such changes.

2.5 Tax Relief on Withholding Tax

The IRO contains provisions for Hong Kong taxpayers to obtain tax credits for overseas withholding taxes paid in those countries with which Hong Kong has concluded arrangements for the relief of double taxation. However, Hong Kong has only concluded one double tax treaty ("DTA") with Belgium, and therefore tax credits can only be claimed for withholding taxes paid in Belgium.

Only limited relief is available for Hong Kong taxpayers on withholding taxes paid in those countries that do not have a DTA with Hong Kong. In such cases, a deduction is available to the Hong Kong taxpayer when the overseas tax is an expense, which must be borne regardless of whether a profit is derived (e.g., withholding taxes). However, such relief does not fully alleviate the taxpayer from double taxation where the income on which the withholding tax was levied is also subject to tax in Hong Kong (e.g., interest, royalties, and service/management/technical fees).

In the light of the government's commitment to creating a network of DTAs with various countries, we propose that the current problem of double taxation of income, which is deemed to be sourced in Hong Kong and which also suffers withholding tax in another (non-DTA) jurisdiction, be addressed by introducing a unilateral tax credit in Hong Kong for the amount of foreign withholding tax paid up to a maximum of 50% of the Hong Kong profits tax payable.

2.6 Profits Tax Rates

In its report, the Advisory Committee considered the argument for increasing profits tax rates. However, the Advisory Committee noted that increasing profits tax rates would not broaden the tax base as the resulting increased tax burden would fall entirely on existing taxpayers.

Accordingly the Advisory Committee indicated that it could not advocate a significant increase in profits tax rates and further indicated that any such increase would go against the international trend of lowering income tax.

Over the last two years the rate of profits tax for unincorporated businesses has risen from 15% to 16% in two stages in line with the standard rate of salaries tax. However, the rate of profits tax for corporations has arisen from 16% to 17.5%. It is understood that these increases in profits tax run counter to the international trend of lowering tax rates, identified by the Advisory Committee. It is further recognised that this increase is seen as a short-term measure to deal with the current budget deficit. However, there are historical precedents indicating that such temporary increases have a habit of becoming permanent increases or surcharges.

For example the historical reason for the difference between the standard rate of profits tax for individuals and partnerships (currently 16%) compared with the higher rate imposed on companies (currently 17.5%) can be traced back to the imposition of a temporary surcharge in 1975. When it was first introduced, it was seen as a temporary surcharge to address a budget deficit. However, it has remained in place and, although for a period the difference was reduced to 1%, it has largely remained at 1.5%.

In view of the international trend to lower the rate of direct taxes, and given the projected decline in the budget deficit, we believe that the rates of profits tax for both individuals and corporations should be reduced at the earliest opportunity. We further believe that the difference or surcharge imposed on companies compared with non-corporate profits tax payers should also be eliminated, either at the time of introducing a GST, or in 2008/09, when the budget is forecast to go into surplus again, whichever occurs sooner.

2.7 Promoting Manufacturing in Hong Kong

As a broad, general measure, we suggest that consideration be given to granting a time-limited 50% profits tax reduction to local manufacturers of goods, for a period of, say, five years. The idea behind this suggestion is to create a competitive taxation environment for the local manufacturing sector, as well as to provide employment opportunities to a range of workers, e.g. the low-skilled sector, which could help to alleviate the continuing high rates of unemployment and under-employment.

2.8 Border Closed Area

According to government statistics, the Border Closed Area separating Shenzhen and Hong Kong covers an area of about 2,600 hectares. This large area was initially set up as a security buffer between the two sides. With Hong Kong having returned to China, the long-term development potential of the Border Closed Area has been part of the subject of a study by the Planning Department in its “Hong Kong 2030: Planning Vision and Strategy”.

The Shenzhen authorities and Hong Kong business groups have put forward various suggestions to develop the border area including the development of the Lok Ma Chau Loop and setting up a cross-border industrial zone or a free trade zone in the border area.

Freeing up land in the Border Closed Area has the potential to generate significant economic benefits to Hong Kong. In this regard, some of the suggestions warrant further study and we would suggest that as a start the government should clearly state its position in relation to the future of this area.

2.9 Estate Duty

The Institute has recommended that consideration be given to the abolition of estate duty in previous budget submissions and, more recently, in its submission in response to the Estate Duty Review Consultation Document.

We note that in the 2004/05 Budget Speech, the government indicated that it had commenced a study on the effects on the economy and on government revenue of adjusting estate duty and how best this should be effected. Subsequently, in July 2004, the above-mentioned consultation document was published. Our submission, a copy of which may be accessed at the Institute's website at: < http://www.hkicpa.org.hk/professionaltechnical/taxation/submissions/submission_201004.pdf >, makes clear that, in principle, we favour the outright abolition of this tax rather than tinkering with amendments to a tax which, in practice, has an extremely narrow base, is arguably inequitable, and which acts as a disincentive to investment. Some of the main issues are as follows:

- Estate duty is not currently a significant source of revenue for the government, amounting to only around 0.7% of total revenue.
- In reality, it does not affect the “super rich”, who are supposedly one of the main groups of intended taxpayers, because they are easily able to ensure that their assets are not subject to it. Instead, it catches a very limited number of people, the bulk of whom could be characterised as being unwary and moderately well-off. (Between 1999-2003, while the average number of new cases examined per annum was 14,460, the number of dutiable cases averaged only 318).

- It is a barrier to the free flow of capital and contrary to Hong Kong's objective of encouraging investment by not taxing investment income.
- Estate duty is the only significant direct tax on capital in Hong Kong.
- Abolition of estate duty would encourage the further development of the financial service sector, in particular, the private asset management industry, in Hong Kong.
- Abolition would provide a further attraction to potential investors from the Mainland and elsewhere, and would give support to the government's policy of promoting investment immigration.
- The abolition and/or reform of similar taxes is an international trend.
- If it were decided to abolish estate duty in phases, a clear timetable for final abolition should be given and, in the interim, exemptions should be given on the basis of assets types – in particular, bank deposits and listed securities – to benefit Hong Kong's further development as an international financial centre.

2.10 Capital Gains Tax

In the Consultation Paper issued by the FS in respect of the 2005/06 Budget, the FS's office raises the question of introducing a capital gains tax in Hong Kong and asks what impact such a capital gains tax would have on the Hong Kong economy. In the information pack which accompanies these questions, we note that capital gains tax is included under the section "Broadening our tax base", at chart 18, with the following comment:

"We need to consider how Hong Kong should seek to improve the stability of revenues. Scope for Capital Gains Tax and Worldwide Tax?"

We would point out that Advisory Committee, which reported on 1 March 2002, specifically addressed the question of the introduction of a capital gains tax for Hong Kong as option 6 in its report. That section set out a review of capital gains tax using the factors that the Advisory Committee applied to all of the options that they reviewed. In its review the Advisory Committee noted: "To be effective capital gains tax legislation is invariably complex. It lacks the relative simplicity that is inherent in Hong Kong's existing taxation legislation."

Paragraph 29 of the report concluded:

"The Advisory Committee considers that a tax on capital gains in Hong Kong should not be pursued given its limited ability to yield significant revenue and that if implemented, it will compromise Hong Kong's simple tax system. The potential gains are outweighed by the costs."

We believe that introducing a capital gains tax would be unlikely to result in an overall gain to Hong Kong, due to the complexity of a capital gains tax system, its limited ability to yield significant revenue, as well as its potential effect of discouraging investors from investing in Hong Kong.

We consider that the relevant factors set out in the Advisory Committee's report are still applicable. Accordingly we do not support the introduction of a capital gains tax in Hong Kong.

2.11 Worldwide Taxation

As indicated in section B 2.10 above, the FS's information pack also raises the question of worldwide taxation. The Advisory Committee reviewed this option. Paragraph 32 of its report states:

"The Advisory Committee notes that a complex system of tax credits together with double taxation arrangements are major prerequisites for a tax on worldwide income. Given Hong Kong's low tax rates, the revenue gain is unlikely to be significant. On balance, the Advisory Committee considers that such a tax should not be pursued."

In the absence of a tax credit system, as discussed in B2.5 above, and a comprehensive network of DTAs, we do not believe that this is the right time to consider the introduction of worldwide taxation in Hong Kong and we concur with the Advisory Committee's conclusion.

We also note that introducing a system of worldwide taxation would represent a major shift in the policy of taxing on the source of income. As such, it should not be considered in isolation but only in the context of a comprehensive review of the system of taxation in Hong Kong.

B.3 COMMUNITY

3.1 User Pays Taxes – Charges and Levies

3.1.1 Duty on alcoholic beverages

According to the consultation documents on the 2005/06 Budget, there are views in the community that the duty on alcoholic beverages should be abolished to facilitate tourism and Hong Kong's development as a regional hub for wine products. On the other hand, it is noted that the duty is commonly regarded as a tax on non-necessity item and generates stable recurrent revenue. It is estimated by the government that it will bring HK\$761 million in revenue for 2004/05.

While it is possible that reducing duty would increase the consumption of alcohol amongst consumers in Hong Kong, the Institute does not believe it to be likely, particularly given the competition from wine-producing countries in the region (e.g. Australia and New Zealand) that abolishing the duty on alcoholic beverages in Hong Kong would have the effect of facilitating wine tourism or Hong Kong's development as a regional hub for wine products. Under the circumstances, we do not see the need for any change at present.

3.1.2 "User pays" principle

As a more general point, we propose that a detailed review of the level of duties and fees levied by the government should be undertaken and that, as far as possible, the "user pays" principle should be adopted. It is reasonable, in principle, that fees and charges that have not been adjusted for some time should progressively be brought into line with changes in the price index over the period, and that the public should have a greater appreciation of the real costs of providing the relevant services. However, this should be seen as part of a larger picture, which would also involve greater accountability on the part of the government for its costs and a willingness to examine how the same level of services might be delivered more efficiently and economically.

3.2 Environmental Taxes

Making Hong Kong a greener city by improving our environment

In the 2004/05 Budget Speech, the FS acknowledged the need to enhance public awareness of environmental protection and that the adoption of fiscal measures may effectively achieve that objective.

At the present, our laws on the environment include provisions prohibiting the use of high sulphur fuels, restricting the disposal of chemical waste, livestock waste, effluent discharges, marine dumping and the dumping of waste in public places.

The government is already charging a lower levy on environmentally-friendly fuels. It is also proposing a charge for the disposal of construction waste, exploring the option of encouraging tyre recycling or levying a tyre tax, and undertaking a review of fees and charges under the "polluter pays" principle, as stated in the 2004/05 Budget.

Against the background of our painful experience from the SARS outbreak and the worsening air pollution problems facing Hong Kong, the Institute proposed a number of fiscal measures in its 2004/05 Budget Proposals last year which, if carried out, could serve as an effective deterrent against would-be polluters. Broad areas that could be looked at would include the introduction of such measures as:

- emission taxes;
- taxes on polluting inputs;
- credits for emission reduction;
- permits to emit a specified amount of a pollutant;
- waste disposal charges;
- deposits/refunds; and
- public sector procurement policies.

More specific measures could embrace, for example:

- a comprehensive review of fuel duties;
- electronic road pricing;
- air and water pollutant taxes;

- landfilling charges;
- taxes in respect of the disposal of plastics, glass, batteries and vehicles;
- taxes on polystyrene foam and plastic bags or other non-biodegradable matter;
- a refund system to encourage recycling;
- carbon and energy taxes (on electricity, coal, gasoline, etc.) and other resource consumption taxes; and
- refund mechanisms to reward the control of pollutants and efficient use of energy.

In addition, tax incentives could be offered for e.g:

- investment in and spending on environmental protection equipment, machinery or systems; and
- grants (such as low/no interest loans) to small and medium-sized enterprises (SMEs) which have insufficient capital to acquire environmental protection equipment, machinery or systems, could also be considered.

Although there are a number of existing environmentally-friendly measures in place and a review is taking place on measures under the “polluter pays” principle, environmental pollution is such an important issue that it warrants further attention in our budget proposal this year. To make Hong Kong a greener city, we propose some specific fiscal measures to promote environmental protection and raise revenue.

Energy conservation measures

- New industrial and commercial complexes adopting approved environmentally sustainable designs could be given additional commercial building or industrial building allowances, for example:

	Initial Allowance		Annual Allowance	
	Existing	Proposed	Existing	Proposed
Industrial Building	20%	25%	4%	7.5%
Commercial Building	NIL	25%	4%	7.5%

- Expenditure on the installation of energy efficient systems for old buildings such as double-glazing and solar energy, could be given a 150% deduction in the year of expenditure.

Environmental Industry

- Companies principally engaged in government-approved operations for the storage, treatment and disposal of toxic and hazardous waste, and which adopt state-of-the-art processes, could be offered a tax exemption for, say, 5 years.
- Giving tax incentives to companies engaged in recycling activities.

Green tax, fees and charges

- Expediting the review in respect of levying fees and charges on, e.g., waste incineration and landfill disposal, under the “polluter pays” principle.
- Giving consideration to imposing a green tax on motor vehicle ownership and non-biodegradable products.

We understand that the Environmental Protection Department is conducting a regulatory impact assessment on tyre tax, in conjunction with the Financial Services and the Treasury Bureau, with a view to issuing a consultation document by the end of 2004. We welcome this initiative taken by the government in exploring the possibility of introducing fiscal measures to enhance environmental protection and hope that this concept will be extended in future.

3.3 Employment

3.3.1 Non-taxability of redundancy payments

Lump sum redundancy/severance payments within the statutory limits under the Employment Ordinance are non-taxable. However, amounts above these limits may be treated by the IRD as potentially taxable, which can result in uncertainty and lead to prolonged debate. The statutory limits meanwhile are not particularly generous and where employees suffer salary cuts during a recession, they may be hit with the double blow of having their tax-exempt redundancy money, which is based on their final salary, correspondingly reduced.

We propose, therefore, that it be made clear that, automatically, employees' redundancy/severance payments from their employers of up to twice the statutory limits will not be taxed. This will be of benefit not only to provide a greater cushion if such persons remain unemployed for an extended period, but it could also help to provide some unemployed persons with financial wherewithal to consider starting up a business of their own. Consideration could in fact be given to allowing even larger amounts of redundancy money to be tax-exempt where a certain proportion of it is invested in a new business.

Secondly, we propose that where an employee's salary has been reduced because of business conditions, and the employer subsequently pays a long-service/severance payment based on the earlier higher salary, then the difference between the long-service/severance payment based on the final salary and the actual payment made by the employer should also be deductible by the employer.

3.3.2 Employers' tax concession to encourage hiring of the long-term unemployed

In order to help relieve the high rate of unemployment in Hong Kong, we suggest that an extra deduction of 50% on the salary costs of employing unemployed persons that have been actively in the job market in Hong Kong for one year or more, be granted to employers in the year of

assessment 2005/06. Measures to prevent abuse would need to be introduced, e.g. any new employees should be additional to the existing workforce.

3.4 Property Tax

Property tax is currently levied on the owner of land and/or buildings situated in Hong Kong at the rate of 16% on the “net assessable value” of the property when the property is rented out. Net assessable value is defined as the consideration payable to the landlord in respect of the right of use of the land and/or buildings, less any rates paid by the landlord and an additional allowance for repairs and outgoings.

While the IRO provides for a specific deduction for rates paid by the landlord against the net assessable amount subject to property tax, no deduction is granted for the government ground rent levied on landlords by the government, which seems to be a discrepancy. Therefore, we propose that section 5(1A) of the IRO be amended to allow a specific deduction for government rent in the calculation of the net assessable value of a property subject to property tax, so as to provide for reasonable deductions in relation to actual expenses incurred by landlords for property tax purposes.

3.5 Interest on Student Loans

At the present time students attending tertiary education who receive student loans from the government are required to repay those loans with interest once they take up employment. However no relief is given for the interest on those loans. Consistent with the objectives of encouraging a highly educated workforce in Hong Kong, we propose that students should be allowed to claim a deduction for the interest they pay on their loans using a system similar to that for home loan interest, namely that a deduction will be permitted for a certain number of years, say, five years, with the students being able to elect in which five years they wish to claim the expense. As it is recognised that many students may not necessarily become employees but may enter professional or business life or become a sole proprietor, it is proposed this relief be available both for salaries tax and profits tax purposes.

3.6 Self-education Expenses

Currently, the deduction for self-education expenses is available in respect of amounts actually paid in the year of assessment, irrespective of the period to which it relates. However in practice it should be noted that in many cases self-education expenses are paid in a year of assessment where the taxpayer may not necessarily have any significant taxable income against which to offset the expenses, particularly if the course involved is a full time course, or if the person involved is unemployed at the time. It is therefore proposed that there should be a form of carry-forward of these expenses for up to three years, so that these expenses may be claimed at a later date when the taxpayer is generating income subject to salaries tax.

3.7 Donations

Due to the economic downturn, charities have found it difficult to raise funds to support their activities. Furthermore, funding for universities, cultural activities and other social services provided by the government has been reducing because of the budget deficit. Charitable donations should be further encouraged in order to develop a more socially-conscious community, so that the level of donations can be sustained even during difficult economic times. We suggest increasing the existing ceiling for allowable deductions from 25% to 50% of assessable profits/income, with a view to removing the ceiling altogether as a longer term objective (possibly in conjunction with introduction of a stronger framework for the regulation of charities).

We propose, in addition, allowing the carrying forward of deductions that the donor has not been able to be set off against tax because the donor has not made a profit during the relevant period. We also propose that the term "approved charitable donation" should be defined for the purposes of the IRO to include donations in kind, such as donations of equipment for medical research, if the goods are valued by a qualified third-party.

3.8 Sponsorship of Arts and Cultural Events

An important ingredient in the mix of what makes the worlds' great cities such vibrant and exciting places is a rich and diverse artistic and cultural life. Diversity and commercial success do not necessarily go hand in hand and most of these cities provide subsidies in some form to the arts and culture, whether this is to municipal museums or artistic performances and exhibitions, etc. This is, however, an issue that is often hotly debated and some people argue that if such activities cannot pay for themselves, then they should not be supported by public funds.

It is the Institute's view that the further development of the artistic and cultural environment will help to enhance the quality of life in Hong Kong, offer benefits to Hong Kong residents, as well as improving Hong Kong's reputation internationally. In this regard, business sponsorship can offer a viable, and perhaps more generally acceptable, alternative to public funding for artistic and cultural events. While corporate sponsors of arts and cultural events should already be able to claim the promotional expenses of their sponsorship, we would suggest consideration be given to allowing deductions on the basis of 150% of actual expenditure in relation to sponsorship of "approved" artistic and cultural events and activities.

B.4 UNDERSTANDING

4.1 Clarity, Certainty and Consistency

One of the strengths of the Hong Kong tax system has traditionally been the fact that Hong Kong's tax legislation has been relatively straightforward and easy to understand. From time to time, contentious areas have arisen in interpretation of the tax law but clarification has

been obtained by reference to court decisions, the use of Departmental Interpretation and Practice Notes or, if necessary, changes to the legislation. This certainty of interpretation has enabled taxpayers to have greater confidence in their dealings with the IRD and has encouraged full disclosure in compliance matters and the belief that their affairs will be dealt with on a consistent basis.

These elements of clarity, certainty and consistency have been fundamental to Hong Kong's reputation as a place to do business. It is important, therefore, that in the future we continue to give priority to the maintenance of these "3 C's", as Hong Kong faces increasing competitive pressures from other cities in the region.

Two key areas on which we need to focus our efforts to protect Hong Kong's reputation as an international business centre are (a) the interpretation of the IRO and (b) enforcement.

Interpretation

Given the reliance of Hong Kong's tax system on the principle of source of profits and the relative ease with which businesses nowadays can, for example, establish operations in one jurisdiction, and subsequently segregate and relocate specific processes or activities, a major area of concern regarding interpretation is the question of offshore profits claims. Ensuring clarity, certainty and consistency in this area is of paramount importance, otherwise Hong Kong could lose business to other jurisdictions where the legislation regarding the taxation of such profits is clearer. We therefore recommend that, to protect Hong Kong's commercial advantage in this area and to establish greater certainty in this area, legislation be introduced to clarify the position regarding offshore profits, particularly in the case of manufacturing and trading profits.

We would also encourage the government to consider following the approach adopted by revenue authorities in various other jurisdictions by publishing the IRD assessors' manual. This would help to promote consistency and to provide an additional level of clarity for taxpayers, regarding both interpretation and their compliance obligations – not only for the source of profits, but for all tax matters.

Enforcement

A key element in the government's fiscal discipline is the efficient use of resources by the IRD in enforcing compliance with Hong Kong tax legislation, so as to ensure collection of the taxes that are properly due. One of the more effective uses of resources in the IRD has been the establishment of field audit teams, which have resulted in significant revenues for the government that may not otherwise have been collected. In addition to the tax assessed, as a result of both field audits and investigations, these activities have also generated further revenue in the form of penalties that have been imposed as part of the settlement with delinquent taxpayers.

Penalties are normally seen as:

- encouraging future timely compliance with the relevant legislation;
- providing financial compensation for loss of revenues in delinquent cases; and
- acting as a deterrent to tax evasion.

While penalties in the case of tax evasion are normally punitive and/or involve prosecution, the impression exists is that increasingly heavy penalties are also being imposed in cases of voluntary disclosure by taxpayers, who may have, inadvertently or otherwise, made an error or omission in their tax returns, and in cases where anti-avoidance measures, such as under section 61A of the IRO are invoked.

The levying of punitive penalties in cases of voluntary disclosure is generally believed to be counter-productive. In their 1986 paper on "Amnesty, Enforcement and Tax Policy", H.B. Leonard and R.J. Zeckhauser point out that some people become tax delinquents by mistake. Such individuals may be willing to remedy their behaviour and become honest citizens if they are not confronted with punishment mechanisms, such as prosecution and penalties.

Accordingly, we propose that the government should encourage voluntary disclosure of errors and omissions in tax filings by providing that those making full voluntary disclosure do not face punitive penalties and/or prosecution.

4.2 Area of Uncertainty (1) Profits Tax – Source of Income

As Hong Kong has adopted a territorial system of taxation under which only income that has, or is deemed to have, a Hong Kong source is subject to tax in Hong Kong, it is essential that the source of income be easily identified.

Whilst it is accepted that there will be occasional cases which involve complex issues to determine the source of income, Hong Kong's tax legislation and its interpretation by the IRD and taxpayers should lend itself to certainty in determining the source of income in the vast majority of cases.

Unfortunately the perception exists currently that there is considerable uncertainty regarding the source of trading profits and manufacturing profits for profits tax purposes. This perception is detrimental to Hong Kong's economy and, if it continues, may result in a movement of trading companies away from Hong Kong or may discourage new companies from establishing in Hong Kong. The increasing use of Macau offshore companies, which, it is claimed, offer taxpayers more certainty in terms of the tax liability on their trading profits, is but one example of other jurisdictions providing greater certainty in this area to the detriment of Hong Kong.

At present profits tax is imposed under section 14 IRO:

"for each year of assessment... on every person carrying on a trade, profession or business in Hong Kong... in respect of his assessable profits arising in or derived from Hong Kong... from such trade, profession or business... as ascertained in accordance with [this Ordinance]"

Although section 15 of the IRO deems certain amounts to be trading receipts, section 14 of the IRO does not set out the general tests or rules as to how the source of profits is to be ascertained.

Rather, reference has to be made to case law and DIPN 21 on the locality of profits. Following the decision in *CIR v Hang Seng Bank* [(1991) 3 HKTC 351] there was a period of certainty regarding the source of trading and manufacturing profits, and DIPN 21 on locality of profits, issued at that time, greatly assisted taxpayer's understanding of the source of profits.

However, recent court decisions have introduced a significant degree of uncertainty and this has been reflected in the interpretation of DIPN 21 by the IRD especially in respect of offshore manufacturing claims and the use of import/export trading companies.

As the determination of source of profits is fundamental to Hong Kong's profits tax regime, we consider that it is no longer appropriate to leave this to an interpretation of (apparently confusing and conflicting) court decisions and DIPNs.

Accordingly, we propose that the government should amend the IRO to include tests to determine the major source of income which are subject to profits tax, including tests for a 50/50 onshore/offshore manufacturing claim set out in DIPN 21, and trading profits. This will restore certainty in the vast majority of cases and maintain Hong Kong's status as a low tax jurisdiction that provides certainty for taxpayers.

4.3 Areas of Uncertainty (2) - Salaries Tax - Source of Employment Income

An area that has become an increasing area of uncertainty in recent years is the source of employment income. Section 8(1)(a) of the IRO contains the basic charging section in respect of Hong Kong source employment and states:

"Salaries tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on every person in respect of his income arising in or derived from Hong Kong from... any office or employment of profit;"

This basic charge is extended in section 8(1A)(a), which brings into charge all income derived under non-Hong Kong employment from services rendered in Hong Kong.

Thus, where an individual has Hong Kong-source employment he will be subject to tax under section 8(1) of the IRO and pay tax on all his assessable income. Where an individual has a non-Hong Kong-source employment, he falls outside the scope of section 8(1) and is taxed under section 8(1A)(a) on the basis of time spent in Hong Kong.

DIPN 10, which was based on a correct interpretation of the law, eliminated much of the conflict on the position of source of employment and is a prime example of the advantages of providing certainty in our tax laws.

However, in recent years there has been a trend to depart from the tests in DIPN 10 and it has been claimed that these tests are not based on a true interpretation of the decision of MacDougall J. in *CIR v Geopfert* [(1987) 2 HKTC 210].

This has led to uncertainty in this important area of our legislation.

We consider that the three tests in DIPN 10 correctly draw on the decision in the *Geopfert* case.

Our detailed rationale is set out in Appendix 4.

The increasing uncertainty in this area is damaging Hong Kong's reputation as a regional base for multinational companies. Accordingly, it is considered that it would be appropriate to amend the IRO to incorporate into the Ordinance the three tests adopted in by MacDougall J. in the *Geopfert* case.

This will reintroduce clarity and certainty into our legislation and so help to enhance Hong Kong's position as a regional base centre for multinational companies.

4.4 Area of Uncertainty (3) – the Secan Decision

We have highlighted in section B 1.4 of our submission the problems arising from the decision in the *Secan* case.

Irrespective of the debate as to whether the decision in *Secan* case is correct, it is a fact that at the present time it remains good law and is therefore binding upon the IRD.

According to the IRD interpretation, *Secan* requires a taxpayer to disclose an item in the same way in its tax return as its accounting disclosure in the statutory accounts (subject to any statutory provisions which call for different treatment). Thus, in the absence of any other specific provision, *Secan* effectively requires taxpayers to recognise their income or losses on the same basis as set out in their statutory accounts, including the recognition of unrealised profits and losses.

While the adoption of international accounting standards in Hong Kong is to be supported, *Secan* creates an unwelcome area of uncertainty in the

tax regime and, in relation to an important aspect of tax policy in Hong Kong, it means in effect that the government is deferring to the International Accounting Standards Board.

Thus, controversial standards, such as IAS 39 (*Transition and initial recognition of financial assets and financial liabilities*), can also result in uncertainty in our taxation system.

We consider that it is necessary for the government to consider the impact of *Secan* and the impact of new accounting standards on the assessment and collection of taxes in Hong Kong.

As proposed in section B 1.4 above, we consider that legislative amendments may need to be considered, on a case-by-case basis, as IASs/IFRSs are introduced in Hong Kong, to counter any adverse tax effects of such standards.

4.5 Areas of Uncertainty (4) – Assess First Audit Later

In recent years the IRD has adopted a policy of tax collection, which is more commonly known as "Assess First, Audit Later (AFAL)". Under this approach, an IRD assessor will issue either an assessment or a statement of loss based on the assessable profit or allowable loss contained in the taxpayer's tax return, without undertaking any review of the tax return. Under this policy, the IRD states that it reserves the right to review the relevant tax return at a later date and to ask questions and/or make amendments to the assessment or statement of loss at any time up to six years from the end of the basis period for which the assessment or statement of loss is issued.

This approach has led to uncertainty and some anxiety amongst taxpayers, who are no longer in a position where they can confirm that their tax affairs have been finalised for any particular year of assessment until the expiry of the statutory time limit of six years from the end of the year of assessment in question. This lack of certainty is seen as a significant disadvantage and is damaging to Hong Kong's reputation, not only as a low tax jurisdiction, but one that offers certainty in the interpretation of its tax laws. This situation is, understandably, the cause of some concern in a developed economy such as Hong Kong.

Moreover, we are not convinced that the AFAL approach adopted by the IRD is supported by the provisions of the IRO. It appears that under section 59(2) of the IRO, an assessor has only two options on receipt of a tax return. Section 59(2) states:

"Where a person has furnished a return in accordance with the provisions of Section 51 [IRO] the assessor may either -

- (a) accept the return and make an assessment accordingly; or*
- (b) if he does not accept the return, estimate the sum in respect of which such person is chargeable to tax and make an assessment accordingly."*

Prima facie, it seems that the AFAL approach does not comply with either of these requirements in that the assessor under AFAL is neither accepting nor rejecting the return. Accordingly we consider that this approach may not comply with the requirements of the IRO.

Even if there was a valid legal basis for the policy of AFAL, taxpayers should be entitled to timely resolution of their tax affairs for each year and thus a reasonable time limit for undertaking the "audit" should be included in the IRO – say one year after the issuing of the assessment.

However, this is no substitute for the proper application of the IRO which ought to entail either a categorical acceptance of a tax return that has been filed (subject to correction of errors or omissions) or the initiation of enquiries at an early stage, so that any dispute as to the quantum of the tax liability can be identified and brought to a timely resolution, and the taxpayer's affairs can be concluded within a reasonable timescale.

As stated above, we believe that the current arrangement, which we understand was adopted due to manpower constraints in the IRD, is harmful to Hong Kong's reputation.

4.6 Areas of uncertainty (5) – Proposal for Shortening Hong Kong's "Time-bar" Provisions

Certainty and predictability are important factors for business and time is often of the essence. Hong Kong's current provisions for re-opening tax affairs create considerable uncertainty for businesses in the finalisation of their tax affairs. This is also a major factor exacerbating the uncertainty for taxpayers of the AFAL approach. We consider that shortening the period under Hong Kong's statutory provisions for re-opening tax affairs would provide additional encouragement to businesses currently operating, or considering operating, in Hong Kong.

Section 60 of the IRO currently allows IRD assessors to raise additional assessments within six years from the end of the year of assessment, and can be further extended to 10 years in cases of fraud. In contrast, the corresponding timeframes in other jurisdictions for the re-opening of tax affairs tend to be relatively shorter. Some examples are set out in Appendix 5.

Given the number of developed and developing jurisdictions that currently offer more favourable (i.e., shorter) timeframes for re-opening tax affairs, we feel that Hong Kong should similarly endeavour to improve the level of certainty provided to businesses in relation to their Hong Kong tax affairs, by reducing the period for re-opening assessments from six to three or four years. This should be subject to an extension to 10 years in cases of fraud.

B.5 SAVINGS IN EXPENDITURE

5.1 Scope for Cost Cutting

In the report of the Task Force on Review of Public Finances, the Task Force recommended that the first priority on the expenditure side was to

control the growth of government expenditure. The growth of government expenditure in money or nominal terms should be aligned to the trend nominal growth of the economy. This discipline should be applied in addition to the existing budgetary guidelines of aligning the growth of government expenditure in real terms with the trend real growth of the economy.

The report of the Task Force suggested that continuation of the current revenue and expenditure policy was not an option. According to the consultation documents on the 2005/06 Budget, despite a promising rate of economic recovery, operating revenue still falls short of fully matching operating expenditure. It has already been mentioned by both the Chief Executive and the FS that the government is serious about tackling the fiscal problem. Fiscal sustainability is of paramount importance to the economic wellbeing of Hong Kong. The need to control government expenditure has been clearly identified and it is considered that further action is still required and should be a priority.

Total public expenditure in 2004/05 is estimated to reach HK\$286 billion, which amounts to 22.5% of GDP. In the 2004 Budget Speech, the FS set a target of containing public expenditure to no more than 20% of GDP. This target is to be achieved by an overall expenditure reduction affecting all government departments.

The government should critically review the various areas of public expenditure, including the cost in relation to the provision of existing services, any plans for new services or expansion of existing services as well as capital expenditure projects. We consider that where cuts need to be made they should not simply be implemented across the board. In our view a proper study of the use of resources within the civil service should be undertaken. In this regard, we note that reports issued by the Director of Audit are consistently able to point to areas of inefficiency and inadequate use of resources in the operation of government services. This suggests that there is more scope for improving productivity and efficiency generally within the public sector. Where appropriate, outsourcing should also be considered.

5.2 Recurrent Expenditure

The government has already undertaken a number of measures to reduce the size of the civil service, such as the freezing of recruitment from 1 April 2003, launching a second round of voluntary redundancy and aiming to reduce the number of civil service personnel to 160,000 by 2006/07. Accords on pay reductions have also been concluded with the respective civil service trade unions. While it is recognised that direct comparisons between the civil service and private sector emoluments are not always straightforward, there may nevertheless be some further scope for reviewing the level of civil service benefits.

In addition, opportunities may exist for streamlining the delivery of services and reducing the layers of bureaucracy and possible overlaps of responsibilities.

We note also the success of the matching scheme for university funding under which universities have been successful in raising a substantial amount of money from private sector matching donations. We would suggest that consideration be given to adopting similar schemes as a means of involving the private sector to a greater extent in other community activities that are currently funded primarily by recurrent expenditure from the government.

5.3 Public Health Care

According to the consultation documents for the 2005/06 Budget, the recurrent public health care expenditure for 2004/05 is estimated to be about HK\$30.3b, constituting about 14% of the government's total recurrent public expenditure for the year. Against a background of aging population, advances in medical technology and rising community expectations, health expenditure is expected to continue to grow in the near future, a trend in line with other advanced economies. It is, therefore, critically important to determine how to maintain a financially sustainable public health care system over the long term.

5.4 Offering Tertiary Education to Overseas Students

To help to develop Hong Kong into a regional centre of excellence for tertiary education, and better utilise the fixed cost facilities in the tertiary education system in Hong Kong, consideration should be given to offering tertiary education programmes to overseas students, either in or outside Hong Kong, having regard to, amongst other things, the full costs of providing those services. Currently, only a relatively low percentage of foreign students come to universities in Hong Kong to study compared with a number of countries overseas that have been successful in attracting interest from overseas students.

5.5 Privatisation of Government Services

To enhance the efficient use of resources and the delivery of public services, further studies should be carried out to identify suitable public services for additional privatisation exercises, which could include postal services and water supplies.

5.6 Capital Expenditure

With a view to cutting capital expenditure, the government should encourage more private participation in major capital projects.

While the option of further bond issues would not directly reduce expenditure, it should help to improve control over cash flow requirements, and to enhance corporate governance through increased transparency and accountability to the public and investors. Public sector corporate governance, particularly in relation to government-controlled corporations, and non-government organisations that receive government funding, is an area that is increasingly coming under scrutiny, because of its importance in ensuring greater accountability and a more efficient and effective use of public monies and resources.

In this connection, in June 2004, the Institute published a corporate governance guide for the public sector, entitled *Corporate Governance for Public Bodies – A Basic Framework*, which we believe may provide pointers to assist public sector organisations to improve their resource management.

Hong Kong Institute of Certified Public Accountants
2 December 2004

Preparing for the Introduction of a GST

In the last Budget, the FS highlighted the narrowness of Hong Kong's tax base and the need in the long run to broaden the base in order to secure a steady source of revenue. We believe there is a clear need to broaden the tax base and for the government to stabilise its future sources of revenue. We also believe that action must be taken now rather than in the long run in view of the continuing fiscal deficit on the operating account.

The government has delayed its target of restoring fiscal balance to 2008-09. The medium range forecast predicts that while there will be a mild consolidated surplus in 2008-09, the operating account for that year will still record a deficit. Moreover, the mild consolidated surplus was predicated on the successful sale or securitisation of government assets of \$96 billion in the five years to 31 March 2009 and the issue of government bonds of \$20 billion in 2004/05, which has since taken place.

As part of the strategy for returning to a fiscal balance, continuing efforts on reducing public expenditure must remain a priority for the Government. In this regard, we are encouraged by the government's aim of containing public expenditure at 20 per cent of GDP or below by 2008/09. However, we do not believe it is sufficient to rely solely on expenditure cuts. Given the structural changes in the economy and the consequential effects they have had on the traditional sources of revenue of the government, it is clear that defects on the revenue side must also be remedied. Thus, we must adopt a two-pronged approach in arriving at a long-term solution for our persistent fiscal deficit problem.

The Advisory Committee considered a number of alternatives to widen the tax base. In its 2002 report, the Advisory Committee recommended the introduction of a GST as the only alternative capable of meeting the objectives of broadening the tax base as well as producing a significant stable source of revenue for the government. The Advisory Committee's recommendation was echoed by the FS in the 2004/05 Budget, when he reiterated that the government had set up an internal committee to conduct a detailed and comprehensive study on the implementation of a GST in Hong Kong. The committee will draw on the practical experience of other jurisdictions and come up with a proposed GST framework suitable for Hong Kong and an implementation timetable as a basis for discussion.

In our proposals for the 2004/05 Budget, we set out the Institute's views on the key basic design features on a GST for Hong Kong. Our views on this issue are reproduced as Appendix 1.1.

In the 2004/05 Budget Speech, the FS stated that "according to a rough estimate, each single percentage point in the rate of GST will yield revenue of about \$6 billion a year, assuming that no exemption is granted. Depending on any exemptions, a GST of 5 per cent would generate around \$20 - \$30 billion revenue for the Government in a full year".

The above statement seems to indicate that the government is considering the granting of exemptions under the GST system proposed for Hong Kong.

In terms of design, we believe that the GST should be kept simple. By keeping it broadly-based, a GST would provide certainty which would minimise administrative costs for the government and compliance costs for business. Exemptions and zero-rating, on the other hand, could create problems to the GST system including the following:

- Exemptions and zero-rating would introduce administrative complexities and disputes on exactly which items should qualify for special treatment.
- Exemptions would lead to cascading (i.e. tax on tax) and will increase total tax where the goods and services are supplied to another business rather than to the final consumer.
- Exemptions can distort economic activities as they could encourage exempt businesses to acquire their inputs from suppliers that were also exempt. Exemptions could also create an incentive for vertical integration or for self-supply as exempt suppliers might wish to secure their goods and services for themselves in-house, rather than purchasing them in the marketplace, to the extent that the result would be to remove tax from those inputs.
- Exemptions could undermine the integrity and self-policing advantages of the GST system, as an exempt person has an incentive to pay its suppliers under the table.
- Zero-rating would lower the total revenue take produced by the tax and could require a higher standard rate to cover the shortfall. It is also not an effective method of compensation, as zero-rating particular items would have the effect of benefiting everyone in the community and not just the truly needy.

We therefore recommend that any zero-rating or exemptions should be kept to a minimum in a GST for Hong Kong.

We appreciate that a GST, as a broad-based tax on general consumption, could add to the burden of low-income families. Therefore, we recommend that appropriate compensations for low-income households should be incorporated in the GST design. Options for targeted compensations are set out in Appendix 1.1.

Another common concern relating to a GST is that it would provide an easy source of revenue for the government. The rate of GST could be incrementally increased over time, which could reduce the incentive for the government to curb wasteful spending and enhance efficiency. We urge the government not to relent in its efforts to control and curb expenditure, as this could be a crucial factor in obtaining public acceptance of the GST. In addition, the government should consider providing an undertaking not to increase the rate of GST for a reasonable period, say 5, or even 10 years, after the date of its introduction.

In conjunction with the introduction of a GST, adjustments to other taxes should be considered. This approach would be consistent with the strategy adopted by overseas jurisdictions on the introduction of GST-type taxes. Tax offsets could also be used as targeted compensations for the low-income group. Possible tax offsets include the following:

- Reductions in excise duty rates;
- reduction or abolition of existing indirect taxes (e.g. vehicle first registration tax, hotel accommodation tax);
- reductions in profits tax and salaries tax rates;

- increases in personal allowances;
- abolition or changes to estate duty and stamp duty;
- reductions in property rates;
- changes to profits tax system (e.g. introduction of group relief).

Proposed Key Basic Design Features for a GST

Set out below are the Institute's views on the key basic design principles on a GST for Hong Kong.

Basic Structure

We recommend that a GST adopted in Hong Kong should be the credit-invoice type. That is, GST is collected at each stage of the chain of production and distribution. Each party charges GST on its outputs (known as "output tax") but can claim credits for all tax paid on the goods and services when received (known as "input tax"). Although the collection of GST is via businesses, because of the credit-invoice offset mechanism, the burden of the GST falls on the final consumer. Due to the multi-stage taxing and crediting, it is relatively difficult to evade the tax. Further, a credit-invoice type GST should avoid cascading in the system.

Rate of GST

A well-known competitive feature of Hong Kong is our low and simple tax regime. If we are to maintain our position as a low tax regime, the GST rate to be adopted should be at the lowest end of the GST rates adopted by other economies.

Prior to its rate increase on 1 January 2003, Singapore at 3%, was the lowest rate in the world. On 1 January 2003, the Singapore GST rate was increased to 4%, which was further increased to 5% on 1 January 2004. Even after the increase, the Singapore GST rate of 5% is still the lowest in the Asia Pacific region, alongside that of Taiwan and Japan.

The GST rate will also depend on the fiscal position and revenue needs of the SAR Government at the time of introduction. As stated in the 2004/05 Budget, each percentage point of GST will raise roughly HK\$6 billion in additional revenue a year, assuming no exemption is granted. Given the recent international developments, Hong Kong should be able to protect our position as a low tax regime if the GST rate adopted is below 5%.

As regards the number of GST rates, although there is a debatable equity argument for the adoption of multiple rates, from the simplicity and efficiency perspectives, a single positive rate should be adopted. It is worthy of note that the vast majority of countries that have introduced a GST / VAT over the past decade have opted for a single rate.

Destination versus origin principle

The destination principle of GST is adopted by almost all countries that have a GST as part of their tax regime. Under this principle, imports are taxed and exports are zero-rated.

An alternative to the destination principle is the origin principle, under which imports are exempt but exports are taxed.

As the international norm is the destination principle, logic dictates that Hong Kong should follow this principle. However, the adoption of this principle will require radical

changes to Hong Kong's existing customs administration. The amount of work in this area should not be under-estimated. It may be possible to reduce the impact by introducing a "temporary import regime", where goods in transit through the territory would not be reflected for GST purposes.

Zero-rating and exemption

The international norm is to zero-rate or exempt certain goods and services. When goods are zero-rated, output tax will be nil as the rate is set at 0%, but input tax can be reclaimed. When goods are exempt, no output tax needs to be charged by the vendor but the input tax cannot be reclaimed.

In a simple system, usually only exports (including tourist purchases¹) are zero-rated. International transportation would be included in this category because the consumption technically does not take place in the jurisdiction of supply. Given the importance of trade and tourism to Hong Kong, we support zero-rating of exports.

Similar to the experience of other jurisdictions, it is likely that interest and political groups will lobby for specific categories of goods to be zero-rated or exempt from GST. As a political issue, arguments will likely be put forward for certain goods, for example food, to be zero-rated for equity reasons. However, zero-rating and exemption will introduce administrative complexities and will drive up compliance costs. Classification of items can lead to confusion and debate; for example, how should food items be defined?

In terms of design, we believe that the GST should be kept simple. By keeping it broadly-based, a GST would provide certainty that would minimise costs for business. However, it would be important for the additional tax burden from the GST on low-income groups to be alleviated. This could be achieved more effectively by targeted compensations (see further comments below) rather than seeking exemptions for particular industries or categories of consumption.

Financial services

The basic problem with a GST on financial services is that their values are often incorporated into interest rate spreads and cannot be easily ascertained on a transaction-by-transaction basis.

In Singapore, most financial services with explicit fees are taxed (except when the services are exported, in which case they are zero-rated), and all others are exempt. Singapore then allows financial institutions to reclaim a large portion of their input taxes on the basis of a fixed percentage that is specific to the type of the institution, but is independent of a particular institution's actual composition of output (i.e. no account needs to be taken of proportion of taxable, exempt, or export supplies).

The International Monetary Fund ("IMF") has suggested that Hong Kong could follow Singapore's example or go one step further to allow full input tax recovery by financial institutions. The latter approach would be equivalent to taxing all financial services for

¹ In general, a tourist refund scheme requires initial payment of GST as part of the purchase price to the retailer, with the tourist reclaiming a refund on departure. Some countries (e.g. the United Kingdom, Korea) also allow retail shops to make arrangements for the goods to be picked up by tourists after they have gone through immigration; in this case, tourists do not have to pay GST upfront, but there will be additional cost for the shops (e.g. arranging for handover of goods at airport).

which explicit fees are charged (except for export services which are zero-rated) and zero rating all other supplies. We support the IMF's suggestion.

Property sector

In practice, taxing the implicit rental values of owner-occupied buildings is not feasible. Even if a value could be imputed, it would still be administratively infeasible to subject owner-occupied residential properties to tax, since this would require the owners of such properties, who are themselves the final consumers, to register for and collect GST. In view of this, it would be necessary to exempt residential rental payments so as to avoid creating a distortion between rental and owner-occupied residential properties.

The implications for other property-related transactions should be carefully considered to ensure that the framework is suited to conditions in Hong Kong

Registration threshold

A characteristic of a GST is that the bulk of its revenue is normally collected from a relatively small proportion of taxpayers. In the interest of cost-effectiveness, it has been suggested that the registration threshold should be set at quite a high level. The Advisory Committee estimated that, with the threshold set at HK\$5 million, 50,700 businesses would need to register for GST, based on March 2001 figures. This represented 25% of all businesses filing tax returns in 1999/2000 or 8% of all entities with a business registration, i.e. including dormant businesses and shelf companies.

Exempt businesses that fall below the threshold, and which transact mainly with taxable businesses, may be put in a disadvantageous position relative to their taxable competitors. Therefore, the option of GST registration should be available for businesses below the threshold, with a minimum registration period to be imposed. This would be consistent with the international norm.

Compensations

A major political argument against the introduction of a GST is likely to be its perceived regressivity, in other words it bears more heavily on those that are less well off. Therefore, appropriate compensations for low-income households should be incorporated in the GST design.

As explained above, we believe that targeted compensations are superior to introducing zero-rating or exemptions for particular items of consumption. There are a number of directly targeted compensations that could be considered, including the following:

- i) Adjustments to salaries tax rates or allowances for lower-income groups;
- ii) increases in CSSA payments;
- iii) reductions in rentals for public housing; and
- iv) reductions in rates;

The Need to Legislate in the light of the Secan Decision

The decision in the Court of Final Appeal in *Secan* has had an impact upon the tax policy of the IRD and the interpretation of the IRO. This was recognised by the IRD in the issue of DIPN 40, "*Profits Tax Prepaid or Deferred Revenue Expenses*", issued in October 2002. The *Secan* decision indicated that assessable profits should be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform to the IRO.

In the judgment, Lord Millet stated:

"Where the taxpayer's financial statements are correctly drawn in accordance with the ordinary principle of commercial accounting and in conformity with the Ordinance no further modifications are required or permitted."

He continued:

"But the profits of a business cannot be ascertained without deducting the expenses and outgoings incurred in making them, and [section 16] is not needed to authorise them to be deducted. Section 16 and 17 (which allow certain deductions) are enacted for the protection of the revenue, not the taxpayer, and in my opinion section 16 is to be read in a negative sense. It permits outgoings to be deducted only to the extent to which they are incurred in the relevant year. In this respect there is no difference between the law of Hong Kong and the law of England. In both jurisdictions expenses and outgoings are deductible in the year in which they are incurred and not otherwise."

Prior to the *Secan* decision, the IRD "generally accepted that if an expense would typically be paid in advance the prepayment would be allowed as a deduction on the basis that the expense has been incurred".

Following *Secan*, the IRD revised its position and this is stated in DIPN 40 in relation to repaid revenue expenses:

"The tax treatment should follow the accounting treatment of such expenses, provided that the treatment in the accounts is in accordance with the prevailing generally accepted principles of commercial accounting and is not inconsistent with any provision in the Inland Revenue Ordinance. In other words, it will not be accepted that any deduction can be claimed in a taxpayer's profits tax computation in respect of the whole amount (rather than the portion amortised) which, although incurred in the basis period under consideration, has not in effect been charged against the taxpayer's accounting profits for that period, because it relates to a future period or periods."

Essentially the IRD has relied upon *Secan* as authority to adopt the approach of determining the assessable profits or allowable losses of the company based on the accounting disclosure or treatment of such items in the company's audited accounts. This has given rise to a number of difficulties, in part due to the adoption of international accounting standards (IAS/IFRS) in Hong Kong, as indicated in section B4.4 of this submission. Although IAS/IFRS are not intended to prescribe standards for tax computations, under the principle of fair value accounting, in some cases, they require the recognition of unrealised profits and losses in audited accounts and, therefore, where these items are included in a taxpayer's profit and loss account, the IRD's view is that

they are subject to tax, as they are recognised in the company's audited accounts, in accordance with international accounting standards adopted in Hong Kong.

This problem can be seen in the context particularly of standards such as IAS 39 and IAS 40, issued by the IASB, which, amongst other things require gains in relation to financial instruments and investment property, respectively, to be recognised as profit even though they may be unrealised. Following *Secan*, it would appear that this income will in principle be taxable in that the basis period, notwithstanding that such income has not been realised and may in fact never be realised in a future period.

This runs contrary to the general principle of tax law set out by Sir Thomas Bingham MR in the case of *Gallagher v Jones* [1993 STC537]:

"It is said that the Crown's treatment of the hire payments contravenes the general principle of income tax law that neither profit nor loss should be anticipated, in affect by anticipating profits. The principle itself, squarely based on the statutory provisions, is not in doubt."

We therefore have an apparent contradiction between a general principle of tax law that profits and losses should not be anticipated and the *Secan* decision. With the adoption of international accounting standards in Hong Kong, strict adherence to the *Secan* decision will have two effects:

- (a) It will result in the anticipation of profits and losses as described above by taxing unrealised profits; and
- (b) it will increasingly allow Hong Kong tax policy to be decided not by the SAR Government, but by the IASB, which publishes and sets IAS / IFRS.

Accordingly, we consider that in order to re-establish authority over our tax policy in Hong Kong and to maintain the general principle that profits and losses should not be anticipated, consideration should be given to amending the IRO to counteract the more adverse consequences of the *Secan* decision.

Tax Amnesty

In a paper on "*Citizens' Attitudes Towards Tax Evasion in Hong Kong*", Richard Simmons and T.Y. Cheng undertook a survey of 654 persons and concluded that Hong Kong citizens have different attitudes to tax evasion dependent upon the size of the evasion relative to income. Evading tax on all of one's income was thought to be unacceptable. Similarly evading tax on a large part of one's income was also considered unacceptable but much less so than evading tax on all of one's income. However, the survey concluded that, in general, Hong Kong taxpayers found that evading tax on a small part of their income was an acceptable and, in fact, seemed to be more acceptable than borrowing money from a friend and not repaying it, stealing a car, or even taking stationery from one's office for private use.

Simmons and Cheng concluded that attitudes towards tax evasion in Hong Kong vary considerably according to the portion of income on which tax is evaded. What was an unacceptable activity when it involved a large part of a taxpayer's income became acceptable when it involved a smaller part. This was despite the fact the tax evasion is an illegal activity in Hong Kong no matter how small, relatively, is the amount involved. The survey indicated that the most common explanations for negative attitudes towards tax compliance in other countries, i.e., that citizens found their tax burdens to be too high or unfair, or that government expenditure was inappropriate, were not applicable in Hong Kong. However, the study stated: "It would seem that the payment of at least some of the tax citizens owe is sufficient to satisfy consciences and rationalise the acceptability of tax evasion These findings suggest that tax evasion may be widespread in Hong Kong."

Simmons and Cheng found a close relationship between citizens' experience of tax evasion as a common activity amongst the people they knew and their attitudes towards tax evasion and also that, in general, respondents believed that tax evasion was common amongst people they knew. They therefore concluded:

"It does suggest that if the Inland Revenue were to intensify efforts to improve voluntary tax compliance through, for example, appeals to conscience or campaigns to educate the population on the relationship between taxation and public spending, any success may build on itself in that improved compliance by some may influence others to copy their example."

A further finding was explained thus:

"Also expected was our finding that citizens' acceptance of tax evasion was related to their belief that the penalties for tax evasion are too high, on the basis that if one finds a certain activity acceptable, one is unlikely to be sympathetic to government attempts to penalise it."

This finding suggests that increasing levels of penalties alone will not encourage future compliance and voluntary disclosure of unrecorded income or tax liabilities is unlikely to take place if punitive penalties and/or prosecution are thought to be a likely consequence. If, as Simmons and Cheng suggest, tax evasion is widespread in Hong Kong, some alternative must be found to encourage voluntary disclosure of unreported income in tax filings, and to encourage increased compliance.

The government should encourage voluntary disclosure of tax evasion in reporting by ensuring that those making full voluntary disclosure do not face high penalties and/or prosecution but are subject primarily to fiscal restitution through the use of interest payments.

As an extension of this, the government should consider encouraging both future compliance and the disclosure of past irregularities by taxpayers by introducing a one-time tax amnesty for a limited and specified period of time. As part of an amnesty, no punitive penalties or prosecutions should be levied. Instead, the tax involved should be assessed, together with a reasonable level of interest, to run from what would have been the original due date of payment of the tax to the date on which the tax was finally paid. This would be an efficient use of IRD resources involving little need for discovery by IRD officers.

This amnesty should then be coupled with increased penalties in the case of subsequent discovery of non compliance relating to the period covered by the amnesty.

There have been numerous examples of tax amnesties in both the developed and developing world. Within the OECD, there have been amnesties in Austria, Australia, Belgium, Finland, France, Greece, Ireland, Italy, Portugal and Switzerland, as well as more than half of the states in the United States of America. In developing countries they have been employed (sometimes repeatedly) in Argentina, Bolivia, Chile, Columbia, India, Pakistan, Panama, Peru, Mexico and the Philippines.

Appendix 3.1 contains some examples of such amnesties.

However, whilst a tax amnesty can, in the short run, generate an increase in tax revenue, reduce administrative costs in terms of collection and also encourage evaders to become compliant in terms of their tax liabilities, particularly where the under-reporting was due to a mistake in the first instance, it is recognised that there are also disadvantages to tax amnesties. For example honest citizens may view an amnesty as unfair and feel less motivated to comply in the future, particularly where amnesties are seen to occur on a regular or semi-regular basis. So, taxpayers who were previously honest, anticipating further amnesties, may reduce their level of tax honesty.

In their paper, "*Tax Amnesty and Political Participation*", Benno Torgler and Christoph A. Schaltegger found that tax amnesties appeared to be more effective in generating tax compliance when undertaken in combination with an increase in future enforcement parameters, compared with amnesties that were offered without changes in the enforcement factor. A stepping up of the enforcement regime subsequent to the amnesties (e.g. greater penalties) may address the concerns of honest taxpayers by indicating that the government is willing to find solutions to tax evasion and to increase prosecution and/or penalties for non-compliance in the future.

It also appears that the effect of a second or subsequent amnesty does not significantly improve tax compliance, and the anticipation of repeated amnesties reduces the positive effect of an amnesty. For example, in the case of Ireland, where there were two amnesties, one in 1988 and one in 1993, the second amnesty did not generate the level of compliance that was experienced in the case of first amnesty.

A tax amnesty in Hong Kong should apply to all open years of assessment, that is, the six years prior to the year of assessment in which it is introduced. It could take one of three main approaches to penalties and financial restitution:

- a. The taxpayer could make a voluntary disclosure of his undeclared income and pay the resulting tax with no penalties, prosecution or interest.
- b. The taxpayer could make a voluntary declaration under the amnesty with no penalties or prosecution, but be liable to pay interest at a reasonable rate, running from the original due date of payment to the actual date of payment. This would provide an element of financial restitution and also prevent honest taxpayers from concluding that they have been unfairly treated.
- c. The taxpayer could make a voluntary disclosure and be subject to punitive penalties without prosecution.

Of the three alternatives the first does not encourage honest taxpayers to comply in future, as it generates a feeling of unfairness. The third does not provide any significant monetary incentive for delinquent taxpayers to come forward, although it removes the threat of prosecution. However, the second alternative would appear to be the most likely to have the desired effect of encouraging declarations under the amnesty, whilst providing financial restitution, especially when coupled with the threat of increased punitive penalties in the future.

It would seem, therefore, that a one-time amnesty, accompanied by a clear statement of intent from the government that, after the amnesty, it will increase penalties relating to future discoveries of tax evasion for the period to which the amnesty relates, could be an effective means of generating tax revenue for the government, and improving future compliance, by enabling taxpayers to voluntarily disclose under-declared income without fear of prosecution or punitive penalties.

Examples of Tax Amnesties Around the World

Country	Amnesty Year	Main taxes covered	Collection (US\$ Million)	% of tax revenue
Argentina	1995	General tax amnesty	3,900	N/A
France	1982	General tax amnesty	19	0.007
India	1997	General tax amnesty	2,500	8.5
Ireland	1988	General tax amnesty	700-750	4
Ireland	1993	General tax amnesty	Significantly lower than 1988	N/A
Italy	1982	General tax amnesty	100	N/A
Italy	1984	Entrepreneurs and self employed	5,000	N/A
New Zealand	1988	General tax amnesty	18 (this was considered a good response)	N/A
United States -New York -New Jersey	1985/86 1996	General tax amnesty General tax amnesty	401.3 359	2 2.6

(N/A = not available)

In addition to the above, in the period from 1982 to 2002, various other states in the United States of America ran tax amnesty programmes with mixed results. The United Kingdom has also recently implemented an amnesty in relation to value added tax. The Mainland is in the process of implementing a tax amnesty on individual income tax, the period for which has been extended beyond the original deadline of 30 June 2004.

Salaries Tax - Source of Employment Income

In recent years, the source of employment income has become an area of increasing uncertainty in relation to salaries tax. Section 8(1) IRO contains the basic charging section in respect of Hong Kong source employments and states:

"Salaries tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on every person in respect of his income arising in or derived from Hong Kong from any office or employment of profit."

This basic charge is extended in section 8(1A)(a), which brings into charge all income derived under non-Hong Kong employment from services rendered in Hong Kong.

Thus, where an individual has a Hong Kong-source employment, he will be subject to tax under section 8(1), IRO and pay tax on all his assessable income. Where an individual has a non-Hong Kong-source employment he falls outside the scope of section 8(1) and is taxed under section 8(1A)(a) on the basis of time spent in Hong Kong.

This so called "time out claim" was a source of considerable uncertainty in the 1980s, with numerous cases proceeding to Board of Review. The matter finally came to the attention of the courts in the case of *CIR v Geopfert*. Following that decision the IRD issued DIPN 10 drawing on the decision of MacDougall J. in the *Geopfert* case.

DIPN 10 adopted the three tests used in the *Geopfert* case to determine whether an individual has a Hong Kong or non-Hong Kong-source employment, namely;

- (a) Where the contract of employment was negotiated and entered into and is enforceable;
- (b) where the employer is resident; and
- (c) where the employee's remuneration is paid to him outside Hong Kong.

However, in recent years, there has been a trend to depart from the tests in DIPN 10 and it has been claimed that these tests are not based on a true interpretation of the decision of MacDougall J. in the *Geopfert* case.

We consider that the three tests correctly draw on the decision in *Geopfert*. In the *Geopfert* case MacDougall J. referred to three major cases, namely:

<i>Pickles v Foulsham</i>	9TC261 (1925)
<i>Bennet v Marshall</i>	22TC73 (1937)
<i>Bray v Colenbrander</i>	34TC138 (1953)

In each of those three cases, the three tests set out above in DIPN 10 were adopted.

MacDougall J. quoted from Lord Normand in *Bray v Colenbrander* as follows:

"My Lords, in each of these appeals the Respondent entered into a contract of employment with an employer resident abroad. The contract was in each case entered into in the country of the taxpayer's residence and it provided for payment of the employee's remuneration in that country."

It seems clear that the three tests are the tests that should be applied. Recent departures from these tests are based on a caveat inserted by Lord Normand as follows:

“Parenthetically it should be said that there is no suggestion that the place of payment was nominal or pretended, or that the real or genuine place of payment was not the place specified in the contract.”

MacDougall J. took the caveat in Lord Normand's comments as authority for his comment that:

"This does not mean that the Commissioner may not look behind the appearances to discover the reality."

However, this limited caveat is now being used as the basis for denying the fundamental importance of the three tests and, instead, using alternative tests. Thus, in some recent cases, the IRD have sought to disallow time claims where the three tests in DIPN 10 met, on the grounds that, inter alia, the individual concerned had to apply for an employment visa in Hong Kong, or had adopted the statutory holidays published in Hong Kong, or had been provided with accommodation in Hong Kong.

The increasing uncertainty in this area is having a negative affect on Hong Kong's reputation as a regional base for multinational companies. Accordingly, it is suggested that it is time to consider amending the IRO to incorporate into the Ordinance the three tests adopted in by MacDougall J. in the *Geopfert* case, as derived from the cases of *Pickles v Foulsham*, *Bennet v Marshall* and *Bray v Colenbrander*.

This will reintroduce greater certainty into our tax regime and enhance Hong Kong's position as a regional base and centre for multinational companies.

Period for Re-opening Tax Assessments in Other Jurisdictions

Countries	Timeframe for re-opening tax affairs
United States	Three years from due date of tax return, or the date of filing, whichever is the later. (Unlimited timeframe where no return filed, or a false or fraudulent return is filed with the intent to evade tax.)
Canada	Four years from date of original notice of assessment, except in certain circumstances when the period can be extended to seven years (e.g., where the taxpayer has exercised their statutory right to carry back an amount (e.g., tax losses or foreign tax credits) to a prior year return). In cases of fraud or misrepresentation due to neglect, carelessness, or wilful default, a taxpayer's tax affairs can be re-opened at any time.
New Zealand	Four years after the end of the year in which the tax return is filed. (Unlimited timeframe for omitted income, fraudulent or wilfully misleading returns.)
Australia	Four years after the end of the year of assessment. (Unlimited timeframe where there is an avoidance of tax due to fraud or evasion.)
Mainland China	Three years from the end of the year of assessment (for revising the amount of tax assessed where an error has been made by the tax authority). Five years from the end of the year of assessment (for revising a return where a "computational type" error has been made by the taxpayer). Unlimited timeframe for returns involving tax evasion or fraud, or where no return has been lodged.
Taiwan	Five years after the return has been accepted as final. (Seven years after the due date for filing a return where a return has not been filed or taxation has been evaded due to fraud.)
Thailand	Five years after the date of filing of a return. (Ten years after the due date for filing a return where a return has not been filed.)
Philippines	Three years after the date of filing of a return. (Ten years in cases of false and fraudulent returns or failure to file a return.)
United Kingdom	Five years and ten months after the end of the tax year (for the tax authorities to make an assessment in the absence of a self-assessment), or 22 months after the end of the tax year (for amending a self-assessment). In cases of fraud or negligence, the timeframe for re-opening tax affairs is extended to 20 years and 10 months.

Countries	Timeframe for re-opening tax affairs
South Africa	Three years after the date of the assessment. (Unlimited timeframe for cases of fraud, misrepresentation, or non-disclosure of material facts.)