

Turning challenges into opportunities

Budget proposals 2009-10



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

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Budget Proposals 2009/10

“Turning Challenges into Opportunities”

PART A: OVERVIEW

Summary of Proposals

1. A summary of the specific proposals contained in this submission is provided below:

Proposals for the community and environment

- (1) Grant a reduction of 75% of the 2008/09 final tax in respect of salaries tax, property tax and tax under personal assessment, subject to a ceiling of \$25,000 in each case.
- (2) Reduce the first three progressive rates of salaries tax to 1%, 5%, and 9%, introduce a new rate of 13% and retain the existing top rate of 17%.
- (3) Before any further changes are made to the personal allowances, a review should be conducted to identify an appropriate base year for any future adjustments.
- (4) Increase a range of salaries tax allowance to help specific and more vulnerable groups through the difficult times ahead. Proposals are:
 - Allow any unutilised portion of the self-education expenses incurred in any year (up to \$60,000 per year) to be carried forward for one year.
 - Increase the maximum number of years for claiming home loan interest from 10 years to 15 years.
 - Increase the elderly residential care expenses from \$60,000 to \$72,000 per year.
 - Increase the child allowance from \$50,000 to \$60,000 per year and additional allowance in birth year of a child from \$50,000 to \$60,000.
 - Increase the allowance and additional allowance for dependent parent/grandparent aged 60 or above respectively from \$30,000 to \$36,000 per year.
 - Increase the allowance and additional allowance for dependent parent/grandparent aged 55 or above but below 60 respectively from \$15,000 to \$18,000 per year.
 - Increase the dependent brother and sister allowance from \$15,000 to \$18,000 per year.
 - Increase the disabled dependant allowance from \$60,000 to \$72,000 per year.
 - Allow deductions for contributions to private medical insurance policies, subject to a cap per person of \$12,000 per year.

- (5) Redundancy/severance payments of up to twice the current statutory thresholds for such payments should automatically be treated as non-taxable.
- (6) Waive rates for 2009/10, subject to a ceiling of \$5,000 per quarter for each rateable tenement.
- (7) Grant an electricity charge subsidy of \$1,800 for the year to each residential electricity account.
- (8) Consideration should be given to adopting a more extensive and coordinated approach to improving the environment, including through specific measures such as:
 - Refund systems to encourage recycling.
 - Traffic congestion-related measures, such as, co-ordination of tunnel tolls, electronic road pricing, and review of public transportation networks.
 - To encourage energy conservation, an electricity surcharge at a low rate should be explored for utility usage by both business and residential accounts, with a set relief for residential accounts to minimise the burden on the lower income group.
 - Additional commercial building and industrial building allowance for new commercial and industrial complexes adopting approved environmentally sustainable designs.
 - Low interest/interest free loans to small and medium enterprises (“SMEs”) for environmental protection equipment.
 - To encourage renovation of older buildings, landlords should be able to opt for the deduction of actual renovation expenses in any given year instead of the flat-rate 20% rental deduction for wear and tear.
- (9) Investigate what incentives would be attractive enough to encourage more people to move away from reliance on public health care services towards using private health care services and conduct a public consultation to obtain views on related issues.

Proposals to strengthen the economy

- (10) Grant a reduction of 75% of the 2008/09 final profits tax, subject to a ceiling of \$25,000.
- (11) As soon as conditions permit, the rate of corporate profits tax should continue to be reduced incrementally with the aim of achieving a rate of 15%, or lower, over time.
- (12) Introduce loss carry-back provisions into the Inland Revenue Ordinance (Cap. 112) (“IRO”).
- (13) Introduce group loss relief into the IRO.

- (14) Subject to various conditions and qualifications being adequately addressed, Hong Kong should consider introducing a more liberal exchange of information regime in the context of concluding a wider network of comprehensive double taxation agreements (“CDTAs”).
- (15) Where no CDTA exists, a unilateral tax credit should be granted for:
- all foreign tax paid on royalties which are subject to Hong Kong profits tax, and
 - other foreign withholding tax paid, up to a maximum of 50% of the Hong Kong profits tax payable.
- (16) Strengthen financial services regulation and investor protection.
- (17) Strengthen corporate governance.
- (18) As an interim measure, refine the rules relating to the exemption from profits tax for qualified offshore funds.
- (19) As longer-term measures, consider additional specific incentives for the fund management and insurance sectors.
- (20) As regards facilitating Islamic financing products in Hong Kong, the tax objective should be simply to provide a level playing field.
- (21) Beyond 2010 (i.e., when the temporary full government guarantee on all Hong Kong deposits expires) the cap on deposits protected under the deposit protection scheme should be reviewed in the light of comparable benchmarks adopted internationally.
- (22) Pending finalisation of the detailed plan for the Lantau Logistics Park, measures to support the logistics sector should be introduced, including:
- Rates exemptions/reductions for storage facilities used directly for the logistics business.
 - Three-year profits tax reduction (of 50%) on income derived from the international freight forwarding business.
 - Improve rail infrastructure.
- (23) Set up a heritage body in Hong Kong along the lines of the National Trust or English Heritage in the United Kingdom, to which cash donations should be deductible as they are to charities.
- (24) Donations of historically valuable private buildings, landmarks, etc. to this body should be treated as donations in kind, without any ceiling against profit or income. Owners should also be permitted to treat a portion of the value as a donation and to receive compensation (for example, a land swap) for the remainder.
- (25) Tax measures should be introduced to support to intellectual property use and development including:
- 100% deductions for the cost of acquisition of trademarks and copyrights.

- Tax credits for any foreign tax paid on royalty income, which is subject to tax in Hong Kong.
- (26) A concessionary rate of 10% for profits tax should be granted to regional offices/headquarters in Hong Kong in respect of management and consultancy income derived from associated entities overseas (subject to suitable anti-avoidance provisions).
- (27) A profits tax exemption should be granted for interest received by regional offices from loans made in Hong Kong to their overseas associates.
- (28) Stamp duty on property transactions should be reduced for properties between \$3 million to \$10 million. A flat rate of \$100 should apply to properties up to \$3 million and the highest rate of stamp duty at 3.75% should apply only to properties costing \$10 million or more. The progressive rates in between should be rationalised accordingly.

Additional technical proposals

- (29) Inland Revenue Rules (“IRR”) on source of profits and employment income should be introduced to include tests for determining source of profit and employment. This would provide greater certainty for the business sector in planning the tax affairs of businesses and senior executives.
- (30) Specific measures, including legislation, interpretations, etc. should be adopted to relieve the potentially burdensome impact of using international financial reporting standards as the basis for determining the taxability of profits.
- (31) A comprehensive set of transfer pricing rules should be introduced, preferably through legislation.
- (32) The statutory time limit for reopening of assessments (except in cases of fraud) should be shortened from six to three or four years.
- (33) A statement of loss should be treated as an assessment, be binding on the Inland Revenue Department (“IRD”) and open to objection by taxpayers.
- (34) Consideration should be given to deeming tax returns to be final if no enquiry has been raised on them within a reasonable period (for example, 12 months).
- (35) Spouses should no longer have to be jointly assessed if they wish to opt for “personal assessment”.
- (36) Consideration should be given to introducing a clearer distinction between trading and investment for tax purposes by reference to, for example, the holding period.
- (37) Options to broaden the tax base should continue to be explored.

Introduction

2. The economic situation for Hong Kong, as for many other jurisdictions, has changed dramatically during 2008. The onset of the global financial crisis that has developed from the sub-prime mortgage issue in the United States, the resulting tightening of credit due to the lack of confidence throughout the financial services sector, and the serious repercussions that this is having on all major economies, poses significant challenges to governments all over the world, and the Hong Kong SAR Government (“the government”) is no exception. Given its external orientation and its role as a financial centre and entrepot, Hong Kong’s economy is vulnerable to the effects of these developments. Stock markets everywhere have fallen dramatically and remain highly volatile, and the full effects of the crisis are still working their way through to the wider economy. A good deal of uncertainty remains and international efforts continue to be made to support the banking sector and to avert a deep worldwide recession. In Hong Kong, these efforts have included making more liquidity available to the banking sector and fully guaranteeing all deposits in banks in Hong Kong until 2010 to ensure that depositors do not lose confidence in the system and relocate their savings. Deposits in banks in Hong Kong stand at around four times the size of the total assets of the Exchange Fund, which is an indicator of the scale of the guarantee and of the seriousness of the situation. The Exchange Fund itself is expected to suffer its first ever full-year loss.
3. Domestic economic growth has slowed significantly and the 2008 budget forecast of 4%-5% GDP growth for the current year has since been revised downwards to 3-3.5%, following a significant drop to 1.7% in year-on-year real GDP growth in the third quarter, down from 4.2% in the second quarter and 7.3% in the first quarter of 2008. Some commentators are predicting that full-year growth will end up below 3%. There appears to be a general consensus that economic conditions will be difficult moving into the first half of 2009 and, at best, uncertain in the latter half. The chief executive and other senior government officials have cautioned that Hong Kong is likely to face a recession in 2009. The unemployment rate, which is a lagging indicator, has shown a slight increase in two consecutive periods up to the end of October 2008. A number of fairly high-profile closures of businesses in Hong Kong and factories in Guangdong have added to the concerns about a major downturn in the economy. The government has recently announced a further \$100 billion support for small and medium enterprises (“SMEs”) in the form of loan guarantees.
4. Taking account of the concessions in the 2008 budget, the government was originally predicting a deficit of \$7.5 billion for 2008/09. In July 2008, the chief executive announced further relief measures costing around \$11 billion. With the drop in revenues from land premiums, stamp duty on property and securities transactions, profits tax and other sources, the deficit can be expected to be substantially larger than the original estimate in the 2008 budget speech. The media have quoted some commentators as anticipating the deficit to rise to \$70-80 billion.
5. The United States and major economies in the European Union are reportedly already in recession. The International Monetary Fund (“IMF”) and the World Bank have revised their world growth projections downward. The IMF has urged countries to stimulate growth to help cushion the economic downturn, through both monetary and fiscal policies. With growth slowing sharply in the Mainland and inflation fears turning to fears about possible deflation, the Central People’s Government has expressed concern and has introduced a range of stimulus

measures. The Hong Kong and Macau SAR Governments have also recently announced stimulus packages to help deal with the crisis.

6. This is the background against which the Hong Kong Institute of Certified Public Accountants makes proposals for the 2009/10 budget. Whilst Hong Kong's economy still faces great uncertainty and given the likelihood of a substantial deficit, there is limited scope for large-scale tax hand outs. At the same time few would disagree these are "rainy days" in which exceptional measures may be called for and for which Hong Kong is reasonably well prepared following two years of large budget surpluses. Therefore, trying to achieve a balanced budget should not be the primary objective in the present circumstances, and "belt-tightening" should not be the underlying approach in the forthcoming budget.
7. The Institute proposes that this year's budget should include measures to support the economy and to ensure, as far as possible, that the costs of doing business in Hong Kong remain competitive and that the community receives necessary assistance during the downturn.
8. We also take the opportunity to reiterate some technical proposals, which we hope the government will review, to reflect international trends and current practices in taxation.

PART B: PROPOSALS FOR THE COMMUNITY AND THE ENVIRONMENT

9. To help cope with the difficult times ahead, we recommend the following measures to help the community through the economic downturn, to improve the environment and increase the options available to taxpayers for health care services.

(I) Supporting the community through the economic downturn

Measures proposed:

- *Grant a reduction of 75% of the 2008/09 final tax in respect of salaries tax, property tax and tax under personal assessment, subject to a ceiling of \$25,000 in each case (paragraph 11).*
- *Reduce the first three progressive rates of salaries tax to 1%, 5%, and 9%, introduce a new rate of 13% and retain the existing top rate of 17% (paragraph 12).*
- *Before any further changes are made to the personal allowances, a review should be conducted to identify an appropriate base year for any future adjustments (paragraph 13).*
- *Increase a range of salaries tax allowance to help specific and more vulnerable groups through the difficult times ahead. Proposals are:*
 - *Allow any unutilised portion of the self-education expenses incurred in any year (up to \$60,000 per year) to be carried forward for one year (paragraph 14(a)).*
 - *Increase the maximum number of years for claiming home loan interest from 10 years to 15 years (paragraph 14(b)).*
 - *Increase the elderly residential care expenses from \$60,000 to \$72,000 per year (paragraph 14(c)).*
 - *Increase the child allowance from \$50,000 to \$60,000 per year and additional allowance in birth year of a child from \$50,000 to \$60,000 (paragraph 14(d)).*
 - *Increase the allowance and additional allowance for dependent parent/grandparent aged 60 or above respectively from \$30,000 to \$36,000 per year (paragraph 14(e)).*
 - *Increase the allowance and additional allowance for dependent parent/grandparent aged 55 or above but below 60 respectively from \$15,000 to \$18,000 per year (paragraph 14(f)).*
 - *Increase the dependent brother and sister allowance from \$15,000 to \$18,000 per year (paragraph 14(g)).*
 - *Increase the disabled dependant allowance from \$60,000 to \$72,000 per year (paragraph 14(h)).*

- *Allow deductions for contributions to private medical insurance policies, subject to a cap per person of \$12,000 per year (paragraph 14(i)).*
- *Redundancy/severance payments of up to twice the current statutory thresholds for such payments should automatically be treated as non-taxable (paragraph 15).*
- *Waive rates for 2009/10, subject to a ceiling of \$5,000 per quarter for each rateable tenement (paragraph 16).*
- *Grant an electricity charge subsidy of \$1,800 for the year to each residential electricity account (paragraphs 17-18).*

Tax rates

10. The proposals contained in our 2007/08 budget submission, to reduce the tax burden on middle-income earners by increasing the salaries tax bandwidth for the progressive rates from \$35,000 to \$40,000, were implemented in the 2008/09 budget.
11. To provide direct support to lower- and middle-income taxpayers during the economic downturn, and to stimulate consumption, we would suggest repeating the concession provided in the previous budget and granting a reduction of 75% of the 2008/09 final tax in respect of salaries tax, property tax and tax under personal assessment, subject to a ceiling of \$25,000 in each case.
12. To assist lower- and middle-income taxpayers, in particular, on a longer-term basis, and to further support the economy, we would suggest revising the progressive rates for the year of assessment 2009/10 by reducing the first three rates to 1%, 5% and 9%, respectively, and introducing an additional rate of 13%. The top rate of 17% should be retained and the bandwidth of \$40,000 should also remain the same. Thus, we propose that there be five progressive rates in total, with intervals of 4% between each, compared with the current four rates and intervals of 5%. The comparison between the current and proposed rates is as follows (see [Appendix 1](#) for examples of the dollar and percentage tax savings):

Current (for the year of assessment 2008/09)		Proposed (for the year of assessment 2009/10)	
First \$40,000	2%	First \$40,000	1%
Next \$40,000	7%	Next \$40,000	5%
Next \$40,000	12%	Next \$40,000	9%
Balance	17%	Next \$40,000	13%
		Balance	17%
Standard rate	15%	Standard rate	15%

13. In the 2008/09 budget, personal allowances were again increased. The Institute reiterates its position that, before any further changes are made, a review should be conducted to establish an appropriate base year for adjusting personal allowances on a continuing basis. We believe that such a review will enable the allowances to be placed on a firmer footing, so that any future adjustments would be justifiable on the grounds of actual (for example, inflationary) changes in the economy and the external environment, rather than being perceived as being ad

hoc. In the meanwhile, caution should be exercised to avoid, as far as possible, any further narrowing of the tax base, given that the narrowness of the tax base is a major cause of the volatility of government revenues and that this creates difficulties for longer-term planning (see [Appendix 9](#)).

Salaries tax allowances and deductions

14. To provide more targeted and effective support for specific and vulnerable groups within the community, we propose the following adjustments to other salaries tax allowances and deductions:
 - (a) Allow any unutilised portion of the deduction for self-education expenses incurred in any year (up to \$60,000 per year) to be carried forward for one year. This will benefit taxpayers who leave the workforce to pursue further education, as they would be able to utilise the allowance upon return to the workforce.
 - (b) Increase the maximum number of years for claiming home loan interest from 10 years to 15 years. Although the amount of home mortgage debt in Hong Kong is comparatively low, this measure can help to provide greater assurance to home owners as property values become increasingly affected by the downturn.
 - (c) Increase the elderly residential care expenses from \$60,000 to \$72,000 per year in the light of increases in the costs of residential care.
 - (d) Increase the child allowance from \$50,000 to \$60,000 per year and additional allowance in birth year of a child from \$50,000 to \$60,000.
 - (e) Increase the allowance and additional allowance for dependent parent/grandparent aged 60 or above respectively from \$30,000 to \$36,000 per year.
 - (f) Increase the allowance and additional allowance for dependent parent/grandparent aged 55 or above, but below 60, respectively from \$15,000 to \$18,000, to maintain the same 50% ratio between this allowance and the corresponding allowance for the dependants above 60 years of age.
 - (g) Increase the dependent brother and sister allowance from \$15,000 to \$18,000 per year.
 - (h) Increase the disabled dependant allowance from \$60,000 to \$72,000 per year.
 - (i) Allow deductions for contributions to private medical insurance policies. Pending the resolution of the long-term healthcare reform and funding arrangements, incentives should be extended in the form of tax deductions to individuals for financing their own medical insurance and that of their non-working dependent family members, subject to a cap per person of \$12,000 per year (see paragraphs 21 to 23).

Redundancy payments

15. Lump sum redundancy/severance payments within the statutory limits under the Employment Ordinance (Cap. 57) are automatically treated as non-taxable. In

view of the economic climate, we propose that it be made clear that employees' redundancy/severance payments of up to twice the current statutory thresholds will automatically not be taxed.

Rates on tenements

16. We propose that rates be waived for 2009/10, subject to a ceiling of \$5,000 per quarter for each rateable tenement.

Electricity subsidy

17. For more immediate support to the community, we suggest that an electricity bill subsidy of \$1,800 for each residential electricity account be provided for the year ending 31 March 2010, as a short-term measure, which amounts to a relief of \$150 per month per account.
18. However, in the longer term, Hong Kong must address the effect of its high electricity consumption on the environment (see paragraph 20(c)).

(II) Improving the environment

Measures proposed:

- *Consideration should be given to adopting a more extensive and coordinated approach to improving the environment including through specific measures such as:*
 - *Refund systems to encourage recycling (paragraph 20(a)).*
 - *Traffic congestion-related measures, such as, co-ordination of tunnel tolls, electronic road pricing, and review of public transportation networks (paragraph 20(b)).*
 - *To encourage energy conservation, an electricity surcharge at a low rate should be explored for utility usage by both business and residential accounts, with a set relief for residential accounts to minimise burden on the lower income group (paragraph 20(c)).*
 - *Additional commercial building and industrial building allowances for new commercial and industrial complexes adopting approved environmentally sustainable designs (paragraph 20(d)).*
 - *Low interest/interest free loans to SMEs for environmental protection equipment (paragraph 20(e)).*
 - *To encourage renovation of older buildings, landlords should be able to opt for the deduction of actual renovation expenses in any given year instead of the flat-rate 20% rental deduction for wear and tear (paragraph 20(f)).*

19. The importance of a good environment and need for environmental protection have been emphasised in the past two budget speeches and, more recently, in the 2008/09 Policy Address¹. The Institute has been advocating greater awareness and more co-ordinated action on a domestic and cross-border front. We are therefore pleased to note that the government will be working hand-in-hand with neighbouring areas to safeguard the environment, as well as economic development².
20. We reiterate that the “polluter pays” principle could be applied more widely, and consideration should be given to adopting a more extensive and coordinated approach to improving the environment through measures such as:
- (a) Refund systems to encourage recycling: We continue to support the proposals regarding the government’s municipal solid waste management strategy and look forward to seeing the detailed proposals, including the producer responsibility scheme on used electrical and electronic equipment that was recently announced in the 2008/09 Policy Address³. We recommend that a refund system to encourage recycling be considered as part of the strategy.
 - (b) Traffic congestion-related measures: In light of the 2008/09 Policy Address announcement to consider measures to regulate traffic⁴, we recommend that the government consider the following measures:
 - (i) More effective co-ordination of the tunnel tolls between the three cross-harbour tunnels.
 - (ii) Electronic road pricing for the congested areas (which could, as a traffic flow measure, extend to the Cross Harbour Tunnel area during peak hours).
 - (iii) Review of the capacity of the public transportation network to accommodate additional usage to complement the above measures.
 - (c) Energy conservation: To encourage energy conservation, we would suggest that the introduction of an electricity surcharge at a low rate (for example, 1%) on usage by business and residential accounts be considered, with a set amount of relief to be granted to residential accounts, to minimise the burden on the lower income group.
 - (d) Allowances for energy efficient buildings:
 - (i) We have been advocating tax measures to encourage energy efficiency in buildings and that consideration should be given to carbon and energy taxes and, therefore, support the initiatives outlined in the Policy Address in this area⁵.
 - (ii) New industrial and commercial complexes adopting approved environmentally sustainable designs could be given additional commercial building or industrial building allowances, for example:

¹ 2008/09 Policy Address, paragraph 90.

² 2008/09 Policy Address, paragraph 92.

³ 2008/09 Policy Address, paragraph 103.

⁴ 2008/09 Policy Address, paragraph 59.

⁵ 2008/09 Policy Address, paragraph 99.

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

- (e) We have proposed on a number of occasions in the past that tax deductions should be provided for the installation of environmentally-friendly equipment. We, therefore, welcomed the announcement in the 2008/09 Budget, that a 100% profits tax deduction for capital expenditure on environment-friendly machinery and equipment, will be given in the first year of purchase. We would also suggest that the government consider offering grants (such as low/no interest loans) to SMEs, which have insufficient capital to acquire environmental protection equipment, machinery or systems, particularly during the economic downturn when environmental concerns might otherwise give way to other priorities.
- (f) Renovation of older buildings:
- (i) While we welcomed the subsidy offered to needy elderly people in the 2008/09 budget to carry out maintenance or safety improvement works in self-occupied properties, more needs to be done. Building maintenance is crucial to the environment, as poorly maintained older buildings could potentially endanger public safety and as well as giving and unsightly appearance to Hong Kong's urban landscape. As many buildings in Hong Kong are aging and in need of remedial work, the current policy of a flat-rate deduction under property tax should be reviewed. The recent incidents involving defective lifts in public housing estates have highlighted the importance of building and installations maintenance.
 - (ii) Property tax is currently levied on the owner of land and/or buildings situated in Hong Kong ("the landlord"), at the rate of 15% based on the "net assessable value" of the property. "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 equal to 20% for deemed repairs and outgoings.
 - (iii) For individual landlords, the flat-rate deduction of 20% from the rent received for wear and tear may be adequate to cover minor renovations, but it is not sufficient to cover major refurbishment or rehabilitation work that may need to be carried out periodically on older buildings. To encourage the renovation of older buildings, landlords should be able to opt for the deduction of actual renovation expenses in any given year. To avoid abuse, this allowance could be subject to a ceiling amount over a fixed period of time. Landlords should still be able to opt for the flat rate 20% as an alternative in any given year.

- (g) Other possible measures include:
- (i) Carbon and energy taxes (for example, on coal) and other resource consumption taxes.
 - (ii) Refund mechanisms to reward the control of pollutants and efficient use of energy.
 - (iii) Imposing a green tax on motor vehicle ownership and non-biodegradable products.

(III) Reviewing the health care system

Measures proposed:

- *Investigate what incentives would be attractive enough to encourage more people to move away from reliance on public health care services towards using private healthcare, and conduct a public consultation to obtain views on related issues (paragraphs 21-23).*

Health care financing arrangements

21. We note that the government is already planning the second stage of public consultation. As health care financing is an important issue, we hope that a range of possible options will be open for discussion.
22. As regards to long-term financing arrangements, we believe that, in practice, the best way forward is likely to involve a combination of various measures, including a broader and more stable base of taxation, appropriate increases in fees based on usage, plus additional sources of financing. We note from the consultation paper that the health care financing arrangements in the advanced economies examined invariably involved a mix of financing sources. For this reason, and given that it is acknowledged that the government will remain the principal funder of the public health services, we would suggest that the issue of health care financing cannot be considered in isolation from the wider issue of identifying stable, long term, sources of public revenue (see [Appendix 9](#) on Hong Kong's tax base).
23. We also believe that, up to a point, tax incentives can be used to encourage taxpayers to invest more in providing for their own health cover, whether this takes the form of deductions for insurance premiums or for contributions into saving schemes for health care funding. More specifically, it is suggested the government should investigate what incentives might be sufficiently attractive to encourage more people to move away from reliance on public health care services towards using private health care. Issues such as whether and how any tax incentives could be recouped if monies were taken out from any dedicated health care funds for non-medical reasons, etc. would need to be discussed in a public consultation.

PART C: PROPOSALS TO STRENGTHEN THE ECONOMY

(I) Keeping the tax costs of business in Hong Kong competitive

24. A government's tax policy is often a key driver to the competitiveness of a jurisdiction and tax policies can be used effectively to retain and attract investment and talent⁶. Hong Kong's simple tax system and low tax rate are favourable factors taken into account by businesses setting up operations in Hong Kong⁷. With this in mind, we propose several measures to ensure that the tax costs of businesses in Hong Kong remain competitive in the face of aggressive efforts from other jurisdictions in the region to increase their share of inbound investment.
25. We set out below proposals on the rate of profits tax, loss relief provisions and double taxation relief.

Rate of profits tax

Measures proposed:

- *Grant a reduction of 75% of the 2008/09 final profits tax, subject to a ceiling of \$25,000 (paragraph 26).*
- *As soon as conditions permit, the rate of corporate profits tax should continue to be reduced incrementally with the aim of achieving a rate of 15%, or lower, over time (paragraphs 27-29).*

26. To provide more immediate support to businesses in light of the economic downturn, we propose a repeat of the concession provided in the previous budget, namely, granting a reduction of 75% of the 2008/09 final profits tax, subject to a ceiling of \$25,000.
27. While Hong Kong's standard tax rate is still relatively low, its effective tax rate may not be so competitive, as other jurisdictions in the region have also been lowering tax rates and offering specific incentives to attract business.
28. We support the measures in 2007/08 Policy Address to progressively reduce the rate of corporate profits tax to 15%.
29. However, against the background of the international trend to lower rates of corporate taxes, we suggest that a study be conducted of Hong Kong's competitiveness, incorporating an international comparison with the corporate tax rates in other jurisdictions (including consideration of the effective rates after incentives), with a view to reducing profits tax rates, over a period, to below 15%, and securing Hong Kong's long-term, competitive position.

⁶ Bauhinia Foundation Research Centre, "A Tax System to Enhance the Business Environment", May 2008, pg. 4.

⁷ 2008 Annual Survey of Companies in Hong Kong Representing Parent Companies Located outside Hong Kong, 6 October 2008.

Loss relief provisions

Measures proposed:

- Introduce loss carry-back provisions into the Inland Revenue Ordinance (“IRO”) (paragraphs 30-35).
- Introduce group loss relief into the IRO (paragraphs 36-38).

Loss carry-back

30. At the present, if a company incurs an allowable tax loss in any year, that allowable tax loss can only be carried forward for use against subsequent profits of that company. Unlike many other advanced tax jurisdictions, Hong Kong does not operate a system of loss carry-back. The absence of loss carry-back provisions can accentuate the effects of fluctuation in a company's economic results, particularly during economic downturns, and can contribute to the cash flow problems experienced by companies.
31. Taxation is a significant cost to many companies and the fact that, when a company incurs a tax loss, the loss can only be set off by being carried forward to some indeterminate time in the future, has an adverse effect on cash flow. During the global economic downturn, it is to be expected that a number of companies will incur losses in the current year, whereas they made a profit in previous years. Those companies will have to pay tax on their past profits, even though they may now be running up losses, thus, adding to their cash flow problems. This situation could be mitigated if Hong Kong's tax law allowed tax losses to be carried back one year to be offset against previous years' profits.
32. However, this has been a recommendation made by the Institute for some time and is not being proposed purely because of the current economic turmoil. There are further factors to be considered. At the present time, the Inland Revenue Department (“IRD”), as a result of their interpretation of the decision in the case of *CIR v Secan Ltd. & Anor*⁸, may seek to tax unrealised profits due to the accounting reporting requirements under which unrealised profits appear in the accounts of companies.
33. Although it is a fundamental principle of tax law that unrealised profits should not be taxed until realised, the IRD interprets the *Secan* decision such that unrealised profits are taxable if they are recorded in a company's audited accounts. Thus it is possible for a company with an unrealised profit at one year end to be taxed on that unrealised profit, only for the company to subsequently discover in the next year that there is in fact a realised loss rather than a profit. In other jurisdictions this is not necessarily a problem as, by having loss carry-back provisions, the realised loss can be carried back to set against the unrealised profits taxed in the previous year. A list of jurisdictions with provisions for loss carry-back is at [Appendix 2](#).
34. However under Hong Kong's current system, while the unrealised profit will be taxed in Year 1, the realised loss in Year 2 can only be carried forward to be set off against future profits.

⁸ [2001] (1HKRC 90-107).

35. In the absence of any resolution to the inconsistency between the interpretation of *Secan*, referred to above and the fundamental principle that unrealised profits should not be taxed, there is an even more pressing case for the introduction of loss carry-back provisions in Hong Kong.

Group loss relief

36. Many businesses operate through group of companies for commercial reasons, whether to diversify the risk of different types of operations and activities, or diversify the risk of operating in different locations. As a result of this, in some cases, certain companies within the group may record allowable losses, whilst others have taxable profits. In most other advanced tax jurisdictions, the tax legislation provides for a form of group loss relief, whereby a company with a loss can transfer the loss to another company in the same group that has profits, thus bringing the overall tax burden of the group into line with the net tax profits of the group.
37. It has been claimed that such systems are open to abuse and would also require complex legislation. However, many other advanced tax jurisdictions have operated group loss relief for significant periods of time without any obvious drawbacks. Our competitors, such as Singapore, have introduced and operated group loss relief system without any evidence of abuse. A list of jurisdictions with provisions for group loss relief is at [Appendix 2](#).
38. We consider that a form of group loss relief could be introduced in Hong Kong to provide a simple, but much needed, measure of relief to corporate groups. Anti-avoidance provisions to prevent abuses could include introducing an appropriate definition of a group (for example, the relevant companies having to be 90% owned by the same parent company) and stipulating that losses can only be transferred to be offset against current profits without, any carry back of losses to the profits of other group companies in previous years.

Double taxation relief

Measures proposed:

- *Subject to various conditions and qualifications being adequately addressed, Hong Kong should consider introducing a more liberal exchange of information regime, in the context of concluding a wider network of comprehensive double taxation agreements (“CDTAs”) (paragraphs 39-41).*
- *Where no CDTA exists, a unilateral tax credit should be granted for:*
 - *all foreign tax paid on royalties which are subject to Hong Kong profits tax, and*
 - *other foreign withholding tax paid, up to a maximum of 50% of the Hong Kong profits tax payable (paragraphs 42-44).*

Comprehensive double taxation agreement framework

39. It has been said that Hong Kong may not be the best location for regional operations because it lacks a network of CDTAs⁹. Hong Kong has so far concluded only four CDTAs, with the Mainland, Belgium, Thailand and Luxembourg. In the Institute's submission of 6 October 2008 on the consultation on the liberalisation of exchange of information in CDTAs, it was recommended that the government conduct a fuller and more detailed analysis of the longer-term advantages and disadvantages of the liberalisation to ensure that, if Hong Kong were to implement more extensive exchange of information, it should do so only in the context of concluding individual CDTAs and so taxpayers will be able to enjoy associated material benefits in conjunction with liberalisation.
40. At the same time, the Institute expressed various reservations or conditions that should be fulfilled if Hong Kong is to liberalise information exchange, including:
- (a) confidentiality of information passed between treaty partners should be protected,
 - (b) the scope of exchange of information should not be open ended,
 - (c) in principle, taxpayers should be informed of any exchange of information about them, and
 - (d) any amendment to the secrecy provisions of the IRO to allow for more extensive exchange of information should stipulate that this applies only in the context of a CDTA.
41. On balance, and subject to conditions, such as those above, being addressed, the Institute considers the arguments for further liberalisation may outweigh those against, given:
- (a) the clear international trend for a more extensive scope of information exchange, and the advantages for Hong Kong of aligning itself with this trend (and conversely the possible downside of not doing so), and
 - (b) the likelihood of potential CDTA partners being more willing to enter into negotiations with Hong Kong, and the economic benefits and more favourable tax reliefs that would accrue from having a wider network of CDTAs.

Tax relief on withholding tax

42. While further CDTAs may be negotiated in future, in order to enhance Hong Kong's position as a centre for regional operations, we propose that the current problem of double taxation of income that is deemed to be sourced in Hong Kong, and which is also subject to withholding tax in another (non-CDTA) jurisdiction, be addressed by introducing a unilateral tax credit for:
- (a) all foreign tax paid on royalties which are subject to Hong Kong profits tax, and

⁹ Bauhinia Foundation Research Centre, "A Tax System to Enhance the Business Environment", May 2008, p.59.

- (b) other foreign withholding tax paid, up to a maximum of 50% of the Hong Kong profits tax payable.
43. The current tax law allows Hong Kong taxpayers to offset Hong Kong profits tax against overseas withholding taxes paid in those countries with which Hong Kong has concluded CDTAs. This means tax credits can only be claimed for withholding taxes paid in the Mainland, Belgium, Thailand and Luxembourg.
44. Aside from this, only limited relief is currently available for Hong Kong taxpayers on taxes paid in non-CDTA countries. In such cases, a deduction is available to the Hong Kong taxpayer when the overseas tax is an expense that must be borne regardless of whether a profit is derived (for example, withholding taxes). This in effect leaves the bulk of the withholding tax paid not relieved (at the current tax rate of 16.5%, 83.5% is unrelieved). Hence, 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 (for example, interest, royalties, and service/management/technical fees).

(II) Reinforcing Hong Kong's economy

45. The following proposals seek to give additional support to Hong Kong's economy in the four "pillar industries", namely financial services, logistics, tourism and professional and producer services, as well as, another key industry, the property sector.

Enhancing and expanding financial services

Measures proposed:

- *Strengthen financial services regulation and investor protection (paragraph 46).*
- *Strengthen corporate governance (paragraph 47).*
- *As an interim measure, refine the rules relating to the exemption from profits tax for qualified offshore funds (paragraphs 48(a)-(e)).*
- *As a longer-term measure, consider additional specific incentives for the fund management and insurance sectors (paragraphs 49(a)-(c)).*
- *As regards facilitating Islamic financing products in Hong Kong, the tax objective should be simply to provide a level playing field (paragraph 50).*
- *Beyond 2010 (i.e., when the temporary government guarantee on all Hong Kong deposits expires) the cap on deposits protected under the deposit protection scheme should be reviewed in the light of comparable benchmarks adopted internationally (paragraph 51).*

46. It is crucial for an international financial centre, such as Hong Kong, to ensure that it has in place an efficient and effective regulatory framework for financial services, which is able to give confidence to investors without stifling enterprise. Recent events indicate that there is a need to consider whether there is an appropriate balance between regulation and business facilitation. We must not allow Hong

Kong's hard-earned reputation for having a robust and well-governed financial sector to come into question, particularly not in the present climate. We, therefore, welcome the proposed initiatives in the 2008/09 Policy Address to strengthen the regulatory framework of the banks, securities and insurance sectors¹⁰ and ensure greater protection for investors.

47. Recent incidents in Hong Kong, as well as factors underlying the financial crisis in the United States and the rest of the world, point strongly towards the need to improve corporate governance, particularly in the area of risk assessment and management, and disclosure. The regulators should be asked to review Hong Kong's current corporate governance framework with a view to strengthening aspects of it.
48. Other measures are also necessary to support Hong Kong's role as a global financial centre. In view of increasing competition from other emerging asset management centres around the region (for example, Japan and Singapore), Hong Kong needs to consider reinforcing its own position. To encourage offshore funds to invest in Hong Kong, we suggest the government consider measures to refine the Offshore Fund Exemption Rules and to ensure that the income generated from the normal operations of an offshore fund are covered. Measures for consideration should include:
 - (a) allowing offshore funds to use Hong Kong-based trustees,
 - (b) relaxing the exemption restriction on offshore funds investing in offshore private companies, other than property holding companies,
 - (c) extending the definition of "specified transactions" to include income from certain fixed income financial instruments as qualified transactions,
 - (d) including interest income as income from specified transactions rather than incidental income, the exemption of which is subject to the 5% cap, and
 - (e) expanding the list of specified stock and future exchanges to include Mainland exchanges.
49. Furthermore, it is an opportune time to consider some longer-term initiatives for the financial services sector. These initiatives should be assessed in detail so that they can be implemented promptly once the economy picks up in order to retain existing, and attract new investment. Initiatives that should be considered include:
 - (a) providing an exemption for Hong Kong resident funds similar to that currently granted to offshore funds, thus providing a level playing field for both onshore and offshore funds,
 - (b) reviewing the existing interest expense deduction rules to encourage international companies to use Hong Kong as their "cash pooling hub", and
 - (c) reviewing the existing charging section, that is, section 23 of the IRO for life insurers, as the current provision is no longer in line with the development of the industry. For instance, income relating to the investment portion of unit link products should not be included as insurance premiums for computing the 5% deemed assessable profits.

¹⁰ 2008/09 Policy Address, paragraphs 24-30.

50. We note that the government will continue to push ahead with the development of an Islamic financing market, which should add to Hong Kong's ability to provide a more extensive range of financial services. However, from the taxation perspective, any tax incentives that may be made available for Islamic financing should be extended to other similar kinds of non-Islamic products to avoid any distortions. The tax objective, therefore, should be to maintain a level playing field.
51. While we understand the immediate impetus for the government to guarantee all deposits with authorised institutions in Hong Kong until the end of 2010, longer-term measures should also be explored. We would suggest that consideration be given to increasing the limit on deposits protected by statute beyond 2010, as the \$100,000 ceiling under the Deposit Protection Scheme Ordinance¹¹ is low by international standards. For example, the regular deposit insurance caps, disregarding temporary measures, for Canada, the United States and the United Kingdom, are at C\$100,000¹², US\$100,000¹³ and GBP50,000¹⁴, respectively.

Supporting the logistics industry

Measures proposed:

- *Pending finalisation of the detailed plan for the Lantau Logistics Park, measures to support the logistics sector should be introduced including:*
 - *Rates exemptions/reductions for storage facilities used directly for the logistics business (paragraph 53(a)).*
 - *Three-year profits tax reduction (of 50%) on income derived from the international freight forwarding business (paragraph 53(b)).*
 - *Improve rail infrastructure (paragraph 53(c)).*

52. The operational efficiency of our logistics industry is world class, yet our land costs and salary levels have pushed up the industry's costs, and hence prices, much above those of its competitors. In recent years, for example, the cargo business through the Hong Kong International Airport and the Kwai Chung terminals has encountered keen competition from neighbouring ports and airports in the Pearl River Delta in terms of costs. For instance, we understand that the terminal charges of Guangzhou Baiyun Airport are less than 20% of those of Hong Kong International Airport. The charges of Kwai Chung terminals are also significantly more than those of Shenzhen.
53. We note that in the 2008/09 Policy Address¹⁵, the detailed feasibility study on the Lantau Logistics Park project is being finalised. In the interim, other measures should be taken to support our logistics industry, which remains an important industry for Hong Kong, providing significant employment. We reiterate our view

¹¹ Cap. 581.

¹² Canada Deposit Insurance Corporation.

¹³ Federal Deposit Insurance Corporation. Exclusive of the temporary increase to US\$250,000 until 31 December 2009.

¹⁴ Financial Services Compensation Scheme.

¹⁵ 2008/09 Policy Address, Policy Agenda, p.21.

that support should be given to international/cross-border freight transportation business through measures such as:

- (a) exemption from or reduction in rates for storage facilities used directly for the logistics business, for example, warehouse, piers, etc.,
- (b) 50% reduction in the rate of profits tax on income derived from the international freight forwarding business, initially for a three-year period, and
- (c) improvements in the rail infrastructure by, for example, building express lines connecting to main railways in Guangdong, to reduce the time and costs of transporting cargo to terminals in Hong Kong.

Attracting tourism and strengthening the sense of community

Measures proposed:

- *Set up a heritage body in Hong Kong along the lines of the National Trust or English Heritage in the United Kingdom, to which cash donations should be deductible, as they are to charities (paragraphs 54(a) and (c)).*
- *Donations of historically valuable private buildings, landmarks, etc. to this body should be treated as donations in kind, without any ceiling against profit or income. Owners should also be permitted to treat a portion of the value as a donation and to receive compensation (for example, a land swap) for the remainder (paragraph 54(b)).*

54. Hong Kong has a unique and interesting history, yet it has limited tourist spots and attractions relating to history, culture and heritage. Hong Kong has its own blend of traditional and modern, Chinese and Western attractions. To encourage a greater sense of the need for conservation, and a more sustainable approach, we suggest that the following tax measures be considered as part of the review of the Urban Renewal Strategy that was announced in the 2008/09 Budget:

- (a) Set up a body in Hong Kong along the lines of the National Trust or English Heritage in the United Kingdom, with the objective of promoting the permanent preservation of lands and buildings of beauty or historic or cultural interest, for the benefit of the Hong Kong community and tourists alike.
- (b) Allow owners to donate designated private buildings, landmarks, etc. to this body, to be treated as donations in kind, without any ceiling against profit or income. Owners should also be permitted to treat a portion of the value as a donation and to receive compensation through, for example, a land swap, for the remainder.
- (c) Cash donations to this body should be treated as charitable donations.

55. Preserving Hong Kong's history and collective heritage is also relevant to improving the quality of life in Hong Kong and strengthening the sense of community. This is important if we wish to continue to retain and attract talent and stimulate creativity and entrepreneurial skills in the community.

Making Hong Kong the preferred choice for regional operations (producer and professional services)

Measures proposed:

- *Tax measures relating to intellectual property use and development including:*
 - *100% deductions for the cost of acquisition of trademarks and copyrights (paragraph 61(a)).*
 - *Tax credits for any foreign tax paid on royalty income, which is subject to tax in Hong Kong (paragraph 61(b)).*
- *A concessionary rate of 10% for profits tax should be granted to regional offices/headquarters in Hong Kong in respect of management and consultancy income derived from associated entities overseas (subject to suitable anti-avoidance provisions) (paragraph 62).*
- *A profits tax exemption for interest received by regional offices from loans made in Hong Kong to their overseas associates (paragraphs 63-64).*

Hong Kong's position as a hub for regional operations

56. According to the 2008 annual survey of companies in Hong Kong representing parent companies located outside Hong Kong¹⁶, Hong Kong continues to be the top choice of location for overseas and Mainland companies to manage their regional business, with an overall 2.7% increase from 2007. It is noted from the survey that, while there was a decrease in the number of regional offices¹⁷, the overall increase was dominated by an increase in local offices¹⁸, coupled with an increase in regional headquarters¹⁹, albeit of a smaller degree. In the Institute's 2007 submission, it was suggested that despite an increase in the number of offices, the size of those offices and number of employees were smaller²⁰.
57. In the Global Competitiveness Report 2008/09 published by the World Economic Forum, Hong Kong has improved slightly from 12th place to 11th place, although still behind its 10th place in 2006. There is clearly room for improvement in this area.
58. Tax costs and benefits are known to be important considerations in choosing a location for regional operations. Other jurisdictions have been successful in attracting specific industries, and even luring existing businesses from Hong Kong, (for example, in the fund management and broadcasting sectors) due in part to their willingness to offer favourable tax treatment.

¹⁶ Annual survey jointly released by Invest Hong Kong and Census and Statistics Department on 6 October 2008.

¹⁷ Office that coordinates offices and/or operations in the region (i.e. Hong Kong plus one or more other places) on behalf of its parent company located outside Hong Kong.

¹⁸ Office that only takes charge of the business in Hong Kong (but nowhere else) on behalf of its parent company located outside Hong Kong.

¹⁹ Office that has managerial control over offices in the region (i.e. Hong Kong plus one or more other places) on behalf of its parent company located outside Hong Kong.

²⁰ South China Morning Post, 11 November 2007, p. A1 (with reference to the Census and Statistics Department).

59. Hong Kong still retains a competitive edge in some sectors because of its infrastructure, including financial and legal frameworks, and skilled human resource pool. However, other factors, such as high land and labour costs, coupled with other negative perceptions about Hong Kong, including concerns over poor air quality, declining standards of English and skill shortages in certain areas, will erode Hong Kong's current advantages, unless measures are taken to preserve Hong Kong's position. Reinforcing Hong Kong's role as a hub for regional operations can also help to support Hong Kong's economy in the long term and create more jobs for both professionals and other personnel. We believe that further tax incentives are desirable to consolidate Hong Kong's position as a platform for doing business in the region and internationally.
60. We recommend various measures below to enhance Hong Kong's competitiveness as a base for group and regional operations. A number of these have been proposed by the Institute previously.

Tax concessions for development of intellectual property

61. In accordance with Hong Kong's increasing focus on value-added services and a knowledge-based economy, the Institute proposes that the tax concessions in relation to intellectual property be extended. The concessions under sections 16E and 16B of the IRO should be reviewed and extended to provide a broader tax framework that makes Hong Kong more attractive as a centre for the development of intellectual property. With suitable anti-avoidance provisions, the following measures are proposed:
- (a) 100% deductions for the cost of acquisition of trademarks and copyrights generally, not only patents.
 - (b) Tax credits for any foreign tax paid on royalty income, which is subject to tax in Hong Kong.

Concessionary tax rate for management fees received from overseas associates

62. To enhance Hong Kong's reputation as a regional centre, a concessionary rate of 10% for profits tax should be granted to regional offices/headquarters in Hong Kong in respect of management and consultancy income derived by the Hong Kong entity from associated entities overseas. Abuse of this relief can be prevented through suitable anti-avoidance provisions (for example, by ensuring that the term "associated entities overseas" is suitably defined).

Tax exemption for interest received on loans made to overseas associates

63. Hong Kong is well equipped to be a regional centre to handle the financial management of overseas associates within a group of companies. However, as financial margins are usually thin, tax measures could provide a further incentive for international businesses to establish their treasury function in Hong Kong.
64. We recommend that, other than in the case of financial institutions, the interest received by regional offices from loans made in Hong Kong to their overseas associates be exempted from profits tax. Currently section 15(1)(f) of the IRO, deems the interest derived from Hong Kong by a corporation carrying on a trade or business in Hong Kong to be subject to profits tax at the standard corporate rate.

Stabilising the property sector

Measures proposed:

- *Stamp duty on property transactions should be reduced for properties between \$3 million to \$10 million. A flat rate of \$100 should apply to properties up to \$3 million and the highest rate of stamp duty at 3.75% should apply only to properties costing \$10 million or more (paragraph 65). The progressive rates in between should be rationalised accordingly.*

65. The property sector is an important sector in Hong Kong's economy. Whilst it has been suggested that the government will seek to support the property market by tightening supply²¹, to help stabilise the property market during the expected economic downturn, we suggest that the rate of stamp duty on property transactions be reduced for properties between \$3 million to \$10 million, such a flat rate of \$100 should apply to properties up to \$3 million and the highest rate of stamp duty at 3.75% should apply only to properties costing \$10 million or more. The progressive rates in between should be rationalised accordingly.

PART D: ADDITIONAL TECHNICAL PROPOSALS

(I) Source of profits and employment income

Measures proposed:

- *Inland Revenue Rules ("IRR") on source of profits and employment income should be introduced to include tests for determining source of profit and employment. This would provide certainty for the business sector in planning the tax affairs of businesses and senior executives (paragraphs 66-69).*

66. Hong Kong's tax system is territorial in nature and it is fundamental to proper implementation of the tax system that there be clear guidelines and certainty as to what constitutes a Hong Kong sourced income or profit and what constitutes a non-Hong Kong sourced (or offshore) income or profit. The former are subject to tax in Hong Kong whilst the latter are not.

67. However in this fundamental area of our system, there has been increasing uncertainty and disagreement between the IRD and taxpayers and their representatives. This can be seen in the two key areas, which relate to source of income, namely source of profits for profits tax purposes and source of employment income for salaries tax purposes. In both these areas, there are significant differences in the interpretation of the law between the IRD and taxpayers and their representatives. The use of the Departmental Interpretation and Practice Notes ("DIPN") to promote the IRD's practice to fill the significant gaps in the interpretation of the law in these two areas is no longer satisfactory. It is an important concept of taxation law that those who administer our tax laws should not also set the tax policy, but there is a risk that this will happen by default in these important areas if steps are not taken to address this matter.

²¹ The Standard, "Propping up property", 17 October 2008.

68. The major differences and interpretation of our tax laws in the important areas of source of profits and employment income and the resulting uncertainty can be clearly seen in the difference of interpretation by the IRD and taxpayers and their representatives. The most recent example is in respect of the Court of Final Appeal decision in the case *ING Baring Securities (Hong Kong) Ltd. v CIR*²².
69. The Institute considers, therefore, that it is time for the tests for determination of source of profits and employment income to be included in our legislation (see [Appendix 3](#)). This could be achieved by the introduction of appropriate IRR without the requirement to amend the IRO. In the case of source of profits, Lord Bridge has already provided the basis for such rules in the *CIR vs Hang Seng Bank*²³ case. Such a course of action would provide a swift and certain remedy for taxpayers and their representatives, and also encourage investment in Hong Kong as businesses intending to invest in Hong Kong, and employ senior staff in Hong Kong, would once again be able to plan the tax affairs of the business and their senior executives with a high degree of certainty, which is now sadly lacking in our taxation system.

(II) Other technical proposals

70. In this section, we suggest that the government consider certain technical tax proposals, relating to the tax implications of accounting standards, a transfer pricing regime, finalisation of tax affairs, updating of personal assessment, taxation of property gains and broadening of the tax base. A summary of the proposals is provided below. The details are contained in appendices as indicated.

Measures proposed:

- *Specific measures, including legislation, interpretations, etc. should be adopted to relieve the potentially burdensome impact of using international financial reporting standards as the basis for determining the taxability of profits (see [Appendix 4](#)).*
- *A comprehensive set of transfer pricing rules should be introduced, preferably through legislation (see [Appendix 5](#)).*
- *The statutory time limit for reopening of assessments (except in cases of fraud) should be shortened from six years to three or four years (see [Appendix 6](#)).*
- *A statement of loss should be treated as an assessment, be binding on the IRD and open to objection by taxpayers (see [Appendix 6](#)).*
- *Consideration should be given to deeming tax returns to be final if no enquiry has been raised on them within a reasonable period (for example, 12 months) (see [Appendix 6](#)).*
- *Spouses should no longer have to be jointly assessed if they wish to opt for “personal assessment” (see [Appendix 7](#)).*

²² [FACV 000019/2006].

²³ [1991] (3HKTC 351).

- *Consideration should be given to introducing a clearer distinction between trading and investment for tax purposes by reference to, for example, the holding period (see [Appendix 8](#)).*
- *Options to broaden the tax base should continue to be explored (see [Appendix 9](#)).*

Hong Kong Institute of Certified Public Accountants
December 2008

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– March 2007

Effect of proposals for salaries tax rates
Examples of the dollar and percentage tax savings

Example 1: Single person – no dependants or children

Income	Tax payable		Dollar reduction in tax	Percentage reduction in tax*
	Current (for the year of assessment 2008/09)	Proposed (for the year of assessment 2009/10)		
HK\$	HK\$	HK\$	HK\$	%
150,000	940	500	440	47%
200,000	5,040	3,480	1,560	31%
250,000	12,140	8,860	3,280	27%
350,000	29,140	25,140	4,000	14%
500,000	54,640	50,640	4,000	7%
750,000	97,140	93,140	4,000	4%
1,000,000	139,640	135,640	4,000	3%

Example 2: Married person claiming two child allowances (working spouse separately assessed)

Income	Tax payable		Dollar reduction in tax	Percentage reduction in tax*
	Current (for the year of assessment 2008/09)	Proposed (for the year of assessment 2009/10)		
HK\$	HK\$	HK\$	HK\$	%
250,000	940	500	440	47%
350,000	12,140	8,860	3,280	27%
500,000	37,640	33,640	4,000	11%
750,000	80,140	76,140	4,000	5%
1,000,000	122,640	118,640	4,000	3%

Example 3: Married person with non working spouse and two children

Income	Tax payable		Dollar reduction in tax	Percentage reduction in tax*
	Current (for the year of assessment 2008/09)	Proposed (for the year of assessment 2009/10)		
HK\$	HK\$	HK\$	HK\$	%
350,000	680	340	340	50%
500,000	19,280	15,280	4,000	21%
750,000	61,780	57,780	4,000	6%
1,000,000	104,280	100,280	4,000	4%

* As percentage of 2008/09 tax liability.

Income levels at which progressive rates and standard rate breakeven

Categories	Current (for the year of assessment 2008/09)	Proposed (for the year of assessment 2009/10)
	HK\$	HK\$
Single person – no dependants or children	1,518,000	1,718,000
Married person claiming two child allowances (working spouse separately assessed)	2,368,000	2,568,000
Married person with non working spouse and two children	3,286,000	3,486,000

Jurisdictions with loss carry-back and group loss relief provisions

Detailed Recommendation
Tax Loss Relief (cont'd)

Jurisdiction	Tax loss carry-back	Group relief
Austria	Not available	Group consolidation
Australia	Not available	Group consolidation
Canada	3 years	Not available
Cyprus	Not available	Loss transfer
Denmark	Not available	Group consolidation
Finland	Not available	Loss transfer ¹
France	3 years	Group consolidation
Germany	1 year	Group consolidation
Ireland	1 year	Loss transfer, consortium relief ³
Italy	Not available	Group consolidation
Japan	1 year	Group consolidation
Luxembourg	Not available	Group consolidation
Malaysia	Not available	Loss transfer
Netherlands	1 year	Group consolidation
New Zealand	Not available	Dual system ²
Norway	Not available	Loss transfer ¹
Portugal	Not available	Group consolidation
Singapore	1 year	Loss transfer
Spain	Not available	Group consolidation
Sweden	Not available	Loss transfer ¹
United Kingdom	1 year	Loss transfer, consortium relief ³
United States	2 years	Group consolidation

Notes:

- ¹ The loss transfer regimes operated in Finland, Norway and Sweden are commonly known as group contribution regime. It allows profits (instead of losses) to be transferred within a corporate group.
- ² New Zealand offers both group consolidation and loss transfer mechanisms to taxpayers on an elective basis.
- ³ Consortium relief is an extension of group loss transfer regime that allows tax losses to be transferred between the consortium entity and its consortium members.

Source of profit and income
Detailed proposals

Measures proposed:

- *To codify the tests for determining the source of profits by the introduction of appropriate rules in the IRR.*
- *To consider updating the basis of salaries tax by taxing employees on the basis of the place where they render their services and, pending consideration of any such change, to codify the tests for the determination of the source of employment under the existing legislation by the introduction of appropriate rules in the IRR.*

Source of profit

1. Hong Kong's tax system is territorial in nature and it is fundamental to the proper implementation of that tax system that there be clear guidelines as to what constitutes Hong Kong source income or profits and non-Hong Kong (or offshore) income and profit. The former income/profits are subject to tax in Hong Kong, the latter are not. However rather than there being certainty in this area, there has been increasing uncertainty due to differing interpretations of court decisions by the IRD and taxpayers and their representatives – due to the absence of clear statutory guidelines. This is demonstrated in the fundamental area of taxation of profits under section 14 of the IRO. Although section 15 of the IRO deems certain amounts to be trading receipts, section 14 does not set out any general tests or rules on how the source of profits is to be ascertained. Rather, in the past, reference has been made to the case law and to DIPN21, "Locality of Profits".
2. Following in the Privy Council case of *CIR v Hang Seng Bank*¹ ("*Hang Seng Bank*") there was a period of certainty regarding the source of trading and manufacturing profits. DIPN21, issued at that time, greatly assisted taxpayers' understanding of the source of profits. However, subsequent interpretation by the IRD of later court decisions has resulted in a significant degree of uncertainty in the IRD practice and administration of the law. This has also been reflected in the interpretation of DIPN21 by the IRD in respect of offshore manufacturing claims and the use of processing agreements with factories in the Mainland.
3. The uncertainty regarding source of profits has increased following the Court of Final Appeal judgement in the case of *ING Baring Securities (Hong Kong) Ltd v CIR*² ("*ING Baring*"). The interpretation of this decision by the IRD seems to be at odds with the interpretation of this fundamental decision by taxpayers and tax practitioners, and demonstrates how wide the difference in interpretation has become and how prevalent the resulting uncertainty has become.
4. We consider the decision in the Court of Final Appeal has wide application to the determination of the source of profits. The IRD's view is that the decision turned on its own facts and does not have general application to the determination of source of profits of taxpayers, where the facts may differ from those of *ING Baring*.

¹ [1991] (3 HKTC 351).

² [FACV000019/2006].

5. In determining the source of trading profits, the IRD's views appears to be that the totality of facts test remains an appropriate approach, as indicated in DIPN21. However, the totality of facts test was dismissed by the Court of Final Appeal in the *ING Baring*.
6. The IRD is of the view that *ING Baring* does not constitute or introduce any new law. In this respect the IRD is correct. There is no new law, but the Court of Final Appeal has clearly stated that an interpretation of the law on source of trading profits that involves a totality of facts test is incorrect.
7. The Institute understands that the IRD propose to issue a new DIPN21 on the basis of the view that the *ING Baring* decision is of limited application (and that the totality of facts test will continue to apply). We are concerned that will simply perpetuate, if not increase, the difference of opinion and uncertainty in the area of source of profits. In the longer term this will be disadvantageous for investment in Hong Kong.
8. Another area of uncertainty regarding source of profit relates to the interpretation of the question of apportionment of profits, which was also dealt with by Lord Bridge in *Hang Seng Bank*. This decision envisaged that there should be an apportionment of profits where the source of profits appeared to have more than one locality.
9. In recent years, most Hong Kong manufacturing arrangements in the Mainland have moved from contract to import processing, as a result of changing government requirements in the Mainland and not for tax-related purposes. For some time, it has been accepted as the norm that Hong Kong taxpayers manufacturing in the Mainland, under a contract processing arrangement, are allowed an apportionment of profits on a 50:50 basis (that is, 50% of their profits are regarded as earned offshore and so not taxable in Hong Kong). Notwithstanding the similarity in substance between contract processing and other forms of processing arrangements, in particular "import processing", the latter are currently denied 50:50 apportionment, due to differences in the legal form between the two arrangements.
10. It is a widely-held view that the IRD should look at the substance of an arrangement not just its form and, in appropriate cases, grant the 50:50 basis of assessment for other types of Hong Kong-Mainland manufacturing arrangements. This issue has been highlighted by the recent High Court case of *CIR v. Datatronic Limited*³. The judgment recognised the importance of substance over form and allowed the taxpayer, which operated an import processing arrangement, to apportion its profits on a 50:50 basis, where the IRD had earlier rejected this.
11. We therefore consider it is time for the government to codify the tests for determining the source of profits. This could be achieved by the introduction of appropriate rules in the IRR.
12. In this respect, it should be noted that Lord Bridge in *Hang Seng Bank* set out guidelines for the determination of the source of many types of profits depending on the nature of the transaction giving rise to the profits.

³ [HCIA 3 and 4/2007]

13. Lord Bridge's comments can be summarized as follows:

Type of Income	Location
Service fee income	The place where the service is rendered
Manufacture of goods	The place where the manufacturing takes place
Letting of property	The place where the property is let
Lending of money	The place where the money is lent
Dealing in commodities or securities by buying and selling	The place where the contracts of purchase and sale are effected

14. We consider that, if these guidelines were adopted as part of the IRR in Hong Kong, this would significantly enhance and restore Hong Kong's reputation as a jurisdiction where the tax legislation is open to clear and certain interpretation.
15. Introducing rules elaborating on those set out above, should restore certainty in the vast majority of cases and ensure that Hong Kong is seen as a jurisdiction where taxpayers know that they can enjoy low and predictable tax liabilities.

Source of employment income

16. Businesses nowadays require mobility of human resources. Key executives, especially those with regional responsibilities are required to travel frequently⁴. To promote Hong Kong as a business centre, there should be a high degree of certainty in the taxation of employment income. We recommend that the current approach adopted by IRD be reviewed, including the policy on time apportionment claims. The current approach in DIPN10, "The Charge to Salaries Tax", does not reflect developments in actual human resource practices.
17. It is accepted by most taxpayers and practitioners that the previous version of DIPN10 reflected the correct interpretation of the legislation and case law and provided the basis for a fairly high degree of certainty. However, in individual cases, IRD assessors departed from this practice note, suggesting that each case had its own facts and referring instead to uncertain, and sometimes questionable, tests for determining the source of employment income.
18. In 2006, views were sought by the IRD on a draft revised DIPN10 and serious concern was expressed by the Institute, amongst others, as the draft revised version seemed to give backing to the very practices that practitioners and taxpayers had found problematic. However, the revised DIPN10, issued in June 2007, contained few changes from the draft version.

⁴ Bauhinia Foundation Research Centre, "A Tax System to Enhance the Business Environment", May 2008, p. 45.

Appendix 3

19. If the government wishes, in principle, to retain the current approach, based on determining where the taxpayer is employed, we believe that certain basic rules on source of employment income should be prescribed in the IRR. This would improve the level of certainty.
20. However, instead of enshrining the existing approach on source of employment income in the IRR, consideration could be given to updating the position by adopting the approach used in other international business centres, namely taxing employees on the basis of where they render their services.

Tax implications of accounting standards
Detailed proposals

Measures proposed:

- *Specific measures, including legislation, interpretations, etc. should be adopted to relieve the potentially burdensome impact of using international financial reporting standards as the basis for determining the taxability of profits.*

1. We recommend that the tax implications of important accounting standards, including relevant new and revised standards be reviewed and where the accounting treatment results in inequitable tax consequences, we recommend that the government introduces offsetting measures, through legislation, tax rulings, etc. to relieve the negative impact of the standards. This is because in principle the tax system should be a coherent, consistent, stand-alone framework, which reflects accepted taxation principles and decisions and policies that focus on Hong Kong's fiscal needs and aspirations. It should not be swept along on the tide of the international financial reporting framework, which is dictated by, and reflects, other purposes, interests and concerns, of which tax is not one.
2. The framework of International Financial Reporting Standards ("IFRSs"), with which the Hong Kong Financial Reporting Standards have converged, aims to facilitate the preparation of financial statements for the purposes of general financial reporting and cross-border investment. IFRSs operate to reflect the fair value (i.e., the notional current market value of the assets and liabilities) of a company in its balance sheet, with the necessary adjustments included in the income statement.
3. In reflecting fair values, economic concepts are used which are not consistent with tax law concepts. Adjustments in the income statement, which may not reflect actual realisations, are now included, whereas traditionally they would be excluded until realisation. Therefore, when the income statement is used as a starting point in the calculation of assessable profits, and no adjustments are permitted to exclude unrealised items, tax may be levied on profits that are unrealised⁵ and which may never be realised.
4. This runs counter to the well-established taxation principle that income or profit should not be taxed before it is realised. Following the decision of the Court of Final Appeal in *CIR v Secan Ltd & Anor*⁶, the IRD have used the case as authority for the view that unrealised profits can be taxed if they are recognised in the taxpayer's profit and loss account in its financial statements.
5. Possible ameliorating measures could include the introduction of a "loss carry-back" (see paragraphs 32-34, Part (C) of main proposal) and tax rulings. As tax rules will differ from jurisdiction to jurisdiction and reflect the fiscal policy of a particular jurisdiction, tax rulings could also be introduced to relieve the impact of taxing on an unrealised basis. For example, although accounting standards in the Mainland are converging with IFRS, the State Administration of Taxation ("SAT") has made it clear that it will not levy tax on the basis of changes in fair value in relation to financial assets and liabilities, investment property, etc., but will instead assess taxpayers' tax liabilities based on the "historical cost" method and realised income (see **Appendix 4.1** for the SAT notice).

⁵ Bauhinia Foundation Research Centre, "A Tax System to Enhance the Business Environment", May 2008, p. 64.

⁶ [2001] (1 HKRC 90-107).

State Administration of Taxation's tax notice 2007 no. 80

财政部 国家税务总局关于执行《企业会计准则》有关企业所得税政策问题的通知

财税〔2007〕80号

全文有效 成文日期：2007-07-07

字体：【大】 【中】 【小】

各省、自治区、直辖市、计划单列市财政厅(局)，国家税务局，地方税务局，新疆生产建设兵团财务局，财政部驻各省、自治区、直辖市、计划单列市财政监察专员办事处：

为便于企业执行 2006 年财政部发布的企业会计准则(以下称新会计准则)，协调会计与税收之间的政策差异，现就执行新会计准则的企业所得税政策问题明确如下：

一、企业对持有至到期投资、贷款等按照新会计准则规定采用实际利率法确认的利息收入，可计入当期应纳税所得额。对于采用实际利率法确认的与金融负债相关的利息费用，应按照现行税收有关规定的条件，未超过同期银行贷款利率的部分，可在计算当期应纳税所得额时扣除，超过的部分不得扣除。

二、企业按照国务院财政、税务主管部门有关文件规定，实际收到具有专门用途的先征后返所得税税款，按照会计准则规定应计入取得当期的利润总额，暂不计入取得当期的应纳税所得额。

三、企业以公允价值计量的金融资产、金融负债以及投资性房地产等，持有期间公允价值的变动不计入应纳税所得额，在实际处置或结算时，处置取得的价款扣除其历史成本后的差额应计入处置或结算期间的应纳税所得额。

四、企业发生的借款费用，符合会计准则规定的资本化条件的，应当资本化，计入相关资产成本，按税法规定计算的折旧等成本费用可在税前扣除。

本通知自 2007 年 1 月 1 日起执行，以前的政策规定与本通知规定不一致的，按本通知规定执行。

【打印】 【关闭窗口】

Transfer pricing regime
Detailed proposals

Measures proposed:

- *A comprehensive set of transfer pricing rules should be introduced, preferably through legislation.*

1. Transfer pricing is an issue that is routinely raised during field audits. Therefore, in line with many overseas tax jurisdictions, proposals for a comprehensive transfer pricing regime should be explored, including the introduction of specific transfer pricing legislation in the IRO and issuance of a practice note with detailed guidance to taxpayers.
2. Dealing with transfer pricing issues through a general provision under section 20 of the IRO is inadequate, as demonstrated in the recent court case *Ngai Lik Electronics Company Limited Vs CIR*⁷, where the IRD had to invoke the anti-avoidance provisions in section 61A of the IRO to defeat certain group transfer pricing arrangements. It is anticipated that enacting specific legislation or providing guidelines on transfer pricing would have no immediate revenue implications. However, in the longer term, the revenue implications would be positive, as such legislation or guidelines would help Hong Kong protect its tax base⁸.

⁷ [CACV 22/2008].

⁸ Bauhinia Foundation Research Centre, "A Tax System to Enhance the Business Environment", May 2008, p.62.

Finalisation of tax affairs
Detailed proposals

Measures proposed:

- *The statutory time limit for reopening of assessments (except in cases of fraud) should be shortened from six to three or four years.*
- *A statement of loss should be treated as an assessment, be binding on the IRD and open to objection by taxpayers.*
- *Consideration should be given to deeming tax returns to be final if no enquiry has been raised on them within a reasonable period (for example, 12 months).*

1. Taxpayers should be entitled to timely resolution of their tax affairs for each year. The finalisation of tax affairs within a reasonable period of time would improve certainty among taxpayers. Suggested measures include:

Shortening the statutory time limit

2. Shortening of the statutory time limit for reopening an assessment, from the current six years to three to four years (subject to an extension to ten years in the case of fraud). It is anticipated that shortening of the statutory time limit would be revenue neutral but it may have some resource implications for the IRD⁹. A list of comparable limitation periods in different jurisdictions is available in **Appendix 6.1**, a number of which cases are shorter than Hong Kong's.

Issuance of statement of losses

3. Statements of losses should be issued within a definite period of time, and should be accorded the same status and treatment as a notice of assessment. Under the current practice, where the IRD does not confirm losses, assessors may require details of a company's business beyond the seven-year statutory period for the retention of accounting records. In addition to the practical inconvenience of having to retain records for extended periods, taxpayers are uncertain whether their losses, which remain unconfirmed, are available for setting off against profits for future years. The issues involved are illustrated in the case of *CIR Vs Common Empire Limited*¹⁰.
4. We recommend that legislative changes be made so that a statement of loss is treated as an assessment, is binding upon the IRD, and can be objected to by taxpayers. Such statements should also be issued within a reasonable and definite period of time after the relevant year of assessment. This should not create significant additional work for the IRD, or result in a loss of government revenue.

⁹ Bauhinia Foundation Research Centre, "A Tax System to Enhance the Business Environment", May 2008, p. 49.

¹⁰ [CACV 83/2006].

Deeming returns as final

5. Consideration should be given to deeming a tax return as final, if no enquiry has been raised within, say, 12 months from the filing of the tax return. Under the IRD's "Assess First, Audit Later" system, it has become more likely that a taxpayer's tax affairs will not be concluded for a particular year of assessment until the completion of the statutory time limit. Moreover, the IRD also has the power to issue protective assessments just before the expiry of the statutory time limit. Therefore, effectively, a taxpayer's affairs could be left unresolved for more than the statutory six-year period. In the United Kingdom, for example, the tax authority has made a commitment to taxpayers that if, no enquiry has been initiated on a filed tax return within 12 months, the return will normally become final.

Statute of limitations in different jurisdictions

Detailed Recommendation

Time-bar Provisions (cont'd)

Statute of limitations	
Australia	Generally speaking, corporate tax returns are subject to a limited review period of 4 years from the date of assessment (including in the case where there is no taxable income or tax payable) for the relevant year of income. An unlimited review period applies in the case of fraud or evasion, and other specific transactions listed in the Tax Act (e.g. adjustments relating to transfer pricing etc).
Canada	A 4 year limit applies to companies that are not Canadian Controlled Private Corporations as defined (3 years in such case). An extension to 7 years applies most commonly to transactions with non-arm's length non-residents and can be affected by treaties. There is no time limit in case of fraud or negligence.
France	The time limit for assessments of corporate income tax expires at the end of the third calendar year following that for which the tax is due. When tax fraud is proven, the time limit is increased by 2 years.
Germany	The regular period for the statute of limitations is 4 years. The period is extended to 5 years for negligent tax fraud and to 10 years for wilful tax fraud.
Japan	The basic statute of limitations is as follows: <ul style="list-style-type: none"> - 5 years from the day after filing due date: in case of underreported tax; - 7 years from the day after filing due date: in case of tax evasion; - 7 years from the day after filing due date: in case of adjustment of tax losses; and - 6 years for transfer pricing purposes.
Korea (ROC)	The statute of limitations is 5 years.
Malaysia	The statute of limitations is generally 6 years from the end of the year of assessment. But no time limit exists where there is fraud or wilful default.
Netherlands	The statute of limitations for making an assessment is 3 years from the end of the fiscal year, extended by the granted extension for filing the tax return. The tax authorities can issue an additional assessment within a period of 5 years, starting from the end of the fiscal year (extended by the granted extension for filing the tax return) if new information obtained proves that the initial assessment was made in an amount lower than the actual tax liability. With respect to foreign-source income, the period for making an additional assessment is 12 years.
New Zealand	The period within which amended assessments may be issued is limited to 4 years from the end of the year in which the return was provided, but this limitation is not applicable where the return is fraudulent, wilfully misleading or omits gross income of a particular nature or from a particular source.
Singapore	Assessments and additional assessments may be made within 6 years (if the year of assessment is 2007 or earlier) or 4 years (if the year of assessment is 2008 or a later year). No time limit exists if there is fraud or wilful default.
Taiwan	Five years after the tax return has been accepted as final. The period is extended to 7 years after the due date of the return where the return has not been filed or taxation has been evaded due to fraud.
Thailand	The tax authorities can undertake a tax examination within 2 years following the date a tax return was filed. The tax authorities can issue an assessment within 10 years where it believes a company has evaded tax.
United Kingdom	General rule - if no enquiry is opened then the period is deemed to be agreed 2 years from the end of the accounting period. However, if the tax return is submitted on time, the tax authorities have 1 year from the due date of submission to enquire into the return. In case the tax authorities become aware of something they should have been made aware of, the limit within which the tax authorities may issue an assessment for a particular period is 6 years after the end of that period. Where a company acting on its behalf is guilty of fraudulent or negligent conduct an assessment may be made at any time not later than 20 years after the end of the accounting period to which the assessment relates.
United States	Generally, 3 years from the date of the tax return, or the date of filing, whichever is the later. There are a number of circumstances that could extend the statute of limitations to more than 3 years.

Personal assessment provision
Detailed proposals

Measures proposed:

- *Spouses should no longer have to be jointly assessed if they wish to opt for "personal assessment".*

1. The requirement for spouses to be jointly assessed under personal assessment is an outdated provision in the tax system and should be reviewed. Personal assessment was introduced some decades ago, for the purpose of reducing tax for certain individual taxpayers who were chargeable to profits tax and property tax. At that time, it was not as usual for both spouses to work and so they would not often have income assessable to tax. Therefore, the tax impact was generally the same regardless of the marital status.
2. Society has changed since then. As both spouses are often working and generating income assessable to tax, electing for personal assessment as a married couple results in having to pay more tax than as two separate individuals. This disadvantage arises due to the availability of progressive tax rates at lower levels of income. Married couples electing for personal assessment enjoy the benefit of the progressive tax rates on a single aggregated income only. This inequality in the tax regime, in effect, discriminates against individuals who are married.
3. Married taxpayers can elect for joint assessment if they wish to do so but, in the contemporary environment, where couples are often economically independent, it is not appropriate to require the total income of both husband and wife to be aggregated and assessed as one income under personal assessment. Personal assessment should be based on an individual's aggregate income without taking into consideration his or her marital status.

Taxation of property gains
Detailed proposals

Measures proposed:

- *Consideration should be given to introducing a clearer distinction between trading and investment for tax purposes by reference to, for example, the holding period.*

1. While trading in property is, in principle, already taxable, the definition of “trading” is not entirely clear. Reference is generally made to the long-standing concept of the “badges of trade”, but in practice each case has to be argued on its own merits. One option would be to have a bright-line distinction between a trading gain and investment.
2. Even though the length of the holding period is considered to be one element of the “badges of trade”, it creates uncertainty for taxpayers, as the length of the period is not specified. As a point of reference, it should be noted the Inland Revenue Service in the United States uses a holding period of one year to distinguish short-term versus long-term capital gains¹¹. Consideration should be given to adopting a similar clear cut off in Hong Kong. We would propose a holding period of three years in Hong Kong and that this should be applicable to both commercial and residential property. In relation to new buildings, the three-year period should be counted from the date of completion. The family home should be exempted from this measure.

¹¹ <http://www.irs.gov/newsroom/article/0,,id=106799,00.html>

Broadening Hong Kong's tax base
Detailed proposals

Measures proposed:

- *Options to broaden the tax base should continue to be explored.*

1. In the 2008/09 Budget Speech, the government stated it would continue to study options on broadening the tax base. We believe that the government should continue to explore options to broaden the tax base, as the narrowness of Hong Kong's tax base is not an issue that will go away, given the challenges faced by Hong Kong including:
 - (a) over reliance on volatile source of revenue,
 - (b) an aging population and low birth rate, thus reducing the size of the work force and increasing health care costs, and
 - (c) need to improve the environment and consider long term sustainability policies, not just economic growth.
2. We believe that the increasing competitiveness of other jurisdictions and the lack of productive and reliable, non-volatile sources of recurrent revenue, poses a threat to Hong Kong's ability to address current and longer-term economic challenges.
3. Various possible options for broadening the tax base are contained in the Institute's March 2007 submission to the government (the executive summary of which is copied at **Appendix 9.1**). Whilst the Institute concluded, at that time, that no single option would be better than a goods and services tax in meeting the key objectives of broadening the tax base, causing minimal economic distortions, achieving a substantial yield at low rates of tax, etc. the submission also suggested that other possible options should be further explored, including, payroll and social security taxes; a single stage retail sales tax; a surcharge on utility supplies and green taxes.

Executive summary of the Institute's submission
on broadening the tax base – March 2007

Introduction

1. Following the release of the government consultation document, *Broadening the Tax Base - What's the Best Option for Hong Kong* in July 2006, the Institute conducted members' forums and set up a working group (the Working Group on Tax Reform ("working group"), originally called the GST Working Group) under the Taxation Committee to prepare the Institute's response, and also to help inform members about the main issues in the debate surrounding a goods and services tax ("GST") and to canvass views from members. The working group launched a dedicated website and issued a series of e-letters to members addressing key issues in the debate on reform of the tax base and a GST and inviting views on those issues through the website. In November 2006, the Institute commissioned an independent market research company to conduct a members' survey on broadening the tax base and a GST.
2. On 5 December 2006, the government published an Interim Report on the consultation and the Financial Secretary ("FS") announced that, in the light of the generally negative response to the consultation proposals, for the remainder of the period of public consultation until 31 March 2007, the government would not be advocating GST as the only or the main option to broaden the tax base.
3. The Institute subsequently held a members' forum on 11 December 2006 attended by the FS at which views were exchanged on other options. Shortly thereafter, on 14 December 2006, the Institute announced the results of its members' survey and submitted a summary of the survey results to the government. We also indicated that a further submission on the consultation document would be made in due course, which would examine a range of options for reform of the tax base. Since then, the working group has been working on a revised submission taking into account the change in the government's position.
4. The submission comprises two main parts: Part A looks at options other than a GST to broaden the tax base, while Part B considers the GST option. The detailed format is governed by the key questions contained in the government's consultation document, which the submission answers in the order in which they appear. The full results of the Institute's survey of members, which provides more information on the response to detailed GST-related questions than the summary sent to the FS in December 2006 are appended to the submission.

The submission

5. Having examined a number of different options to broaden Hong Kong's tax base, the Institute concludes that, prima facie, there is no option that, by itself, would be better able than a GST to meet the objectives of broadening the tax base, reducing volatility in revenues, causing minimal economic distortions, achieving a substantial yield at relatively low rates of tax, etc. However, if a GST is not to be pursued, there are other options that merit further study.

Part A

6. In Part A, the submission examines the following options:
 - increasing rates of salaries tax and profits tax

- decreasing personal allowances
 - payroll and social security taxes
 - poll taxes
 - increasing rates on tenements
 - increasing stamp duty on property
 - increasing stamp duty on stock transactions
 - capital gains taxes
 - taxation of interest income
 - dividend tax
 - tax on worldwide income
 - wholesale or retail sales taxes
 - air, land and sea departure tax
 - taxes on mobile phones and signboards
 - selective consumption taxes
 - import/export levy
 - financial transactions tax
 - environmental or green taxes
 - surcharge on utility supplies
7. For a variety of reasons, many of the above options were found to be unsuitable; for example, they continue to rely on the same narrow tax base and on direct taxation; they are too volatile or too easy to avoid; they conflict with the existing simple tax system because, for example, definitional and other technical difficulties would make them complex; they would provide a low yield (e.g., because Hong Kong taxes according to the source principle, so revenue from an overseas source would be non-taxable); the potential downside, possibly combined with other of the afore-mentioned factors make them unappealing.
8. Nevertheless, the Institute suggests that, in the absence of GST, certain options, mainly those indicated below, should be examined in more detail, either on their own, or as part of package of measures that together could achieve a yield of a similar order to a GST. These options are not without disadvantages, which we note.
- Payroll and social security taxes: Such taxes are fairly common overseas. This is a broad based form of tax and, if introduced in Hong Kong, could give more people a direct and visible stake in Hong Kong's future economic and social development. On the downside, such taxes would not reduce reliance on direct taxation. The Advisory Committee of New Broad-based Taxes ("Advisory Committee") calculated that each 1% in the form of a payroll tax would generate \$5.8 billion annually.
 - Increasing rates on tenements: The Advisory Committee noted that "rates do provide a broadly-based stable source of revenue that is relatively less affected by cyclical movements in business profits and, to a significantly lesser extent personal incomes. Rates are very much broader-based than either profits tax or salaries tax... The mechanism to increase rates is simple and an increase in the level of rates generates meaningful additional revenue". However, the disadvantage is that Hong Kong already relies heavily on property-related taxes and a significant increase in rates might be a disincentive to businesses locating here.
 - Increasing stamp duty on stock transactions: The duty currently stands at 0.2% per transaction shared between the vendor and the purchaser. While

the trend internationally may be to reduce this form of taxation, Hong Kong can be distinguished from other markets as it has no capital gains taxes, no dividend tax, limited withholding taxes, etc. The growth in revenue from this source is due in part to the increase in market turnover resulting from Hong Kong's status as a capital-raising centre for Mainland enterprises. Stamp duty on stock and real property transactions in 2006/07 increased from an original estimate of HK\$14.8 billion to a revised estimate as at 1 March 2007 of HK\$23.4 billion. Much of that increase is believed to be from stock transactions. This form of taxation is quite broad based given the strong retail element in Hong Kong's securities market. On the downside, this will inevitably remain a relatively volatile source of revenue.

- Single stage retail sales tax ("RST"): RSTs have in the past been fairly common and they still operate in most of the individual states of the United States. A single-stage RST would be broad based and could be less complex than GST, particularly if charged on presumptive rather than individual transaction basis. At the same time, it would not have the self-checking feature of a multi-stage consumption tax, it could be seen as regressive in the same way as GST, and could give rise to disputes between taxable entities and the tax authorities, where retail sales form only part of a firm's business.
- Air, land and sea departure tax, in particular a tax on land crossings between Hong Kong and the Mainland: This form of tax was under consideration for several years, although the proposal was eventually dropped by the government. Such a tax would be broad based and, in our view, equitable. On the other hand, at a rate of about HK\$20 per crossing to the Mainland, it would raise only around HK\$2 billion and, were numerous exemptions to be given, e.g. to people who cross the boundary on a daily or frequent basis, the tax would become more complex to administer, more selective and less broad based.
- Environmental or green taxes: Revenue from environmentally related taxes averages roughly 2% of GDP in OECD member countries. This would amount to around HK\$30 billion were Hong Kong to achieve the same, whereas we estimate that, in 2005/06, the actual figure was less than 1% in Hong Kong. While we recommend that a feasibility study should be carried out on introducing a comprehensive green tax regime in Hong Kong, green taxation would not provide an ideal alternative to a consumption tax, as the yield would be uncertain and the issue is complicated by the social policy objectives that would be inherent in any system of environmental taxation.
- Surcharge on utility supplies: A surcharge on utility supplies, such as gas and electricity, could be easily calculated and conveniently collected by the utility companies on behalf of the tax authorities. It would also be broadly based but, at a low rate, it would not generate large amounts of revenue. Based on the published accounts of electricity and gas companies for the year ended 31 December 2005, a levy of 5% would generate tax revenues HK\$2.25 billion and each percentage of tax (levied on turnover) would generate between HK\$450 million and HK\$475 million.
- Dividend tax: A dividend tax may also be worth considering, although, on balance, it may well be that the disadvantages would outweigh the advantages. This would be the case particularly if the proposal were to involve an imputation system, to credit the recipient with the corporate tax paid on the profits from which the dividend derives.

Part B

9. Part B of the submission looks at a GST in the light of the reaction from the community and the findings of the survey of members of the Institute. The framework and design features proposed in the consultation document, such as exemptions, compensatory and assistance measures to households and businesses, are examined and commented upon.
10. While at the macro level, the Institute is broadly supportive of the framework proposed in the consultation document (which incorporates a number of the design features advocated by the Institute in a GST system), the main conclusion in this part of the submission is that, if the government is to revive the GST proposal in the future, then various issues need to be addressed which have not been covered in the current proposals or not in sufficient depth to remove the considerable uncertainties. These issues include:

- The lessons that should be learned from jurisdictions where a GST has been implemented fairly smoothly and also from problem implementations
- A commitment should be given to conduct more detailed economic and fiscal modelling and forecasting to test any proposed system
- Concerns expressed by the community during the consultation need to be addressed in greater depth, such as the impact of a GST on low- and fixed-income groups, including retirees and on Hong Kong's competitiveness
- More emphasis needs to be placed on education and information in the first instance, e.g., how moving away from direct taxation towards more indirect taxation provides the individual with greater choice and can encourage both saving and investment

Consideration needs to be given to the type of GST system that might be more acceptable in Hong Kong. As the main objective at the outset is not to raise revenue, it could be introduced at a lower rate (e.g., 3%). Were a policy of minimal exemptions and zero-rated items to be adopted, more work would need to be done to explain the rationale to the community, and a review of the adequacy of the compensation package would need to be conducted, which would take account of e.g., the impact of taxing basic services

- More information is needed about the real costs to small and medium-sized businesses where they voluntarily register, and the implications for them where they do not register
- More information should be provided on the impact on the import/export trade
- Information should be provided as to the pre-GST educational programmes and pre- and post-GST support services that would be available to help manage the transition
- Answers should be given to questions about administration, both structural (e.g., who would administer the tax and how would staff be trained? Matters

relating to investigation and enforcement and dispute resolution) and procedural (e.g., impact of group transactions and arrangements for bad debt relief).

11. In terms of the economic and industry sector impacts, the Institute feels that the direct and indirect impacts of the introduction of a GST in Hong Kong may have been underestimated in the proposals.
12. As regards returning the additional funds raised from GST back to the community, in principle the Institute supports reductions in profits and salaries taxes. However, the submission makes the point that the introduction of a GST should be part of a cohesive package of tax reforms, which should include incentives for business and offsetting benefits for different groups of taxpayers (including the middle income group) and for low income earners. A study on Hong Kong's competitiveness should be conducted to determine the most appropriate package of measures to maximise benefits to the overall economy.