Hong Kong Society of Accountants

Hong Kong : Re-enter the Dragon

HKSA PROPOSALS FOR THE 2002/03 BUDGET

CONTENTS

1. OVERVIEW

1.1 INTRODUCTION

We live in interesting but uncertain times. In the past 4.5 years, Hong Kong has felt keenly the impact of major local, regional and global events. Having experienced a smooth transfer to Chinese sovereignty, Hong Kong then weathered the storm of the Asian financial crisis, which was followed quickly by a period of global slowdown, with diminishing expectations of a quick recovery. Now the whole outlook has been thrown into an even greater and more unexpected state of uncertainty by the terrorist attacks in the United States in September and the fall-out from these, the short-term effect of which may well be to hit specific activities and sectors harder than others. On a more positive note, after more than a decade, the Mainland has finally entered into the World Trade Organization ("WTO"). While this should provide a boost for global trade it brings with it particular challenges and opportunities for Hong Kong.

More than ever in recent times Hong Kong must deal with both immediate and longer-term problems. We appear to be on the brink of a further period of recession of an indeterminate duration and consumer confidence is already low. Unemployment is on an upward trend again. Economic growth projections have been revised downwards several times despite rapidly decreasing interest rates. Many households are locked in a situation of negative equity in relation to their principal investment namely, their property. Something may also need to be done to ease the burden of the worst-off members of the community but whatever measures are taken must not jeopardise or compromise our reputation for, and commitment to, free, open and competitive markets.

Putting aside for a while our immediate difficulties, more needs to be done to lend substance to the vision of Hong Kong as a World City, in terms of our economy, culture and social development. As much as anything else the community needs to regain its self-confidence. Lack of confidence tends to feed on itself allowing worst fears to become self-fulfilling prophecies. Hong Kong must revive the entrepreneurial spirit and "never say die" attitude which has made this small place such a glittering success in the past. This will not be an easy task and it will be necessary for the community to work together to harness the very best qualities that this modern vibrant city has to offer - the talent, inspiration, experience and work ethic. Still, Hong Kong has shown the resolution to overcome significant difficulties in the past and we believe that it can do so again in the future. The title of the Society's Budget submission this year - ***Hong Kong: Re-enter the Dragon*** - incorporating references to Hong Kong's past and present, reflects the spirit, strength, resourcefulness and confidence that have helped Hong Kong to achieve its present status and which we will need to call upon again to meet the challenges that we now face.

At the practical level, firmly establishing Hong Kong as a World City does not simply mean mimicking laws and regulations adopted in other jurisdictions. There is no reason why high standards of practice and conduct cannot be achieved while also recognising and being proud of Hong Kong's uniqueness. We should absorb, filter and adapt to our own circumstances and requirements, as appropriate, ideas and practices that may reflect current trends in other countries.

Clearly, we will not be able to find the solutions to all the various challenges facing Hong Kong simply by putting our tax regime under the microscope. However, the tax structure can provide a useful adjunct and support to other policy measures and can constitute an important element in the overall legal and policy framework that represents one face of Hong Kong to potential and actual investors. Maintaining and further developing a favourable, clearly-delineated and predictable system of taxation remains important to the future of our economy, as does promoting the qualities and benefits of our system to the rest of the world. In this submission, the Society considers some tax-related measures that might assist our efforts to achieve our immediate and longer-term goals.

1.2 *ECONOMIC OUTLOOK*

In mid-November 2001, the Chief Executive warned the public that Hong Kong could expect several quarters of negative growth. However, the third quarter economic figures actually showed better than expected statistics with marginal growth of 0.4% over the second quarter, although this reflected a 0.3% decline over the same quarter in 2000. This prompted the Government to revise downwards the 2001 GDP forecast to 0%, following previous forecasts for real GDP growth of 1%, in August 2001, 3%, in May, and 4% at the time of the 2001 Budget Speech. Negative growth is still expected in the final quarter of the year.

Prior to the release of the third quarter figures, in November 2001 the Asian Development Bank (ADB) had already downgraded its forecast for Hong Kong's GDP growth (from 4% in April 2001) to minus 0.4% for the year, whilst predicting that the downturn would be short-lived with growth of 2% expected next year assuming the global downturn ends by the middle of 2002. However, the frequency and size of the revisions in forecasts more than anything else reflects the underlying uncertainties in world and regional markets. This is further evidenced by statistics from the United States which showed in October the strongest increase in consumer sales for any month on record following declining confidence prior to that and, not surprisingly in view of the September 11 terrorist attacks, a large fall in September 2001. However, at the end of November 2001, the US Commerce Department announced that, taking into account of all the indicators, in practice the US economy had been in a recession since March 2001. The OECD overall is projecting the combined OECD economies' GDP to contract 0.3% in the second half of this year, the first contraction in 20 years, and growth is expected to be weak, at 1%, in the first half of 2002. Japan's economy was also weak prior to September 11. The Japanese Government is expecting Japan's economy to contract by around 1% in the year to March, the worst figure for many years, following an earlier forecast of 1.7% growth and unemployment, at 5.5%, is at the highest level in decades. Elsewhere in this region, the Taiwan Government has also reduced its GDP forecast for the year to -0.37% from its original estimate of 6.48% growth and some economists in Taiwan believe that the final figure will be more like -1.5%. Singapore is also facing a contraction of around 3% and Malaysia's third quarter figures were also in negative territory. However, the Philippines Government is still expecting the Philippines to achieve its targeted positive growth of 3.3%. Furthermore, despite the general pessimism throughout much of the world, at least in the short-term, the OECD, the International Monetary Fund and the ADB, all forecast solid growth for the Mainland of 7.3%-7.4% for 2001 and 6.8%-7.2% for 2002, which continues to represent opportunities for Hong Kong businesses.

In Hong Kong, in the third quarter of 2001, the Composite CPI fell by 1.0% over a year earlier. For the 12 months ended September 2001, the Composite CPI was on average 1.7% lower than in the preceding 12-month period. In October the CPI fell a further 1.2%, which represents 3 years of continuing deflation so far. Retail sales in September 2001 were down 4.4% year-on-year by value and 1.7% by volume.

The unemployment rate rose again to 5.5% in the period August-October 2001, up from 5.3% in July-September. This translates to around 194,000 people (up 8,400) out of work. Under-employment rose to 2.6% (representing 91,000 people, an increase of 6,600), up 0.1% from July-September and 0.4% from the previous three-month period.

1.3 FISCAL POSITION

The 2001 Budget projected a HK$3 billion overall deficit for 2001 - 2002. The actual figure is now likely to be much higher with land sales falling far below estimates, the deferral of the sale of further shares in the Mass Transit Railway Corporation which were expected to raise $15 billion, and a general decline in Hong Kong's main external markets following the events of September 11. Some analysts are now predicting a deficit of between $50-70 billion, but the actual figure will depend to some extent, as always, on patterns of expenditure in relation to e.g. capital works. Fiscal reserves stood at HK$430 billion as at 1 April 2001. These had fallen to $367.3 billion by 31 October 2001, which is due partly to the difference in timing between the main periods of public expenditure and income and falls in stock prices.

As at 31 October 2001, the foreign currency reserves held by the Exchange Fund stood at US$113.1 billion compared with $102.7 billion at 31 October 2000. This makes Hong Kong the world's fourth largest holder of foreign currency reserves, after Japan, the Mainland and Taiwan.

Overall the fiscal position of the Government remains sound but whether this will be so in the longer term will depend on the speed of the recovery world-wide and the fundamental nature of the revenue/expenditure shortfalls that are currently being experienced in Hong Kong. In relation to the latter, the findings of the Task Force on Review of Public Finances are still awaited.

1.4 CONTROLLING PUBLIC EXPENDITURE

In the light of the economic circumstances prevailing in Hong Kong, and globally, and with a projected deficit now substantially greater than that originally forecasted, the Government needs to look critically at its own expenditure. While it would not for example make sense to discontinue essential public works and infrastructure projects, which can themselves help to stimulate the economy generally, there may be other areas of expenditure where further efficiency savings can be made and more effective supervision can help to minimise any waste. All options should be considered. However, the Society's submission, in keeping with our past practice, focuses on the revenue side of the accounts and not upon the expenditure side.

1.5 SUMMARY OF PROPOSALS

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

BUSINESS

Improving the business environment generally in Hong Kong

Immediate measures

1) There should be no change in the rates of profits or property taxes. (P. 15)

2) To mitigate the impact of provisional profits and property tax assessments on the cash

flow of new businesses, which may currently be required to pay two years' worth of tax in their second year of operation, the liability for the provisional element in the first profits tax and property tax assessments should effectively be payable in stages over three years. (P. 15)

3) Deductions should be allowed, subject to qualifying criteria, for interest incurred or paid on money borrowed at arms' length from overseas associates for the production of assessable profits. (P.15-16)

4) Provision for group relief should be introduced in Hong Kong. (P. 16)

5) Losses incurred in the current year of assessment should be able to be carried back for one year to be offset against assessable profits in the previous year. (P. 17)

6) A tax credit should be given for overseas withholding tax on the export of services. (P. 17)

Medium to longer term measures

7) The provisions of s16G of the Inland Revenue Ordinance (IRO) should be reviewed with the aim of broadening the definition of "prescribed fixed asset" to provide an immediate 100% write-off for research and development in fields such as the fashion design, film and professional service sectors. (P. 18)

8) An immediate 100% deduction should apply to the costs incurred in upgrading commercial buildings for the purpose of adapting to hi-tech usage requirements or making the building more environmentally friendly, subject to qualifying criteria being met. (P. 18)

9) The $40,000 allowance for self-education should be increased to $60,000 in relation to information technology (IT), logistics, design/creation, film production, hospitality, environmental enhancement and languages and related undergraduate, postgraduate or professional training courses. (P. 18)

10) Deductions of a multiple of actual expenditure should be offered to employers who send staff on recognised Potunghua, English or other language training programmes. A range of suitable language programmes should be approved for the purpose of the deduction. Business sector sponsors of suitable language training programmes should be able to claim deductions of a multiple of the cost of sponsorship, subject to qualifying criteria being met. (P. 19)

11) Courses on e.g. basic principles of commercial law should be run to assist small businessmen to set up their own businesses and to provide on-going business advisory services (for

small and medium-sized enterprises). The cost of attending such courses should be deductible as to a multiple of actual expenditure and sponsors of approved courses should be able to claim deductions of a multiple of the costs of the sponsorship, subject to qualifying criteria as to whether, e.g. the recognised institution offering the courses is a local or an overseas institution. (P. 19)

12) Tax incentives by way of, e.g. full or partial salaries tax exemption for up to five years should be offered to attract professionals with specific high-level skills from overseas to work in those sectors, e.g. IT, in Hong Kong which have a shortage of skilled professionals, subject to qualifying criteria being met. (P. 19)

13) A concessionary 50% tax exemption on profits should be available to businesses manufacturing goods in Hong Kong for export. (P. 20)

14) Consideration should be given to extending the concession proposed in (13) above to all manufacturing in Hong Kong for a period of, say, five years, to encourage the retention of a manufacturing base and provide greater employment opportunities. (P. 20)

15) A profits tax exemption should be granted to regional headquarters established in Hong Kong, in respect of management and consultancy income derived from associated entities overseas. (P. 21)

Incentives for specific business sectors

Financial services

16) Fund management and trustee services within the fund management industry should be eligible for a 50% reduction in the rate of profits tax. (P. 22)

17) The existing profits tax exemption for overseas mutual fund corporations investing in Hong Kong should be extended further. (P. 22)

18) The stamp duty rate on share transactions should be further reduced to 0.15%. (P. 23)

Information Technology

19) A reduction in the profits tax rate by, say, 50% should be offered to investors, e.g. venture capital companies which invest a prescribed minimum amount in IT companies or projects in Hong Kong, which have a certain percentage and number of employees residing in Hong Kong. (P. 23)

20) An outright deduction from salaries tax of $30,000 should be allowed for the purchase of personal computers and related software, including the basic cost of subscribing to an Internet Service Provider. (P. 24)

Logistics

21) To further the initiatives mentioned in the Chief Executive's Policy Address (p.19, 20) with respect to developing Hong Kong as a logistics centre, logistics businesses, whether existing or start-ups, according to prescribed criteria, should benefit from a 50% reduction in profits tax rate for an initial period of five years. (P. 24)

Design/creation

22) Under section 15(1)(b) of the IRO, sums payable to a person for the use of or right to use intellectual property in Hong Kong are deemed to be taxable receipts from a trade, profession or business carried on in Hong Kong. Under section 21A of the IRO, the assessable profits of a person in respect of such taxable receipts are taken to be 10% of the sum derived from a party which is not an associate. To encourage greater utilisation of intellectual property for design/creation-related work in Hong Kong and so enhance the climate for innovation and invention, the deemed percentage of 10% under section 21A should be reduced to 0%. (P. 24)

23) To encourage greater invention and innovation in fields such as tourism, urban renewal, environment and safety, which will also have a positive impact on the quality of life in Hong Kong, incentives should be offered to private sector entities by way of deductions for multiples of actual expenditure on approved initial design-related consultancy work (which is not subsequently capitalised, see item 24 below) with respect to, e.g. construction, tourism infrastructure, environmental enhancement, security and anti-terrorism projects. (P. 24-25)

Tourism/culture

24) Subject to approval as significant capital projects on a case-by-case basis, incentives such as an immediate write-off in the year that the expenditure is incurred should be provided for significant environmental enhancement or anti-pollution projects aimed at upgrading or improving the local infrastructure (including, where appropriate, any capitalised initial design-related feasibility/consultancy work). (P. 25)

25) Consideration should be given to offering tax concessions to encourage the staging of major international attractions in Hong Kong. These could include, e.g. a partial profits tax exemption for promoters in relation to staging certain types of events here. (P. 25)

26) Incentives, e.g. an immediate write-off in the year that the expenditure is incurred should be provided for building and operating world-class sports and entertainment complexes, and theme parks, to be approved on a case-by-case basis in the future. (P. 25)

27) Hotel and restaurant refurbishment should be eligible for an immediate write-off in the year that the expenditure is incurred. (P. 26)

28) Incentives in terms of, e.g. deductions for multiples of the actual costs incurred should be made available for employing traditional craftsmen/artists in craft or artistic creation in the context of specific tourist attractions, such as theme parks, hotels and restaurant premises, with the aim of preserving and fostering Hong Kong's unique cultural heritage. (P. 26)

29) Incentives by way of an immediate write-off in the year that the expenditure is incurred should be provided for the restoration of old buildings on a case-by-case basis, with the aim of preserving and supporting Hong Kong's varied architectural and cultural heritage. Consideration should be given to the establishment of a Heritage Commission to assist in the development of policies and the implementation of practical measures to promote the preservation of significant and worthwhile aspects of Hong Kong's cultural and physical history. (P. 26)

30) Hotel accommodation tax should be reduced or, if possible, abolished. (P. 26)

The film industry

31) The measures proposed under items (7) and (12) above should bear in mind the needs of the local film industry amongst others. Thus the limited salaries tax concession proposed under (12) could be extended to skilled technicians in this industry, where there is a demand for certain skills and a shortage of supply locally. Incentives should also be considered to encourage e.g. co-productions between Hong Kong and the Mainland, and Hong Kong and other overseas film makers, shot wholly or partly in Hong Kong. In addition consideration could be given to extending the definition of "prescribed fixed asset" under s16G of the IRO to other plant and equipment used in the film industry. (P. 27)

The fashion design industry

32) Similar incentives to those proposed for the film industry in (31) above should also be made available to the fashion design industry in Hong Kong. (P. 27)

Improving business in Hong Kong as part of China and enhancing Hong Kong's position as the Mainland's natural trading partner

Measures to enhance co-operation in the Pearl River Delta Region

33) Existing depreciation allowances for relevant port facilities and equipment and related cross-border (land) haulage transport should be enhanced to provide an immediate 100% write-off in the year of purchase for such items. (P. 28)

34) Consideration could also be given to reducing the first registration tax for other commercial road vehicles e.g. vans and coaches which are used mainly for cross-border transportation between Hong Kong and the Mainland in the ordinary course of business of their owners. (P. 28)

Capitalising on the opportunities in the Mainland - the WTO, the 2008 Olympics, etc.

35) Courses should be run to assist small and medium-sized businesses to enter into the Mainland's market and to provide related advisory services to small and medium-sized enterprises. Subject to qualifying criteria being met, the cost of attending such courses should be tax deductible up to a multiple of actual expenditure, and sponsors of approved courses should be able to claim tax deductions of a similar multiple for such sponsorship. (P. 28)

36) A Resources Centre should be established to provide information, courses and a mechanism for networking in respect of WTO-related developments. This could be, e.g. a joint private sector/education sector project. Multiples of the actual costs of using the centre, e.g. subscriptions, attendance fees, search fees should be deductible. (P. 29)

37) An immediate deduction in the year of expenditure should be granted to Hong Kong businesses for the initial capital costs of fitting out liaison/representative offices in the Mainland. (P. 29)

38) Consideration should be given to providing tax incentives by way of, e.g. deductions for multiples of actual expenditure for consultancy/feasibility work in relation to bidding for projects related to the 2008 Beijing Olympics, subject to eligibility criteria being met. (P. 29)

The taxation of Hong Kong-Mainland cross-border businesses - reviewing apportionment and the double taxation arrangement

39) The Inland Revenue Rules and the relevant Departmental Interpretation & Practice Notes (DIPN) issued by the Inland Revenue Department (IRD) and related administrative arrangements dealing with the issue of apportionment should be reviewed and expanded with the aim of ensuring that they cater fully for the contemporary Hong Kong as an exporter of services. (P. 30)

40) Greater flexibility should also be provided in relation to recognising different forms of processing agreements. (P. 30)

41) The on-going discussions on expanding the scope of the arrangement for the avoidance of double taxation on income between the Mainland and Hong Kong (the Arrangement) should proceed rapidly so that Hong Kong will not be at a disadvantage as against jurisdictions with comprehensive double tax treaties with the Mainland (which cover, e.g. interest and royalties), once competition increases with the Mainland's entry into the WTO. (P. 30-31)

42) Upon revision of the Arrangement, it should then be subject to review by the Mainland and Hong Kong authorities on an annual basis (rather than every five years) as a matter of good practice. (P. 31)

PERSONAL TAXATION

Rates of salaries taxes and allowances

43) There should be no change to the rates of salaries tax, or to the amounts of personal allowances in 2002/03 , except as indicated in Schedule 1. (P. 31)

44) To mitigate the financial impact of the provisional salaries tax assessment on new employees in the first year after they join the workforce, who may currently be required to pay two years' worth of tax in their second year of work, the provisional element in their first salaries tax assessment should effectively be payable in stages over three years. (P. 31)

Estate duty

45) The need for, and the operation of, estate duty should be thoroughly reviewed. (P. 32)

If it is considered that estate duty should be retained, it is proposed that a review of the

Estate Duty Ordinance should be undertaken with the following objectives: (P. 32)

- Eliminating various anomalies, e.g. the problem of the wide definition of a "controlled company" might deter some overseas investors from investing in Hong Kong listed shares through a personal investment company as the HK$7.5 million threshold, below which disclosure is not required to be made, does not apply to these cases, and
- Improving the drafting of its provisions with simpler and clearer wording.

IMPROVING THE TAXATION SYSTEM

Broadening the tax base

46) The Society welcomed the opportunity to review and comment on the Advisory Committee on New Broad-based Taxes' consultation document (the "Consultation Document"). The Society's comments on the Consultation Document are set out in detail in its submission to the Advisory Committee. (P. 32)

47) In line with the view expressed by the Society in the above submission, we believe that an expanded land and sea departure tax would be equitable from a conceptual point of view and acceptable. Further detailed consideration could be given to the implications of its introduction, as a potential source of additional revenue. (P. 33)

48) The Advisory Committee noted that the existing personal allowances are high by international standards. They have been increased substantially over the past 10 years, which has taken many wage earners outside of the tax net altogether. In the longer term there is an argument for the personal allowances to be reduced, either by positive action or, more gradually, by attrition. (P.33)

Comprehensive Review of the Inland Revenue Ordinance

49) A comprehensive review of the IRO should be carried out with the aim of ensuring that the IRO is appropriate for Hong Kong in the twenty-first century. Arising from this, significant redrafting to simplify and clarify its provisions is necessary and desirable. (P. 34)

Technological and commercial developments

50) Any reform of the Hong Kong's taxation system should ensure that it has a stable and broad tax base and the flexibility to adapt to technological and commercial developments. (P. 34)

SOCIAL MEASURES/MEASURES TO RELIEVE HARDSHIP

Selective rates rebates and increase in mortgage interest relief

51) The Society welcomes the proposals in the Chief Executive's Policy Address (p.27) to reduce rates payment by a maximum amount of $2,000 for all ratepayers for the coming year, and to raise the tax deduction ceiling for housing loan interest to $150,000 per year for this and the next year of assessment (which has been enacted into law). Both proposals are in line with proposals previously made by the Society. (P. 34)

Employment

52) In addition to the short-term jobs proposed to be created in the Chief Executive's Policy Address (p.25, 26), incentives, e.g. a tax deduction for a multiple of the first-year costs of employment should be allowed to employers who employ persons straight from recognised retraining schemes. A further, more limited, tax break could be offered in the second year of employment to discourage replacement of staff after the first year. (P. 35)

53) Tax incentives by way of, e.g. deductions for multiples of the actual costs incurred on employing each long-term unemployed person in, e.g. cultural and environmental enhancement projects should be offered on a case-by-case basis to private sector employers. (P. 35)

54) Employees should not be taxed on any redundancy/severance payments from their employers of up to twice the statutory limits. Consideration should be given to allowing even larger amounts to be tax-exempt where a certain proportion of it is invested in a new business. (P. 35)

55) Where an employee's salary has been reduced due to the recession, etc. and the employer subsequently pays a long service payment according to the previous higher salary, then the difference between the theoretical long service payment based on the final salary and the amount that the employer actually pays to the employee should also be deductible by the employer. (P. 35)

56) Where an unemployed person incurs costs in attending approved training courses, he should be allowed to carry forward the right to claim a deduction for a multiple of the actual cost of attendance incurred on approved courses to the time when he first becomes liable to pay salaries tax, subject to a reasonable time limit. (P. 36)

Charitable donations

57) In order to encourage greater private sector contributions to charities, the present ceiling

for allowable deductions should be increased from 10% to 20% of assessable profits/income and consideration should be given to abolishing the ceiling altogether. (P. 36)

58) Where a company makes a donation in a year in which it has incurred a loss, it should be allowed to carry forward the right to claim a deduction to the time when it becomes liable to pay profits tax, subject to a reasonable time limit. (P. 36)

59) The possibility of providing for deductions for donations in kind should also be examined. (P. 36)

1.6 CONCLUSION

While Hong Kong's immediate fiscal position remains sound, with all the signs of a deficit that will be considerably higher than that previously projected for 2001-2, unemployment at a historically high levels and on an upward trend, economic growth this year likely to be in negative territory and continuing deflation and lack of consumer confidence, the Hong Kong community is facing difficult and uncertain times. Improvements will depend on the general upturn in world markets which is itself uncertain but most believe will happen sometime during the course of next year, barring major unexpected events. Hong Kong also needs to take further stock of its own position in the changing world order and to encourage and support those fields of enterprise which are best positioned to thrive in future. During this period of transition the community's morale and confidence are in an urgent need of a boost and they need to believe that the Government is doing all it can to tide Hong Kong over the impact of the global situation and to steer a course that will be beneficial for Hong Kong's future economic and social well-being.

While the concerns of the community need to be addressed, the opportunities opened up by the rapidly developing Mainland market need to be seized. Hong Kong should do its utmost to capitalise upon the Mainland's accession to the WTO. This means ensuring that local businesses are fully informed about its practical implications and channels and procedures for entry into the market and that overseas investors are fully apprised of the advantages of establishing a base in Hong Kong from which to expand into the Mainland.

While further adjustments to a low tax regime can at best represent only one piece in the jigsaw, nevertheless this submission seeks to take account of immediate needs and those of Hong Kong's future. The Society is aware that many of the concessions and incentives proposed in it, if implemented, would apparently tend to lead to further reductions in revenue at a time of anticipated deficits. However, we believe that creating a positive environment for business and social development will attract more investment to Hong Kong, create more employment and is more likely to bring about an early return of the "feel good factor", all of which will ultimately lead to increased revenues.

2. DETAILED PROPOSALS

2.1 BUSINESS

2.1.1 Improving the business environment generally in Hong Kong

2.1.1.1 Immediate measures

Rates of profits and property taxes

We recognise that profits and property taxes are important sources of revenue for the Government and that the indications are that the deficit for 2001/02 will be very much larger than was forecasted at the time of the 2001 Budget Speech. However, given the difficult economic conditions in which many businesses are operating, the Government should not be looking to increase the level of profits and property taxes, despite the expected shortfall in revenue. On the other hand, it is important that the present economic difficulties should not be used as a reason to diminish the already very narrow tax base. Therefore, we propose that the existing rates of profits and property taxes remain unaltered.

First payment of provisional profits and property taxes

Currently new businesses may be required to pay up to two years' worth of final and provisional profits and property taxes in their second year of operation, depending upon when they were established. Although ideally they would have set aside enough fund to covers this, in the present economic climate many new businesses may be experiencing cash flow problems, even where they have made some profits over the period, and so the impact of this large one-off liability could be severe. To mitigate this impact, we suggest that the full assessment of the provisional element ordinarily contained in the first profits tax and property tax assessments of new businesses should instead be carried out in stages over the first three years in which tax is payable by the company.

Deductibility of interest paid to overseas associates

As we have previously proposed, section 16(2) of the IRO should be amended to allow deductions for interest incurred or paid on money borrowed at arms' length from overseas associates for the production of assessable profits. The current position of the IRD, which is to deny the deduction of this interest entirely, acts as a disincentive to the establishment of regional headquarters and offices and other (group) operations in Hong Kong. It also distorts the normal commercial decision-making process of large group businesses, as the restrictions discourage borrowing from within the group in favour of borrowing from outside financial institutions.

We understand that it may be necessary to introduce some restrictive criteria as a safeguard against possible abuses, such as requiring that interest should be paid at a commercial or arms' length rate; that the overseas associate should hold equity in the Hong Kong borrower and an appropriate debt to equity ratio be maintained during the relevant year of assessment; that the funds should be to promote, establish or expand the borrower's business in Hong Kong; and that the recipient of the interest should be subject to profits tax, or a similar tax, in its home jurisdiction.

Group relief

As with the proposed incentives for regional offices, the Mainland's imminent entry into the WTO, and the increased business opportunities that this will bring about, should prompt an urgent consideration of the merits of this proposal which asks for no more than is available in a number of developed tax jurisdictions around the world.

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

For the definition of "group", section 45 of the Stamp Duty Ordinance could be adopted, namely the test of beneficial ownership of a minimum of 90% of the issued share capital. All relevant companies should be chargeable to profits tax in Hong Kong, although they need not be locally-incorporated. Procedures relating to notification, etc. would need to be formulated. We would propose that only losses occurring after the introduction of such relief should qualify.

Loss carry back

We have also previously proposed an arrangement for loss carry back. The ability to carry back losses for a given year of assessment against the assessable profits of a previous year would give businesses greater flexibility to obtain relief. This would be a very useful benefit in this period of economic transition for Hong Kong. In order to make the proposal administratively simpler to implement, we would suggest limiting the facility to the carrying back of losses for one year only.

Tax credit for overseas withholding tax on export of services

In his Policy Address (p.21), the Chief Executive proposed to set aside $100 million to establish a fund to support, on an equal matching basis, useful projects that can enhance the standard of professional services in Hong Kong. He also stated that the Government would continue with an in-depth study on the demand for continuous learning in Hong Kong's professional sector and its needs in respect of the various practices. The Government would also join hands with the professions in promoting their services to open up new markets in the Mainland and overseas.

The fact that professional or consultancy services provided by a Hong Kong service provider to an overseas client are often subject to "double taxation" has tended to make our exported professional services less competitive. Withholding taxes are often imposed by overseas jurisdictions in which the recipient of professional and consultancy services is resident, where those services are provided from outside of the jurisdiction. The same is true of the provision of management services by a regional office. These withholding taxes are typically imposed on the gross payment regardless of whether or not a profit is made. The net payment is then often subject to further Hong Kong tax in the hands of the Hong Kong service provider, resulting in a high effective rate of tax on such service income. Despite the changes made to section 16(1)(c) of the IRO, the problem still persists. In order to create a more level playing field between Hong Kong and our competitors in the region, we propose that a unilateral tax credit be given in respect of foreign tax levied on service income, up to the amount of the actual Hong Kong tax payable on the service fee.

2. DETAILED PROPOSALS

2.1.1.2 Medium to longer term measures

Enhanced investment/depreciation allowances

The Policy Address (p.17, 18, 20) highlighted the need to enhance the capabilities of the fashion design, film and professional service industries. We agree that these are important sectors for Hong Kong. We suggest therefore that the definition of "prescribed fixed asset" under s16G of the IRO be reviewed to provide an immediate 100% write-off for research and development (according to criteria to be defined) in fields such as the fashion design, film and professional services industries.

To encourage the upgrading of commercial buildings to adapt to the hi-tech usage requirements of businesses, thus improving their productivity in an increasingly competitive and cost-conscious environment, we propose that an immediate 100% deduction should be given for the costs incurred in upgrading existing and new commercial building for hi-tech usage. Subject to qualifying criteria being met, additional expenditure for the purpose of making buildings more "environmentally friendly" should also be eligible for an immediate deduction.

Improving the knowledge/skill base

The Policy Address (p.4, 6) highlighted the rapid change from an industrial economy to a knowledge-based economy, and the need for Hong Kong to excel in high value-added services.

We propose that the existing HK$40,000 deduction for self-education expenses should be increased to HK$60,000 to encourage salaries-tax-payers to attend approved courses in IT, logistics, design/creation, film production, hospitality, environmental enhancement and languages, and related undergraduate, postgraduate and professional training courses. In order to emphasise this objective, we would suggest that in conjunction with the change, the aim and intention of enhancing the above skills and knowledge should be well publicised.

The Policy Address (p.13) also referred to the Government's policy to promote bi-literacy and tri-lingualism in secondary and primary schools. The need for linguistic proficiency amongst the workforce in Hong Kong generally is also widely regarded as being vital for Hong Kong's economic development. It is true that Hong Kong cannot hope to develop further as one of the world's great locations for business and commerce and be seen as a culturally diverse and cosmopolitan city so long as the community's language abilities continue to decline. It will also not be possible to maximise the future opportunities arising from our position as a bridge between the east and the west if the trend is not reversed. Standards of Potunghua and English both need to be improved, yet when one looks around the evidence suggests that Hong Kong is becoming more mono-lingual than before.

We would suggest therefore that the possibility be explored of offering various kinds of additional financial incentives to support the strengthening of language training and usage. Deductions for a multiple of actual expenditure should be offered to employers who send staff on recognised Potunghua, English or other language training programmes. A range of suitable language courses should be approved for the purposes of the deduction. Business sector sponsors of suitable training programmes should be able to claim deductions for a multiple of the cost of sponsorship, subject to qualifying criteria being met.

In addition to training and retraining opportunities for the employed and unemployed respectively, courses on, e.g. basic principles of commercial law should be run to assist individuals to set up their own businesses. Such courses should extend to cover on-going business advisory services to small and medium-sized enterprises, which should include speakers from sectors that have a direct interest in, or experience of, the operation of such businesses, particularly banks and other suppliers of funds, and successful entrepreneurs.

Where the cost of attending such courses would already be 100% tax deductible, we would propose increasing the allowable deduction to a multiple of actual expenditure. In order to encourage greater participation by big businesses, we would also recommend that sponsors of approved courses should be allowed a deduction for a multiple of the costs of sponsorship. The availability of such tax incentives should be subject to qualifying criteria as to whether, e.g. the recognised institution offering the courses is a local or an overseas institution.

The Policy Address (p.22, 23) emphasised the need to not only invest in local human resources, but also attract talent from other parts of the world. Tax incentives by way of, e.g. full or partial salaries tax exemption for up to five years could be provided to attract professionals with specific high-level skills from overseas to work in those sectors, where the local supply of skilled personnel cannot meet the demand, such as IT, subject to qualifying criteria being met. The aim should also be to target in particular those personnel and sectors where skill and knowledge transfer can be facilitated and would be most advantageous for Hong Kong.

50% profits tax exemption for manufacturing in Hong Kong

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

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

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

Attracting regional headquarters

Hong Kong has traditionally been a magnet for regional offices and headquarters operations of international corporations doing business in the Mainland and other parts of Asia. In recent years, however, there have been indications that some businesses are considering moving, or have already relocated. Foreign companies cited the high cost of residential accommodation and staff as the most unfavourable factors in setting up a regional operation in Hong Kong.

The Government has suggested that in the current economic downturn, given the deflation and declining property prices, these factors are self-correcting. They have pointed out that the number of regional operations of foreign companies in Hong Kong increased 7.9% in the 12 months to June 2001 to a record 3,237. The number of regional headquarters rose 10.4% to 944 as of 1 June 2001, while regional offices climbed 6.8% to 2,293. Hong Kong's low taxes and simple tax system was cited by a vast majority of the companies surveyed by the Administration as a favourable factor for setting up regional representation. However, the bare statistics notwithstanding, it ought to be recognised that the downturn is affecting most other countries in the region just as much as it is Hong Kong, and therefore the cost differentials referred to above will not necessarily disappear. In the effort to attract foreign companies to set up regional offices and headquarters operations in Hong Kong and to maintain those which are established in Hong Kong, therefore, the system of taxation may still have a further role to play.

Tax exemption for management and consultancy services in respect of associated entities

We propose that a profits tax exemption should be granted to regional headquarters as classified by the Administration, in respect of management and consultancy income derived from associated entities overseas. "Associate" will need to be suitably defined.

Apart from enhancing our capacity to provide financial, technological and management support sought by the growing market in the Mainland, by encouraging regional headquarters to set up and remain in Hong Kong, the economy here will also benefit from the accretion and development of the knowledge and skills that are by-products of this process. In the long run, multinational enterprises with a regional base here are more likely to channel further investment and business into Hong Kong.

With the Mainland's entry into the WTO Hong Kong will have to be more competitive than ever to encourage overseas investors to establish their regional and/or China base here. This is an opportunity that we cannot afford to pass by and we must take proactive measures to "sell" Hong Kong to potential international investors, at the same time as helping local businesses to expand into the Mainland market. The success of efforts to attract new investment will give rise to various related benefits, including generating more employment and helping to stimulate the property market in Hong Kong.

2.1.2 Incentives for specific business sectors

2.1.2.1 Financial services

We believe that the Mainland's entry to the WTO should prompt an assessment of how the tax regime can be further enhanced to signal to investors the continuing advantages of using Hong Kong as a base and stepping stone for doing business in the Mainland, including in respect of the provision of financial services. We believe that specific incentives should be offered to attract business here as part of an overall package to promote Hong Kong's particular benefits to overseas investors.

The financial services sector is one in which Hong Kong excels and the industry here is already enjoys a high reputation internationally. A considerable amount has been done to improve the financial infrastructure and standards of governance in the industry. This work must continue, as financial services will remain a core sector in the economy.

2. DETAILED PROPOSALS

Concessionary profits tax rate for fees earned by fund managers and trustees providing management services in relation to mutual funds, unit trusts and similar collective investment vehicles

Fund management and trustee services within the fund management industry should be eligible for a 50% reduction in the rate of profits tax. The aim is to ensure that Hong Kong maintains a critical mass of such financial service providers. Supporting financial services and infrastructure tend to congregate where the fund management industry is concentrated.

Extension of exemption for mutual fund corporations

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

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

Stamp duty on stock transactions

In order to ensure that Hong Kong's stock market remains competitive vis-á-vis other markets in the region, we propose that the stamp duty on transactions in company stocks be further reduced. Last year saw another step in the progressive reduction in the duty with a cut from 0.225% to 0.2%. We recommend that this process be carried on and that in the coming Budget the duty should be reduced to no more than 0.15%.

2.1.2.2 Information Technology

Tax incentives for qualified investors

A reduction in the profits tax rate by, say, 50% should be offered to investors, e.g. venture capital companies which invest a prescribed minimum amount or more in IT companies or projects in Hong Kong, which have a certain percentage and number of employees residing in Hong Kong.

Special deduction for computer hardware/software and internet connection

An outright deduction from salaries tax of $30,000 should be allowed for the purchase of personal computers and related software, including the basic cost of subscribing to an Internet Service Provider.

2.1.2.3 Logistics

The Policy Address (p.19, 20) referred to the following proposals/initiatives with respect to developing Hong Kong as a logistics centre:

- Hong Kong could promote the development of an inter-modal system and consider other supporting facilities to speed up the flow of goods and information;
- The provision of integrated services would also strengthen Hong Kong's competitive advantage as a supply-chain base;
- A new Steering Committee on Logistics Development, to be chaired by the Financial Secretary, would give direction on accelerating the development of a logistics industry with Hong Kong characteristics; and
- A Logistics Development Council would also be set up to provide a forum for the public and private sectors to discuss and co-ordinate matters concerning the industry and to carry out joint projects.

To further these initiatives, those businesses, whether existing or start-ups, which fall within the criteria of logistics businesses (according to criteria to be prescribed) should benefit from a 50% reduction in profits tax rate for initial period of five years.

It is believed there are many existing businesses in Hong Kong that pull together the creation of items that are then sold overseas. Raw materials are typically sourced in the Asia Pacific region, and typically manufactured in the Mainland, i.e. garments, household items, electrical goods, etc. These are the types of businesses which, if based in Hong Kong, will be likely to utilise the logistics and transport infrastructure in Hong Kong, and may well fall into this category.

2.1.2.4 Design/creation

Reviewing the operation of section 21A of the IRO

It is in Hong Kong's interests to encourage the optimum use of intellectual property in local enterprises, which can help to promote and facilitate the spread of innovation and invention in business.

Under section 15(1)(b) of the IRO, sums received by or accrued to a person for the use of or right to use intellectual property in Hong Kong are deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong and are therefore taxable. Under section 21A of the IRO, the assessable profits of a person in respect of such taxable receipts are taken to be 10% of the sum derived from a party which is not an associate as defined in section 21A(3). To encourage greater utilisation of intellectual property for design/creation-related work in Hong Kong and so enhance the climate for innovation and invention, we propose that the deemed percentage of 10% under section 21A should be reduced to 0%. Nevertheless, where the payer of such sums is an associate, the assessable profits in respect of such taxable receipts should, for anti-avoidance purposes, still be taken to be 100% of the sums received.

Updating infrastructure and enhancing the environment

Enhancing infrastructure and environmental protection were also two important themes touched on in the Policy Address (e.g. p.16, 17 and 24). To encourage greater invention and innovation in areas that will have positive benefits for the quality of life in Hong Kong, tax incentives should be offered to private sector entities by way of deductions for multiples of actual expenditure on approved initial design/creation-related consultancy work with respect to, e.g. construction, tourism infrastructure, environmental enhancement, security and anti-terrorism projects. This should apply to feasibility/consultancy work in relation to innovative and creative design. Where these costs are subsequently capitalised and benefit from the incentives for significant environmental enhancement or anti-pollution projects, referred to below then this particular benefit should not apply, i.e. there should be no "double benefit".

2.1.2.5 Tourism/culture

Hong Kong needs to do more to emphasise its own unique attractions as a destination for tourists particularly as the Mainland and other locations in the region step up their own marketing to potential visitors. Hong Kong has a unique and interesting history and we should do more to promote and preserve it. If we are hoping to be able to rely on a growth in tourism from this region and the Mainland in particular, then we will need to offer more and different attractions to compete successfully with rival destinations.

The Disney project is one major attraction that will be coming on stream. We should also consider how we could best develop areas such as the harbour front that have not been utilised to their full potential as a tourist attraction. Other projects that aim to preserve elements of Hong Kong's culture and tradition would also be likely to be popular, such as the concept of "living museums" that have been set up successfully overseas, where tourists could for example see traditional craftsmen at work on items such as bird cage manufacturing, production of hand-painted posters, jewellery working etc.

Consideration should also be given to providing incentives for significant environmental enhancement or anti-pollution projects. Subject to approval as significant capital projects on a case-by-case basis by the relevant Government departments, including obtaining an Advanced Tax Ruling from the IRD, tax incentives, e.g. an immediate write-off in the year that the expenditure is incurred should be offered.

In addition, we should consider how we might encourage and facilitate the staging of events that will showcase Hong Kong to the rest of the world and so help to mark out this city as a unique location. In some cases tax breaks may be of help in promoting permanent attractions and the staging of major events. This should be further examined. Consideration could for example be given to granting a partial profits tax exemption to promoters in relation to the staging of certain types of international events here.

Consideration should also be given to providing incentives, e.g. an immediate write-off in the year that the expenditure is incurred, for building and operating world-class sports and entertainment complexes, and theme parks, to be approved on a case-by-case basis in the future, including obtaining an Advanced Tax Ruling from the IRD.

2. DETAILED PROPOSALS

The extension of refurbishment allowances from hotels to other businesses in the 1998 Budget was a useful concession. However, we believe that a distinction can be drawn between the hotel and restaurant sectors, which rely heavily on ambience to attract customers, and other businesses. In order to clarify an ambiguity which has apparently arisen since the introduction of the general building refurbishment concession, it should be made clear that the case law dealing with hotels and restaurants has not been superseded by the new section 16F of the IRO and that hotel and restaurant renovation will continue to be eligible for the standard depreciation allowances accorded to plant and machinery. Hotel and restaurant refurbishment should be eligible for an immediate write-off in the year that the expenditure is incurred. To encourage hotel and restaurant operators enhancing the individualistic and artistic attraction of their premises, consideration should be given to providing incentives by way of, e.g. deductions for multiples of the actual costs incurred in employing each traditional craftsman/artist in craft or artistic creation in the context of specific tourist attractions such as theme parks, hotels and restaurant premises.

Not enough has been done in the past to preserve Hong Kong's architectural heritage. There are still a number of old houses and other historic buildings that in many countries overseas would be protected and conserved which in Hong Kong are being allowed if not actually encouraged to fall into disrepair with to a view to future redevelopment of the site. The reconstruction of Murray House at Stanley has shown how the environment can be improved immeasurably by preserving old buildings of character, although it would be preferable and would add more life and colour to Hong Kong to preserve such buildings in their original location. This is frequently done overseas and given the importance of retaining physical links with history and culture to the tourist market as well as towards enhancing the sense of belonging and quality of life for residents, it should also be given a much higher priority in Hong Kong. We propose therefore that tax incentives should be provided by way of an immediate write-off in the year the expenditure of costs is incurred in restoring old buildings on a case-by-case basis.

More generally, we would suggest that consideration be given to establishing a Heritage Commission to assist in the development of policies and the implementation of practical measures to promote the protection and preservation of worthwhile and significant aspects of Hong Kong's cultural and physical history. This will help to enhance Hong Kong's potential as a tourist destination as well as increase the community's own sense of belonging and pride in itself.

We also propose a reduction or, if possible, abolition of hotel accommodation tax to enable the travel industry to offer tourists generally more competitive packages.

2.1.2.6 Film industry

The Policy Address (p.18) referred to the Government's initiatives in providing a favourable environment for the film industry to grow - promoting the establishment of an advanced film production centre, funding relevant manpower training, carrying out overseas promotions and facilitating location shooting in Hong Kong. There is a considerable amount of talent in the film industry in both Hong Kong and the Mainland and there is scope for artistic co-operation between the two places. Hong Kong films are well-known and very popular, in Asia particularly, and the awards won by Hong Kong film-makers and technicians at overseas film festivals, culminating in the Oscars won by technical personnel working on the film "Crouching Tiger Hidden Dragon", which was awarded the Oscar for Best Foreign Film, clearly demonstrate the level of ability to be found in Hong Kong. This should be given further encouragement.

The measures proposed above in relation to providing an immediate 100% depreciation allowance for capital expenditure in respect of research and development, and the limited tax holidays for highly-skilled overseas personnel, should bear in mind the needs of the film industry. Thus the salaries tax concession proposed could, for example, cover technicians who have skills in the most advanced techniques for producing computer-generated/ enhanced special effects, provided there is a demand for such skills in Hong Kong coupled with a lack of supply. Further consideration could also be given to extending the provision for an immediate write-off of capital expenditure to other plant and equipment used in the film industry.

2.1.2.7 Fashion design

Fashion design is another industry where Hong Kong shows creativity and there is an opportunity for Hong Kong to be a creative centre for designs that fuse eastern and western styles, particularly given that in future Asian models and Asian-influenced styles are likely to become more popular around the world. Hong Kong is commonly seen as a bridge between the east and the west but the emphasis is often more on being a conduit for western enterprises wishing to do business in the Mainland. More should be made of the opportunity to introduce eastern, and particularly Chinese culture to the west. The fashion industry is one field in which this could be done. We would suggest that similar incentives be made available to the fashion design industry as to the film industry, as described above.

2. DETAILED PROPOSALS

2.1.3 *Improving business in Hong Kong as part of China and enhancing Hong Kong's position as the Mainland's natural trading partner*

Unless they are prepared for and able to adapt to the changes that the opening up of the Mainland markets will bring about, Hong Kong businesses could fall victim to increased competition from overseas. This will be particularly true for small and medium-sized enterprises.

Enhancing co-operation with the Pearl River Delta (PRD)

It is essential that we have efficient, top quality port and land transport services to link Hong Kong with the Mainland and the rest of the world. To some extent we will be competing directly with modern port and related services in southern China. Hong Kong must remain cost competitive and second-to-none in terms of expertise and efficiency. In order to ensure that the quality of our infrastructure is maintained through adequate investment in port services, we propose an enhancement of existing depreciation allowances for upgrading of the relevant facilities and equipment to an immediate 100% write-off in the year of purchase for such items. The related cross-border haulage transportation should also be eligible for this benefit.

Tax concession for other commercial road vehicles used for cross border transportation

To reduce the cost of and facilitate cross border transportation between Hong Kong and the Mainland, consideration could be given to offering a reduction in first registration tax for other commercial road vehicles e.g. vans and coaches, which are intended for use in cross border transportation between Hong Kong and the Mainland in the ordinary course of business of their owners.

2.1.3.1 *Capitalising on the opportunities in the Mainland - the WTO, the 2008 Olympics, etc.*

Helping Hong Kong businesses to understand the expanded WTO opportunities

To ensure that small and medium-sized enterprises will be able to capitalise on the opportunities arising from the Mainland's WTO entry, courses should be run to assist small and medium-sized businesses to enter into the Mainland's market and to provide related advisory services to small and medium-sized enterprises. Subject to qualifying criteria being met, the cost of attending such courses should be tax deductible up to a multiple of actual expenditure and sponsors of approved courses should be able to claim tax deductions of a similar multiple for such sponsorship.

Establishing a Resources Centre and networking arrangements

The establishment of a WTO Resources Centre focusing on providing relevant information and running practical courses would be an important step in helping Hong Kong businesses understand the full implications of the Mainland's WTO membership and how they can benefit from it. Such a project could be undertaken in the form, for example, of a joint enterprise between the business and educational sectors. A mechanism for networking should also be set up to assist in bringing together potential partners for joint ventures in the Mainland. We note that the Trade Development Council is already doing some work in this area but there is scope for the more direct involvement of business. Although individual firms may be in competition with one another, the size of the Mainland market is large enough to accommodate all and some co-operation at a basic level to assist businesses to grasp the fundamentals of the WTO agreement and what commitments the Mainland has made to liberalise over what time-frame, will be of benefit to Hong Kong and business here generally.

Making the right preparations early will be very important to Hong Kong enterprises in gaining a substantial foothold in the more liberal markets in the Mainland. We therefore propose that the costs of using any resource centre or similar services, subscriptions, attending courses, etc. should all be tax deductible to the level of multiples of actual expenditure.

Deductions for initial fitting-out costs of liaison/representative offices

With greater opening up of the Mainland's markets, more Hong Kong firms will want to consider setting up representative offices in the Mainland, especially those that want to expand their business horizons to places other than the southern cities. Renting suitable office space can be costly and although the setting-up costs may be deductible expenses, the initial capital fitting-out costs will not normally be. In order to encourage such initiatives, which will be to the ultimate benefit of Hong Kong, we propose that an immediate deduction in the year of incurring the costs be allowed to Hong Kong businesses against the capital costs of fitting out liaison/representative offices in the Mainland.

Incentives for businesses in respect of the 2008 Beijing Olympics

Consideration should be given to providing tax incentives by way of, e.g. deductions for multiples of actual expenditure on feasibility/consultancy work which is carried out for the purpose of bidding for projects related to the 2008 Beijing Olympics, subject to eligibility criteria being met. Such eligibility criteria might include, e.g. a certain proportion of the work being required to be conducted in Hong Kong.

2. DETAILED PROPOSALS

Apportionment of offshore income and expenditure

The Mainland's entry to the WTO should prompt an examination of the current taxation regime with respect to not only manufacturing, but also other business activities carried out on a cross-border basis, possibly as part of the review of the Hong Kong-Mainland double taxation arrangement.

We suggest that the Inland Revenue Rules and relevant IRD Departmental Interpretation & Practice Notes (DIPN) and related administrative arrangements should be reviewed with the aim of enhancing flexibility in the recognition and implementation of apportionment. The arrangements, which focus on manufacturing, need now to take account of the fact that Hong Kong is increasingly a services-based economy. In addition, there ought to be more flexibility as regards the form of legal agreement that is recognised as a processing agreement for the purposes of apportionment. For commercial reasons for example it may be preferable for a different entity other than the Hong Kong entity to effect the sales of goods processed, which under the current arrangements would disqualify the Hong Kong company from the 50/50 split.

Reviewing the Hong Kong-Mainland double taxation arrangement

As the Mainland has acceded to the WTO, one of the questions that needs to be addressed in relation to our relative competitive position, is whether the Arrangement Between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income ("the Arrangement") should be expanded to provide Hong Kong investors with benefits comparable with those enjoyed by investors from countries which have full tax treaties with the Mainland.

Currently, the Arrangement provides that exemption from business tax is specifically available on income from air, shipping and land transport operations carried out by Hong Kong enterprises in the Mainland. However, unlike the conventional models, at present it does not cover matters such as passive income, withholding tax and immovable property. In addition, it does not include provisions such as those dealing with tax sparing and non-discrimination. As a result, Hong Kong investors may find themselves at a disadvantage relative to businesses from treaty countries once competition intensifies now that the Mainland has entered the WTO.

Hong Kong should take this opportunity to strengthen its role as a gateway to investments in the Mainland. Modification or reform of the Arrangement should continue to be a priority on the agenda of any future consultations between the two sides. With the Mainland's accession to the WTO, a level playing field should apply and Hong Kong investors should be able to compete on equal terms with their competitors. On the basis of the WTO's "most favoured nation (MFN)" principle, Hong Kong, as a separate contracting party, should be able to enjoy treatment no less favourable than any other WTO member operating in the Mainland. Review of the Arrangement should therefore be expedited and suitable revisions considered, so that Hong Kong will not be at a disadvantage as against jurisdictions with comprehensive double tax treaties with the Mainland (which cover, e.g. interest and royalties) once the competition increases.

To ensure that the Arrangement as revised will continue to meet the needs of all the stakeholders concerned, the Arrangement should be subject to review by the Mainland and Hong Kong authorities on an annual basis (rather than every five years) as a matter of good practice.

2.2 PERSONAL TAXATION

Rates of salaries taxes and allowances

In order for Hong Kong to maintain a strong position in the current economic climate, we need to maintain a competitive position in the field of human resources. A significant factor in human resources development is the maintenance of a competitive environment for taxing employment income.

We recognise that salaries tax is an important source of revenue for the Government and it is especially important that the present economic difficulties should not be used as a reason to diminish the already very narrow tax base. We therefore propose no changes to the rates of salaries taxation or to the amounts of personal allowances in 2002/03, except as shown in Schedule 1. A summary of the proposed salaries tax allowances and the implications of the existing basic provisions can be found at Schedules 1-3.

To mitigate the financial impact on new employees of paying effectively up to two years' worth of salaries tax in the first year that tax becomes payable, as with our proposal above in relation to new companies, we suggest that the provisional tax element in a new employee's first tax assessment should effectively be assessed and be able to be paid in stages over a three-year period.

There has been a global trend towards lower rates of personal taxation and we believe that the standard rate of salaries tax should be reviewed as part of any package of indirect taxation that may be introduced to broaden the tax base.

Estate duty

The need for, and the operation of, estate duty should be thoroughly reviewed.

If it is considered that estate duty should be retained, it is proposed that a review of the Estate Duty Ordinance should be undertaken with the following objectives:

- Eliminating various anomalies, e.g. the difficulty of making a gift with no reservation of a benefit arises from the lack of de minimis provisions to explain when a gift is complete or not; the problem of the wide definition of a "controlled company" which might deter some overseas investors from investing in Hong Kong listed shares through a personal investment company as the HK$7.5 million threshold, below which disclosure is not required to be made, does not apply to these cases; with regard to exempt proceeds from insurance policies it is not clear that the proceeds are excluded in arriving at the cumulative estate, on which the Estate Duty liability is actually calculated (as is the case for the matrimonial home exemption). The matrimonial home exemption does not apply in the situation where the matrimonial home is held by a company that is owned only by the spouses, which in our view should also qualify; and
- Improving the drafting of its provisions with simpler and clearer wording.

2.3 IMPROVING THE TAXATION SYSTEM

Broadening the tax base

The Society welcomed the opportunity to participate in the consultation exercise on the Advisory Committee on New Broad-based Taxes' consultation document. The Society's comments on the consultation document are set out in detail in its submission to the Advisory Committee issued in October 2001.

In that submission, the Society expressed the view that, if it is determined that a broad-based indirect tax is necessary, then a general consumption tax (GCT) would be the most suitable method of maintaining and stabilising revenues. Nevertheless, further analysis is required as to the most appropriate type of GCT for Hong Kong, e.g. a goods and services tax/value-added tax, or a retail or wholesale sales tax.

The submission also pointed out that it would be important to achieve what could be a delicate balance between keeping the rate of any such tax relatively low while generating sufficient revenue to justify the costs of introducing and operating the system, and at the same time fulfilling the objective of genuinely broadening the tax base.

Offsetting measures such as reducing the rates of, e.g. salaries, property and profits taxes and increasing the monthly Comprehensive Social Security Assistance (CSSA) payments to qualified recipients should be implemented to lessen any immediate adverse impact of the introduction of a GCT on the economy.

Land and Sea Departure Tax

Given that departures from Hong Kong by air and also, to the Mainland and Macau, by sea are already subject to a departure tax, it is in principle reasonable to consider imposing a tax on land and sea departures generally.

According to the Consultation Document, a tax on all land and sea departures from Hong Kong could provide a further broad-based source of revenue. If set at $18 per departure (the current rate for Macau and Mainland departures by sea), it would yield some $900 million a year in revenue.

Whilst the feasibility of an expanded departure tax remains an issue requiring further consideration, the Society believes that such a tax would be equitable and acceptable from the conceptual point of view. As such, a more detailed study of its potential implications, including possible disbenefits, could be conducted to determine if it should be introduced and, if so, whether it could be implemented quickly and effectively as an additional source of revenue.

Reviewing personal allowances

In our submission to the Advisory Committee on New Broad-based Taxes, the Society noted that the existing personal allowances are high by international standards. They have been increased substantially over the rate of inflation during the past 10 years, which has taken many wage earners outside of the tax net altogether. In addition, the significant reduction in the top marginal rate of salaries tax and broadening of the tax bands has cut the number of tax payers who pay at the standard rate. As a result, the level of income necessary to trigger the standard rate is also high by international standards, particularly given the comparatively low standard rate of personal taxation in Hong Kong. Under the circumstances, the Society believes that, in the longer term, there is an argument for the personal allowances to be reduced, either by positive action or, more gradually, by attrition.

2. DETAILED PROPOSALS

Comprehensive review of the Inland Revenue Ordinance

Not only does the IRO have its origins in a different time and economic environment, but it is surprising how little it has evolved over the years. There have, of course, been numerous amendments, but these have more often been made to introduce narrow concessions or anti-avoidance provisions rather than to adapt the legislation to new business practices or a changed economic environment. We feel that there are many areas of the IRO which are outdated, inappropriate, unclear or which are difficult to apply properly or meaningfully in the current environment and are not equipped to deal clearly with many modern and emerging business practices. Accordingly, the Society is of the view that a comprehensive review of the IRO should be undertaken, which should include significant redrafting to simplify and clarify its provisions, to ensure that the IRO is appropriate to the twenty-first century and Hong Kong's place therein.

Technological and commercial developments

Any reform of the Hong Kong's taxation system should ensure that it has a stable and broad tax base and the flexibility to adapt to technological and commercial developments in relation to, e.g. e-commerce.

2.4 SOCIAL MEASURES/MEASURES TO RELIEVE HARDSHIP

Partial rates rebates and increase in mortgage interest relief

The Society welcomes the proposals in the Policy Address (p.27) to reduce rates payment by a maximum amount of $2,000 for all ratepayers for the coming year, and to raise the tax-deduction ceiling for housing loan interest to $150,000 per year for this and the next year of assessment (which has been enacted into law). Both proposals are in line with the Society's proposals previously made.

2.4.1 Employment

IIncentives to employ unemployed/newly trained persons

The Policy Address (p.25) suggested that the creation of job opportunities should rest mainly with the private sector. The issue of unemployment is a difficult and emotional topic. While Hong Kong is suffering from rising unemployment and is going through a transition that requires inter alia a greater focus in future on higher-value-added services, the community continues to absorb a large number of mainly unskilled workers from the Mainland who are eligible to settle in Hong Kong due to family connections. There are issues that must be considered at the political level. However, we believe that there are some practical measures that can be taken that may be of some assistance to the unemployed.

In conjunction with retraining, encouragement needs to be given to new businesses trying to start up, and existing employers, to take on newly retrained staff. In addition to the short-term jobs proposed to be created in the Policy Address, therefore, we propose to provide to employers a tax deduction of a multiple of the first-year costs of employing staff from recognised retraining schemes. Measures should also be introduced to discourage employers from dismissing staff recruited under this programme after the first year and taking on new workers, in order to repeat the benefits without offering long-term employment opportunities. Consideration could also be given therefore to allowing a more limited tax break during the second year of the relevant workers' employment with that employer.

We also suggest that tax incentives by way of, e.g. deductions for multiples for the actual costs incurred on employing each unemployed person in, e.g. cultural and environmental enhancement projects should be offered on a case-by-case basis to private sector employers.

The Government could consider giving some preference to companies that employ a certain number of staff from training schemes in the awarding of government tenders, subject to such persons being employed on minimum terms and conditions.

Non-taxability of redundancy payments

Lump sum redundancy/severance payments within the statutory limits under the Employment Ordinance are non-taxable. However, amounts above these limits may be treated by the IRD as potentially taxable, which can result in uncertainty and lead to prolonged arguments. The statutory limits meanwhile are hardly overly generous and where employees have previously suffered salary cuts due to the recession, they may be hit with the double burden of having their tax-exempt redundancy money, which is based on their final salary, correspondingly reduced. We propose therefore that employees should not be taxed on any redundancy/severance payments from their employers of up to twice the statutory limits. Consideration could in fact be given to allowing even larger amounts of redundancy money to be tax-exempt where a certain proportion of it is invested in a new business.

Secondly, we propose that where an employee's salary has been reduced due to the recession, etc. and the employer subsequently pays a long-service payment based on the previous higher salary, then the difference between the long service payment based on the final salary and the actual payment made by the employer should also be deductible by the employer.

2. DETAILED PROPOSALS

<u>Deferred deductions for retraining fees</u>

Where an unemployed person incurs costs in attending approved training courses, it is most unlikely he will be gaining the benefit of any tax deductions, as he is unlikely to be liable for any tax. We would suggest that such persons be allowed to carry forward the right to claim a deduction for a multiple of the actual cost of attendance on approved courses, to the time when they first become liable to pay salaries tax, subject to a reasonable time limit.

2.4.2 Charitable donations

With the projected future increase in the population of Hong Kong, there will be greater demand for social services, some of which are provided by charitable organisations. Charities are also involved in areas such as running retraining courses for the unemployed. Private sector support for these activities is both necessary and desirable. We believe that the participation of private sector corporations can be further encouraged by increasing the present limit on allowable deductions for charitable donations from 10% to 20% of assessable profits/income. Consideration could also be given to abolishing the limit outright. This measure should also help charities to secure greater stability in their income even in times of fluctuating business profitability.

In addition, we believe that where a company makes a donation in a year in which it has incurred a loss, it should be allowed to carry forward the right to claim a deduction to the time when it becomes liable to pay profits tax, subject to a reasonable time limit.

We are aware that some donors are more willing or able to make donations to charity of property in lieu of money. Donations in kind should be recognised and encouraged because they may provide a lifeline to worthy causes during times of economic difficulty when traditional forms of income can be severely reduced. In some jurisdictions overseas (e.g. the US) the tax regime makes provision for gifts in kind as well as cash to be granted tax deductions. We believe that this is an area that merits serious consideration in Hong Kong.

Hong Kong Society of Accountants

December 2001

SCHEDULE 1

Salaries Tax - 2002/2003 Budget Proposals

Personal Allowances

		Proposed 2002/2003 HK$	Present 2001/2002 HK$
Personal allowance	(single)	108,000	108,000
	(married)	216,000	216,000
Single parent allowance		108,000	108,000
Child allowances:	1st child	30,000	30,000
	2nd child	30,000	30,000
	3rd to 9th child (each)	15,000	15,000
Dependent Parent allowance		30,000	30,000
Additional Dependent Parent allowance		30,000	30,000
Dependent Grandparent allowance		30,000	30,000
Additional Dependent Grandparent allowance		30,000	30,000
Disabled Dependant allowance		60,000	60,000
Dependent Sibling allowance		30,000	30,000
DEDUCTIONS			
Training expenses		60,000	40,000*
Home Mortgage Interest	(2-year period)	150,000	150,000
Elderly Residential Care expenses		60,000	60,000

*for 2001-03

Rates of Tax

Standard Rate to remain at 15%

Progressive Rates

Existing / Proposed	
First 35,000	2%
Next 35,000	7%
Next 35,000	12%
Balance	17%

SCHEDULE 2

Implications of Existing Salaries Tax Provisions

Income levels below which Salaries Taxpayers are not required to pay tax

	Present/Proposed HK$
No dependants' allowances	
Single	108,001
Married	216,001
Married + 1 child	246,001
Married + 2 children	276,001
Married + 3 children	291,001

Income levels above which Salaries Taxpayers begin to pay tax at the maximum marginal rate

	Present/Proposed HK$
No dependants' allowances	
Single	213,001
Married	321,001
Married + 1 child	351,001
Married + 2 children	381,001
Married + 3 children	396,001

SCHEDULE 2

Income levels at which Salaries Taxpayers enter the standard rate zone

	Present/Proposed HK$
No dependants' allowances	
Single	1,443,000
Married	2,361,000
Married + 1 child	2,616,000
Married + 2 children	2,871,000
Married + 3 children	2,998,500

Existing Tax Implications for a Married Couple with Two Children (No dependants' allowances)

Income HK$	Present Tax/Proposed Tax HK$
300,000	480
350,000	3,630
400,000	10,580
500,000	27,580
750,000	70,080
1,000,000	112,580
1,500,000	197,580
2,000,000	282,580
3,000,000	450,000

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