

Threats and Opportunities:

Hong Kong's Olympian Challenges

Budget Proposals 2008-09



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

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PART A: OVERVIEW

Economic Outlook

1. Hong Kong's economy remains buoyant, although GDP growth slowed slightly in the third quarter of 2007 to 6.2% in real terms compared with 6.8% in the third quarter a year earlier. On the strength of the economic data, the government revised upward the forecast GDP growth for 2007 as a whole to 5% - 6% compared with the range of 4.5% - 5.5% projected in the 2007/08 Budget Speech.
2. The Composite Consumer Price Index ("Composite CPI"), has shown a year-on-year increase since October 2006. For the 12 months ended October 2007, the Composite CPI was on average 3.2% higher than in the preceding 12-month period, while for the third quarter, the index rose by 2.7% from a year earlier. The forecast for the Composite CPI in 2007 as a whole will almost certainly be higher than the 1.5% forecast at the time of the 2007/08 Budget.
3. The unemployment rate fell to 3.6% in the period September-November 2007, down from 3.9% in August-October 2007, and the lowest figure since February-April 1998. This translates to around 127,700 people out of work. The under-employment rate declined from 2.3% in August-October 2007 to 2.2% in the three months to November 2007. Total employment increased to 3,508,800 in September-November 2007 out of a total labour force of 3,636,500. (All September-November figures are provisional).
4. The financial markets, in particular the stock market, have been highly active in 2007, with recent offerings such as the largest ever internet IPO since Google, with the successful listing of AliBaba.com. The market turnover for securities in October 2007 reached a single-month record high of HK\$3.49 trillion. In October 2007, the Hang Seng Index surged above the 31,000 mark. However, since then, the market has showed considerable volatility. Total turnover for eleven months of the year reached HK\$19.67 trillion, compared with a turnover of HK\$8.33 trillion for the whole of the previous year.
5. Given its external orientation, Hong Kong's open economy is constantly vulnerable to factors beyond its control, including the fall out from the problem of the issue of sub-prime lending in the United States ("US"), the effects of asset price inflation in the Mainland, and the impact of global events and factors, such as oil prices. In this regard, the International Monetary Fund has recently cut its forecast of growth in the US next year to 1.9% from a projection of 2.5% in July 2007. Efforts to control the rapid growth of the Mainland economy, meanwhile, have not had any obvious effects, with GDP growth hitting 11.5% in the first half of 2007 compared with 10.7% year-on-year in 2006, 10.4% in 2005 and 10.1% in 2004. Following this, in September 2007 the World Bank projected an increase of 11.3% for the whole of 2007. The inflation rate in the Mainland hit an 11-year high of 6.9% in November 2007. Therefore, further measures to control the rapid pace of growth in the Mainland may therefore be introduced and, if so, these could have a dampening effect on the economy in Hong Kong.

Fiscal Position

6. The overall fiscal outturn in 2007/08 is now likely to be significantly better than the HK\$25.4 billion surplus estimated in the 2007/08 Budget, with the improved state of the economy and consequently the increasing amount of revenue to be collected. The FS has already indicated that the surplus is expected to be double the initial forecast for 2007/08.
7. Fiscal reserves stood at HK\$387.5 billion on 31 October 2007, compared with HK\$288.7 billion as at 31 October 2006. Prior to the recent upward revision in the GDP forecast, the government forecast that the reserves would stand at HK\$391.2 billion by end-March 2008, representing 19 months' of government spending. It is likely that this figure will now be higher.
8. As at 31 October 2007, the foreign currency reserves held by the Exchange Fund stood at US\$142.2 billion compared with US\$132.7 billion at 30 November 2006.

Summary of Proposals

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

I. THREATS

B1) Maintaining a low and simple tax regime: clarity, certainty and consistency

10. The Hong Kong Institute of CPAs ("Institute") takes the opportunity of the commencement of the term of office of the new Financial Secretary ("FS") and new administration to reiterate several important tax issues and proposals that have not so far been taken up. The Institute also puts forward some new ideas to help strengthen the underlying economy and improve the quality of life in Hong Kong.
11. Firstly, we believe that it is essential for priority to be given to maintaining clarity, certainty and consistency in Hong Kong's tax system, otherwise there is a real danger that Hong Kong's reputation for having a low and simple tax regime could be adversely affected. In order to enhance clarity, certainty and consistency, some fundamental issues need to be addressed in statute, e.g., through rules under the Inland Revenue Ordinance ("IRO"), instead of by practice notes issued by the Inland Revenue Department ("IRD"). The recent Court of Appeal judgment case of *ING Baring Securities (Hong Kong) Limited v. CIR* has shown that the IRD's interpretation may not always be supported in law. Relevant matters include:
 - The taxation of unrealised gains and losses, which has become a more significant issue following the court of final appeal decision in *CIR v Secan Ltd & Anor* ("Secan"), as interpreted by the IRD;
 - the tests for determining source of profits in relation to, e.g. trading income and manufacturing profits (under section 14, IRO); and
 - the tests for determining source of employment income (under section 8, IRO).

12. The implementation of the “Assess First, Audit Later” (“AFAL”) system for assessing of tax returns, introduced in 2001 has, in practice, led to increased uncertainty for many taxpayers as it has become more likely that a taxpayer’s tax affairs will not be concluded for any particular year of assessment until the completion of the statutory time limit of six years. Taxpayers are entitled to timely resolution of their tax affairs for each year and thus a reasonable and certain time limit should be specified in the IRO for undertaking the "audit" of a tax return. We suggest that if the IRD has not begun enquiries within twelve months of the filing date, a tax return should normally be regarded as final. This is similar to the commitment made to taxpayers by the Inland Revenue in the United Kingdom (“UK”).
13. To provide more certainty to businesses, the “time bar” period for re-opening tax affairs under section 60, IRO, should be shortened from six years to three or four years, which would be in line with a number of other jurisdictions.
14. Legislative changes should be made to provide that a statement of loss issued by the IRD should be treated as an assessment, so that it is binding upon the IRD and the taxpayer can object to it if he or she does not agree with it.

B2) The need to keep abreast of changing business developments and practices and to remain competitive in the region

15. Hong Kong needs to keep pace with and react to changing business developments and practices in order to remain competitive in the region. The Institute believes that, in this context, some of the tax issues that need to be addressed include:
 - The concept of “substance over form” should be recognised in relation to, e.g., businesses trading in Hong Kong with manufacturing processing agreements in the Mainland;
 - the apportionment of profits, where profits are partially sourced in Hong Kong and partially overseas, should be given statutory backing;
 - the need for a comprehensive transfer pricing regime should be explored as section 20, IRO and the relevant provisions of the Mainland DTA are quite generic and cannot satisfactorily deal with the increasingly common issue of transfer pricing;
 - group/loss relief should be introduced; and
 - “loss carry-back” should be allowed, i.e., losses incurred in the current year of assessment should be permitted to be offset against the assessable profits of one previous year.

B3) Improving the quality of life

16. More needs to be done to create a sustainable environment and improve the quality of life in Hong Kong. The Institute’s tax proposals include the following:
 - Improving the environment: Additional environmental protection measures should be considered as part of a more co-ordinated environmental policy, which should also take on board climate change. For example, energy conservation and sustainability in the design of new commercial and

industrial buildings should be given tax concessions and electronic road pricing should be introduced to reduce traffic congestion.

- Preserving culture and heritage: We suggest considering the establishment of a dedicated body, similar to the UK National Trust, and allowing private buildings to be donated to this body to be treated as donations in kind. Cash donated to the body should be tax deductible. Donors to charities that wish to do so, should also be able to transfer the benefit of the relevant tax deductions to those charities.
- Promoting the Olympic ideal: To help promote the physical and mental benefits of sport to the community in the Beijing Olympics year, in which Hong Kong will participate directly, in 2008/09, donations to the Hong Kong Athletes Fund for elite sportsmen, or other approved sports development funds, should be distinguished from other charitable donations and should be tax deductible without any ceiling against income or profits.
- Creating employment opportunities: Provide incentives to relocate back office functions to satellite towns to create employment and improve the local economy and local community development.

B4) Addressing Hong Kong's narrow tax base

17. Although the economy is now in much better shape than it was before, the continuing narrowness and inherent volatility of the tax base reduces Hong Kong's ability to tackle the economic challenges ahead, as well as the flexibility to compete in other areas of the tax system. We refer the FS to the Institute's March 2007 submission in response to the consultation on broadening the tax base. Whilst the Institute concluded that no single option would be better than a goods and services tax in meeting the various objectives, the submission also suggested that other possible options should be further explored either singly or in combination, including: payroll and social security taxes; a single stage retail sales tax; a surcharge on utility supplies and green taxes.

II. OPPORTUNITIES

B5) Enhancing Hong Kong's status as a business and financial centre and supporting key sectors

18. In view of the improvement in the economy, the Institute supports the proposal in the Chief Executive's 2007/08 Policy Address to reduce the corporate profits tax rate and the standard rate of salaries tax by one per cent to 16.5% and 15% respectively.
19. Given the global trend towards lowering the rate of direct taxes, the government should conduct a study with a view to implementing further reductions in Hong Kong's profits tax rate in future, having regard to factors such as (i) the fiscal position; (ii) international trends; (iii) the effective tax rates in competing jurisdictions, particularly for industries that are vital for Hong Kong's economic well-being (e.g., service industries). The study should also consider whether there is a justification for continuing to maintain the differential between the corporate profits tax rate and the rate for unincorporated businesses.

20. In view of the substantial surpluses currently being generated, the tax burden on middle-income earners, who pay at the higher marginal rates of taxation, can be reduced. We propose that marginal rates should all be decreased by one percent to 1%, 6%, 11% and 16% and that the salaries tax bands should be widened from HK\$35,000 to HK\$40,000.
21. We do not propose any change in personal allowances in 2008/09. We suggest that there be a further look at personal allowances with a view to identifying an appropriate base year for future adjustments, which should take account of actual (e.g., inflationary) changes in the economy and avoid further narrowing of the tax base.
22. To support the development of value-added services, Hong Kong's tax regime should provide for the following:
 - Deductions for the cost of acquisition of trademarks and copyrights generally, not only patents and know-how;
 - deductions for the interest expenses incurred (for the period before the relevant property is used to produce assessable profits) in financing the acquisition of trademarks and copyrights generally, not only patents and know-how;
 - tax credits for any foreign tax paid on the royalty income concerned.
23. To support the logistics sector which has been identified as one of the strategic industries in Hong Kong's economy, we propose:
 - Exemption from or reduction in rates for storage facilities used directly for the logistics business, e.g. warehouses, wharfs, etc;
 - 50% reduction in the rate of profits tax on income derived from the international freight forwarding business, initially for a three-year period; and
 - improvements in the rail infrastructure between Hong Kong and the Mainland, to reduce the time and costs of transporting cargo to terminals in Hong Kong.
24. To enhance Hong Kong's competitiveness as a location for regional offices, service centres and group companies, the following measures should be considered:
 - Full profits tax exemption should be given to regional headquarters/offices in Hong Kong in respect of management and consultancy income derived by the Hong Kong entity from associated entities overseas;
 - interest income received by regional offices from loans made in Hong Kong to their overseas associates should be exempted from taxation;
 - a unilateral tax credit should be given for the amount of foreign withholding tax paid (in jurisdictions with no double taxation agreement ("DTA") with Hong Kong) on income sourced in Hong Kong, of up to a maximum of 50% of the amount of Hong Kong profits tax payable on such income.

25. A survey of business community should be concluded to better understand Hong Kong's competitiveness in terms of the cost of doing business.

B6. Promoting health and education

26. It is essential to determine how to maintain a financially sustainable public health care system over the long term. As part of this the following should be explored:
- Providing for a tax deduction/incentives for individuals to invest in medical insurance or voluntarily contribute monies into a dedicated MPF-type fund for future medical expenses. Amounts paid into a dedicated fund should be deductible up to a fixed amount, but be taxable if taken out for non-medical uses.
 - Extending the “user pays” principle to some non-essential medical services, such as non-emergency ambulance services.
27. The current deduction limit of HK\$60,000 for self-education expenses should be increased to HK\$80,000 to assist taxpayers to attend approved courses, given the increasing costs of many educational programmes. Claims for self-education allowances should be able to be carried forward for up to three years, when it is more likely the recipient will be working and able to take advantage of the deduction.
28. Assistance by way of, e.g., more extensive loans or subsidy arrangements should be considered for students' tuition fees.
29. In addition, to help develop and improve their skill sets, knowledge and employability, a deduction of up to HK\$12,000 in aggregate should be available for any membership subscriptions of approved professional bodies, and not only for one membership, as is currently allowed.

B7) Government services

30. To enhance the efficient use of resources and the delivery of public services, the government should continue reviewing its existing services and monitoring market conditions to identify services that could be privatised, and to determine the most appropriate time for doing so.

B8) Additional technical proposals

31. Spouses should be able to elect individually for personal assessment and not have to be jointly assessed.
32. The following property-related measures should be introduced:
- Define trading gains in property, more specifically, by reference to a holding period of less than two years, with an exception for the family home.
 - Increase the ceiling for the flat rate of HK\$100 stamp duty on real property to properties costing up to HK\$3 million from the current limit of HK\$2 million, given the continuing property price inflation. Subsequently, adjust the ceiling in line with the property price index.

- Individual property owners should be encouraged to enhance the environment, safety and value of older building stock by allowing the option of deducting either actual renovation expenses, or the existing flat rate of 20% of the rent received. The former type of deduction could be subject to a maximum amount over a certain period, to avoid abuses.

PART B: DETAILED PROPOSALS

Threats and Opportunities for Hong Kong's Role as an intermediary and a gateway to the Mainland and the Region

I. THREATS

1. We outline below, with more supporting information in the appendices, a number of issues that the Institute believes will have a bearing on how successful Hong Kong will continue to be in attracting investment in the future. We have raised several of these issues once or more in our budget proposals and in a letter to the Financial Secretary ("FS"). We take this opportunity of the commencement of the term of office of a new administration to recap and emphasise that these issues have not gone away and need to be addressed.
2. Tax is by no means the only consideration when overseas investors decide whether to use Hong Kong as a base or a conduit for doing business in or with the Mainland and other regional markets, but it is nevertheless an important consideration. Hong Kong's low tax rates and simple regime are often quoted high up on the list of Hong Kong's advantages. This is not in itself a revelation, but questions are being asked about whether changes are taking place that could threaten this aspect of Hong Kong's attractiveness?
3. The Institute believes that there are several concerns about tax administration in Hong Kong, notwithstanding the apparent strength of the economy at present, which, if they are not addressed in good time, could result in a loss of business to other markets, which may not be easy to recover. We look briefly at these concerns in turn below.

B1) Maintaining a low and simple tax regime: Clarity, certainty and consistency

4. A tax system that is uncertain and which does not allow taxpayers to predict their liability accurately or to know when their liability for any given year will be finalised cannot be called simple.
5. One of the strengths of the Hong Kong tax system has traditionally been the fact that Hong Kong's tax legislation has been relatively straightforward and easy to understand. From time-to-time contentious areas have arisen in interpretation of the tax law but clarification has been obtained by reference to court decisions, the use of Departmental Interpretation and Practice Notes ("DIPNs") by the Inland Revenue Department ("IRD") or, if necessary, changes to the legislation. This certainty of interpretation has enabled taxpayers to have greater confidence in their dealings with the IRD and has encouraged full disclosure in compliance matters as well as the belief that their affairs will be dealt with on a consistent basis.

6. In our view, it is essential that we continue to give priority to maintaining clarity, certainty and consistency in our tax system, as Hong Kong faces increasing competitive pressures from other international cities in the region.
7. Unfortunately, in recent years, a significant degree of uncertainty has been introduced into the administration of the tax system as a result of various factors, including court decisions and IRD practices that stray from the published position. As a result, taxpayers and their representatives are increasingly unable to plan with certainty in relation to some fundamental areas, such as the source of employment income and the source of profits for profits tax purposes and the taxation of unrealised gains and losses.
8. In this regard, strong reservations were expressed by practitioners about the revised DIPN 10 *The Charge to Salaries Tax* when it was in draft form because it does not help to resolve the fundamental uncertainties that have developed around the question of when is employment to be regarded as non-Hong Kong based employment (see paragraphs 21 to 22 below). A second example is DIPN 11. This explains, amongst other things, the Assess First Audit Later (“AFAL”) system, which introduced in 2001 to screen tax returns for automated assessment and other, more high-risk, cases for further audit. Practitioners have queried whether there is a basis in law for such a system of handling assessments and have expressed concern that, for many cases, the AFAL system means in practices that the case remains “in limbo” for up to six years (see paragraphs 26 to 27 below).

Taxation of unrealised profits and losses

9. The decision of the Court of Final Appeal in *CIR v Secan Ltd & Anor* [2001] (1 HKRC 90-107) (“*Secan*”), which has had an impact on the policy of the IRD and the interpretation of the Inland Revenue Ordinance (Cap.112)(“IRO”), has brought about further uncertainty and inconsistencies in the system.
10. The IRD sees the *Secan* case as authority that unrealised profits can be taxed if they are recognised in the taxpayer’s profit and loss account in its financial statements, which runs counter to the well-established taxation principle that income or profit should not be taxed before it is “realised”.
11. International Financial Reporting Standards (“IFRS”), with which Hong Kong Financial Reporting Standards have converged, have developed increasingly in the direction of reflecting the existing and contingent values of the assets and liabilities of an enterprise in its balance sheet, with the necessary adjustments included in the profit and loss account. In reflecting and measuring such values, some economic concepts have been used which are not consistent with tax law concepts.
12. For instance, the valuation of an asset may be adjusted upwards because of changes in the economic environment in which the enterprise operates, even if the enterprise has carried out no sales at all during the accounting period. The increase in the value would then be included in the profit and loss account as profit, even though there has been no accompanying change in cash flow.
13. A specific example of the adverse effect of this is the potential cash flow problem that construction companies face as they may handle discrete projects, in contrast to the regular, large turnover that is characteristic of financial institutions. We acknowledge that, in the case of a single contract construction company,

which is taxed on the stage of completion basis, but which makes an eventual loss on the contract overall and subsequently ceases business, pursuant to DIPN 1, the IRD may by concession be prepared to re-open previous years' assessments where profits were taxed. While this is to be welcomed, multi-contract companies may also face cash flow problems and still be required to pay tax on unrealised gains.

14. IFRSs aim to facilitate the provision by companies of general-purpose financial statements and they are useful for, and geared towards, the purposes of international and cross-border investments. The treatment of tax, however, does not necessarily follow accounting (e.g., in the case of the different treatment of depreciation for accounting and for tax purposes). Tax rules will differ from jurisdiction to jurisdiction and reflect the fiscal policy of a particular jurisdiction. We note also that, although accounting in the Mainland is converging with IFRS, the State Administration of Taxation 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 extract of notice at [Appendix 1](#)).

Consistency

15. There is also an issue consistency here. If the principle of taxing on the basis of the profit and loss account were applied across the board, shares issued to employees as part of their salaries, which are treated as an expense in the profit and loss account, could, in principle, be deductible in computing the company's assessable profit. However, for some time the proper treatment was in doubt before the IRD ultimately disallowed deductions on the grounds that such expenses were capital in nature. Our concern is not so much about the conclusion in this particular case but, rather, that taxpayers were left in doubt about the rules to be applied, and how they would be applied given, on the one hand, the IRD's broad interpretation of the decision on *Secan* and, on the other hand, the lack of any clear indication of how share awards should be treated for tax purposes.
16. The IRD's approach also does not recognise the fact that other jurisdictions where IFRSs have been adopted may have other measures in place that can help to mitigate the problems outlined above, such as provision for tax loss carry-back, which means that an unrealised profit that is taxed in a particular year may be offset by a loss carried back in subsequent years, if that profit is in fact never realised. Hong Kong does not have similar loss carry-back provisions in its tax system. Group relief, which is common in other jurisdictions but also not provided for in Hong Kong, is another measure that could help to mitigate the negative effects referred to above (See paragraphs 44 to 50 below).
17. The above concerns have been conveyed to the IRD by a number of business and professional bodies, including the Institute but, so far, no specific action has been taken or proposed to deal with the problem.
18. The level of certainty in Hong Kong's tax system needs to be enhanced in order to protect Hong Kong's standing as an international financial centre. This includes making clear laws and, in some cases, establishing and adhering to clearly spelled out practices in DIPNs. However, ultimately DIPNs are not a substitute for legislation if the aim is to achieve the maximum clarity and certainty.

Source of profit and income

19. A matter that is fundamental to Hong Kong's tax system, namely the "source principle" has also become an area of significant uncertainty. The present situation, in which significant gaps in the IRO are supposedly dealt with by DIPNs, is not satisfactory. It is an important concept of taxation law that those who administer tax laws should not also set the tax policy. Furthermore, the IRD states that DIPNs do not purport to provide a binding interpretation and practitioners note that there has been an increasing and worrying trend in recent years for assessors to diverge from the published practice.
20. If DIPNs are to be meaningful and useful, taxpayers should be entitled to rely on them to provide a clear statement of the IRD's practice, which should be consistent with the IRO. If a taxpayer adheres to the information contained in a DIPN, he should have a reasonable degree of certainty about his tax treatment. Unfortunately this is no longer always the case in relation to the fundamental area of the source of income and profit.

Source of employment income

21. In the case of DIPN 10 *The Charge to Salaries Tax*, for example, most taxpayers and their representatives accept that the previous version of DIPN 10 reflected the correct interpretation of the legislation and, in the past, provided a fairly high degree of certainty. However, increasingly, 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, highly questionable tests, for determining the source of employment income. This was particularly problematic where, due to a change in practice, matters agreed previously were subsequently called into question.
22. In 2006, views were sought on a revised DIPN 10 and serious concern was expressed by the Institute, amongst others, about the revised version, as it merely seemed to give backing to the very practices that practitioners and taxpayers had found problematic. Unfortunately, the situation had become complicated due, in part, to a number of board of review decisions, after the important court case of *CIR v Goepfert* [(1989) 1 HKRC 90-003], which had not necessarily adopted a consistent approach on this issue. Despite the strong reservations that were expressed on the draft, the revised DIPN 10, which was published recently, contains little or no change to the basic principles reflected in the earlier draft.

Source of profit

23. Similar problems have arisen with regard to DIPN 21, *Locality of Profits* regarding the circumstances in which profits are chargeable to profits tax. The Institute has also made comprehensive comments in relation to revisions to DIPN 21 with the objective of improving the level of predictability. While some of the issues are no doubt quite complicated, given the complex multi-jurisdictional transactions that are commonplace in modern business, current IRD practices tend to exacerbate the uncertainty. The recent court of final appeal judgment in the case of *ING Baring Securities (Hong Kong) Ltd. v CIR* [FACV000019/2006] ("*ING Baring*") has, hopefully, clarified the question of determining source for certain specific types of transaction. It has also demonstrated that the IRD's position may not always be tenable in law.

Certainty through legislation

24. If the published practice cannot be relied upon to provide the necessary level of certainty in Hong Kong's tax administration, this points to the need to legislate for greater clarity in key areas of our tax laws. In this regard, we consider it important for the restoration of certainty in our tax legislation that specific areas of the IRO be reviewed and amended as appropriate. These include:

- (i) How the source of employment income under section 8 should be determined. 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 should be prescribed in the IRO. This would improve the level of certainty over the existing method, which involves dealing with the issue through a DIPN that has regard to court and board of review decisions, some of which appear to be inconsistent with one another.

However, instead of enshrining the existing approach on source of employment income in the law, the position could be updated by adopting the approach used in other international business centres, namely taxing employees on the basis of where they render their services.

- (ii) The clarification of the source of profits under section 14, IRO. There is also considerable uncertainty in this fundamental area of the taxation of profits. Although section 15, 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, reference has to be made to case law and DIPN 21. Following the decision in the Privy Council case of *CIR v Hang Seng Bank* [(1991) 3 HKTC 351] ("*Hang Seng Bank*") there was a period of certainty regarding the source of trading and manufacturing profits, and DIPN 21, issued at that time, greatly assisted taxpayer's understanding of the source of profits. However, later court decisions introduced a significant degree of uncertainty and is reflected in the interpretation of DIPN 21 by the IRD, especially in respect of offshore manufacturing claims and the use of import/export trading companies.

Similarly the issue of apportionment of profits tax, especially 50/50 apportionment for Hong Kong companies manufacturing goods in the Mainland, has become a bone of contention, given the current restriction of apportionment to "contract processing" arrangements only, even though practitioners and taxpayers argue that in substance many instances of "import processing", which is legal apparently now favoured by the Mainland authorities, are, in substance, the same as contract processing.

There seems to be no reason for continuing with this state of uncertainty, as the *Hang Seng Bank* case identified the source of various types of income and profits, which could be used as the basis for rules under the IRO. As the determination of source of profits is fundamental to Hong Kong's profits tax regime, we consider that it is no longer appropriate to leave this to an interpretation of (apparently confusing and conflicting) court decisions and DIPNs. The question of the apportionment of manufacturing and other profits, which has also become a problematic area for practitioners and taxpayers, could be addressed at the same time, including tests for determining a 50/50 onshore/offshore manufacturing claim. In this regard, it is noted that, in delivering the judgment in *Hang Seng Bank*, Lord Bridge stated the following:

“There may, or course, be cases where the gross profits deriving from an individual transaction will have arisen in or be derived from different places. Thus, for example, goods sold outside Hong Kong may have been subject to manufacturing and finishing processes which took place partly in Hong Kong and partly overseas. In such a case the absence of a specific provision for apportionment in the Inland Revenue Ordinance would not obviate the necessity to apportion the gross profit on sale as having arisen partly in Hong Kong and partly outside Hong Kong.”

While DIPN 21 is in the process of being updated, this has been progressing slowly because of the complexities and also because an important court of final appeal judgment, in the case of *ING Baring* was awaited. However, the judgment in this case has now been delivered, on 5 October 2007. This particular case concerned the source of commission income, but the court of final appeal made some useful general points in the judgment and this provides a good opportunity to consider whether rules on source for various types of business income (e.g., manufacturing, trading, commission) should now be included in rules under the IRO.

Introducing rules based on the above cases 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.

- (iii) Legislation to deal with the adverse effects of the *Secan* decision and the adoption of IFRSs, as explained above. Some jurisdictions provide in law for the carrying back of tax losses, so that a loss in a current year of assessment may be set off against a profit in the previous year or years, which can help to alleviate the problem (see paragraphs 48 to 50 below). Also group relief (see paragraphs 44 to 47 below) may enable group companies to, inter alia, minimise the adverse impact of applying *Secan*.
25. The Institute provided further details of these technical matters in a letter sent to the then FS in January 2006. We continue to suggest that an ad hoc working group be set up to review these and other problematic areas of the IRO, on a one-off project basis or, as an alternative, that the Joint Liaison Committee on Taxation (“JLCT”) be given a specific mandate to undertake this review, identify areas of concern and propose draft legislation.

Assess First Audit Later and finalisation of assessments

26. The current policy of tax collection, commonly known as “Assess First Audit Later (AFAL)”, was introduced only a few years ago. Under this approach, an IRD assessor will either issue an assessment or a statement of loss based on the assessable profit or allowable loss contained in the taxpayer’s tax return, without undertaking any review of the tax return. The IRD then reserves the right to review this position for up to six years from the end of the basis period.
27. We consider that the legal basis of the AFAL approach is unclear and have asked the IRD to explain it but, regardless of the legal basis for the AFAL, the practice is unsatisfactory, because it creates a fundamental uncertainty in that a taxpayer cannot be sure that his or her tax liabilities have been finalised at any time for up to six years after the end of a particular basis period. Taxpayers should be entitled to timely resolution of their tax affairs for each year and thus a reasonable time limit for undertaking the “audit” should be included in the IRO. By way of comparison, in the United Kingdom (“UK”), the Inland Revenue makes a general

commitment that if it has not begun enquiries within twelve months of the statutory filing date, a tax return will normally become final. We would suggest a similar time frame be applied in Hong Kong.

Shortening Hong Kong's time-bar provisions

28. While taxpayers understand that they are required by law to keep their accounting records and documents for the previous seven years, adoption of the AFAL approach, especially for companies with tax losses in some years, is creating significant confusion among taxpayers.
29. The law states that past assessments cannot be made beyond seven years prior to the current year of assessment. However, if this period is preceded by years in which losses were made, and under the current practice the IRD does not confirm losses, it is possible that assessors will require details of a company's business for prior periods well beyond seven years and, if sufficient information is not forthcoming, the losses may be permanently "lost" and unavailable for setting off against future profits.
30. This practice is confusing to taxpayers and it also means that assessments/losses are not finalised within a reasonable time frame. Some companies that are subsidiaries of overseas companies have to explain to overseas auditors the reasons for this treatment, and it is often difficult for overseas auditors or holding companies to comprehend.
31. The potential for re-opening of tax affairs is also a major factor exacerbating the uncertainty for taxpayers arising from the AFAL approach referred to above. Section 60, IRO, currently allows assessors to raise additional assessments within six years from the end of the year of assessment, which can be further extended to ten years in cases of fraud. In contrast, the corresponding time frames in various other jurisdictions for the re-opening of tax affairs tend to be relatively shorter. Some examples are set out in [Appendix 2](#).
32. Given the number of jurisdictions that currently provide more limited time frames for re-opening tax affairs, we feel that Hong Kong should similarly reduce the "time bar" period from six to three or four years. This should continue to be subject to an extension to ten years in cases of fraud.

A statement of losses to be treated as an assessment

33. The treatment of losses, as indicated above, is another problem area in Hong Kong. Currently a statement of loss issued by the IRD is legally not treated as an assessment. It is not binding upon the IRD and the taxpayer cannot object to it. This is unhelpful for taxpayers, as they cannot be sure whether losses are available for setting off against profits for future years.
34. 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.

B2) The need to keep abreast of changing business developments and practices and to remain competitive in the region

Trading in Hong Kong and processing agreements in Mainland

35. "Low" is a relative concept. While Hong Kong's basic rates of tax are still relatively low, other jurisdictions in the region have also been progressively lowering their tax rates and, in addition, offering specific incentives to attract business. Hong Kong is in danger of going in the other direction, because, for example, the value of existing incentives has diminished in some cases, because of changes in business practices without any corresponding updating of, or increased flexibility in, the tax regime.
36. One example of this relates to Hong Kong companies engaging in manufacturing in the Mainland. Typically, they enter into a processing or assembly arrangement with a Mainland entity while Hong Kong serves as a sales and/or finance centre. Under DIPN 21, where the Hong Kong manufacturer retains the management and control of the offshore processing operations, a 50/50 apportionment basis applies to income earned by the Hong Kong manufacturer on the sale of goods. This provides a simple approach to resolving the question of whether manufacturing operations in the Mainland should or should not be considered to be more immediately responsible for the generation of sales income. However, the IRD strictly limits the application of this apportionment to certain specific legal forms of processing arrangements, known as "contract processing".
37. In the recent years, for various reasons, a different form of arrangement known as "import processing" has become more prevalent and, we understand, the form more favourably treated by the Mainland government. Under import processing, the Hong Kong company continues to provide expertise in terms of technical know-how, management, production skills, design, skilled labour, training and supervision for its manufacturing facilities in the Mainland, although the facilities are structured as wholly-owned foreign enterprises, with, generally, common ownership with the Hong Kong company.
38. The IRD does not recognise these latter arrangements for the purposes of 50/50 apportionment on the grounds that the Mainland entity is regarded as a separate legal entity and so the arrangements are on a principal-to-principal footing and the source rule does not apply. This discounts the substance of the arrangement and focuses only on the form and would seem to us to be counter-productive at a time when Hong Kong should be trying to boost incentives for investment.
39. With a rapidly improving business environment, including banking facilities and telecommunications, in the Mainland, the need for manufacturers to maintain a sales and/or finance office in Hong Kong is diminishing. Given also the increasing competition from the tax systems of neighbouring jurisdictions, Hong Kong faces a real threat of losing its status as a centre for the sales/finance office function. If these functions cease to be undertaken in Hong Kong, this is also likely to have a negative impact on the local logistics industry.
40. The IRD should consider whether in substance, in respect of the Hong Kong entity, a particular arrangement can essentially be regarded as processing agreement or offshore manufacturing arrangement. If so, then the Hong Kong entity involved should be eligible for a 50/50 apportionment of profits tax. This would also take into account the changing practices in the Mainland, where it has become

increasingly difficult to set up processing agreements in the form envisaged by DIPN 21. We also believe that the *ING Baring* case supports the view that the substance rather than the form of a transaction should be given more weight, i.e., in that case, it was made clear that the essential questions to ask are what in substance the taxpayer has done to earn the relevant profits, and where was it done?

Apportionment of profits

41. The difference in treatment between “contract processing” and “import processing”, referred to above, is not based on any distinction made in case law. While, as indicated above, the principle of apportionment generally was confirmed in the *Hang Seng Bank* case established, greater clarity and flexibility is required in relation to the practice of apportioning profits where they are sourced partly in Hong Kong and partly offshore.
42. We propose, therefore, that the concept of apportionment be given statutory backing by including a general statement in the IRO that profits sourced partly in Hong Kong and partly offshore should be apportioned on a basis that is reasonable and appropriate in the circumstances of the case (c.f. Rule 2B of the Inland Revenue Rules under the IRO). The actual basis of apportionment could then be established through, for example, a clear set of transfer pricing rules.

Need for transfer pricing rules

43. Proposals for a comprehensive transfer-pricing regime should now be explored. Transfer-pricing rules are commonly found in countries with significant cross border activities and also Hong Kong does not have advanced pricing agreements with other jurisdictions. Currently Hong Kong deals with transfer pricing under section 20, IRO, which is a general provision. It is noted that, in the past, the IRD has expressed the view that taxpayers generally prefer to be chargeable to tax in Hong Kong rather than other jurisdictions and, therefore, formal rules are not necessary. However, transfer pricing is an issue that is routinely raised during field audits and practitioners consider that section 20 is not sufficient to address transfer-pricing issues. While the Double Taxation Arrangement (“DTA”) between Mainland and Hong Kong includes transfer-pricing provisions, these provisions are quite generic and do not provide a complete solution in relation to the Mainland. Clearly also, they cannot deal with transfer pricing between Hong Kong and other jurisdictions.

Group relief/loss relief

44. The Institute has been advocating for many years that some form of group relief should be introduced in Hong Kong. Group relief, namely the facility to offset losses by companies within the same group, is common in many developed tax jurisdictions and Hong Kong is placed at a disadvantage by not offering this treatment. The need for group relief has become even more apparent given the IRD’s interpretation of the decision in *Secan* (see above).
45. In its 2006/07 Budget, the government responded to the numerous calls for group relief to be introduced, by arguing that it would come at a heavy cost to government revenue, is prone to abuse and would also entail complex legislation.

46. However, systems of group relief have been successfully implemented in a number of developed tax jurisdictions in Asia, including Singapore, Australia, Japan, Malaysia, as well as in the United States (“US”), UK and some European countries. We are not aware of any evidence of widespread abuse in these jurisdictions.
47. As a result of the *Secan* case, unrealised profits (e.g., a nominal profits on a hedging arrangement) may be subject to profits tax, even though they might not be realised until a later period, or not at all. Introducing group relief in Hong Kong would at least enable unrealised gains, in principle, to be offset by losses incurred by other group companies.

Loss carry-back

48. The IRO currently allows losses incurred in one fiscal year to be offset against profits for subsequent years. However, the economic value of the loss to the business is diminished, bearing in mind that a business usually needs more cash in a year in which it makes a loss than in a year when it is profitable. On the other hand, the law does not allow a loss incurred in one year to be offset against profits for any prior year.
49. Again in the light of *Secan*, an unrealised gain in investments, for example, which is required to be reflected in the profit and loss account, could be taxable, even though ultimately there may be no gain realised at all. While, in principle, unrealised losses may also be set off against other profits or carried forward, where a business does not have other profits, and fails to make a profit in subsequent years before ceasing business altogether, it will not be able to set off such losses, even though it may previously have been taxed on its unrealised gains. This is inequitable.
50. The government’s response to the Institute’s proposal to introduce loss carry-back arrangements in Hong Kong, has been to suggest that such provisions would come at a cost to government revenue. However, many countries with advanced taxation systems, e.g., Germany, Japan, the US and the Netherlands, have introduced loss carry-back provisions. To limit any effect on government revenue, the amount that may be carried back could be capped and the period of carry back could be limited to one year.

B3) Improving the quality of life

51. The current strength of the economy is only one factor in attracting the investment, skills and talent, which are the lifeblood of our success. The state of the environment and the quality of life in Hong Kong are other, increasingly important, factors.
52. Due to the poor quality of the environment, some people are already leaving Hong Kong to protect their children’s and their own health. Concrete action needs to be taken on this front. Hong Kong also needs to do its part in minimising the effects of climate change.
53. There is evidence of growing concern amongst Hong Kong residents about the destruction of well-known landmarks that connect them with the past, in order to clear sites for redevelopment and “progress”. More citizens are questioning whether unrestrained redevelopment and progress are the same thing.

54. Amongst those who are leaving Hong Kong due to environmental concerns are some of Hong Kong top athletes. Not enough attention is given to sport in Hong Kong. Encouraging participation in sports helps to promote a healthy body and mind and it can also enable the young to appreciate the values of positive competition and sportsmanship. The year of the Olympics in Beijing, in which Hong Kong will play a part, would be a very good year to do more in this area.
55. Very serious concern is being expressed about the gulf between rich and poor and the alienation that some residents who live in the more remote satellite towns feel.
56. The perception that quality of life in Hong Kong is lacking, and even that it is deteriorating, is potentially very damaging to Hong Kong. Moreover, it is a not a view that is expressed only within Hong Kong or the local media, but it is also being talked about and reported internationally.

Improving the environment

57. The 2006/07 Budget Speech acknowledged the need to enhance public awareness of environmental protection and that the adoption of fiscal measures and the “polluter pays” principle may help to achieve that objective. The Chief Executive has also emphasised in his Policy Addresses that priority should be given to fighting pollution. The Institute agrees that priority be accorded to this area and has been advocating greater awareness and more co-ordinated action on a domestic and cross-border front for several years.
58. We support the proposals regarding the government’s municipal solid waste management strategy and welcome the consultation that has been launched on idling engines. We look forward to seeing the proposals implemented.
59. Proposals are in the pipeline for the introduction of charges on solid waste. While this may help to encourage the minimisation of certain types of waste, the Institute has suggested that consideration be given to applying the “polluter pays” principle more widely, and to the introduction of additional forms of environmental protection measures as part of a co-ordinated environmental policy. Consideration could be given to:
 - Emission taxes.
 - Taxes on polluting inputs.
 - Credits for emission reduction.
 - Permits to emit a specified amount of a pollutant.
 - Targeted public sector procurement policies.

More specific measures could embrace, for example:

- A comprehensive review of fuel duties.
- Electronic road pricing.
- Air and water pollutant taxes.
- Taxes in respect of the disposal of plastics, glass, batteries and vehicles.
- Taxes on polystyrene foam and plastic bags or other non-biodegradable matter.
- A refund system to encourage recycling.

- Carbon and energy taxes (on electricity, coal, gasoline, etc.) and other resource consumption taxes.
 - Refund mechanisms to reward the control of pollutants and efficient use of energy.
 - Imposing a green tax on motor vehicle ownership and non-biodegradable products.
60. In addition, tax incentives, such as accelerated depreciation allowances, or deductions in excess of 100%, could be offered as incentives. Possible measures include:
- Concessions for investment in, spending on, environmental protection equipment, machinery or systems;
 - grants (such as low/no interest loans) to small and medium-sized enterprises (SMEs) which have insufficient capital to acquire environmental protection equipment, machinery or systems.
61. There is now a general consensus amongst the scientific community that human activity is contributing to climate change and that, unless the observable rise in temperatures is curbed significantly, it will have a devastating effect on the planet. Greater energy efficiency is part of the solution. We propose the following as one possible measure to encourage energy efficiency in buildings:
- New industrial and commercial complexes adopting approved environmentally sustainable designs could be given additional commercial building or industrial building allowances, for example:

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

- Expenditure on the installation of energy efficient systems for old buildings such as double-glazing and solar energy, could be given a 150% deduction in the year of expenditure. Any potential disincentives to such spending should also be reviewed and addressed as far as possible.

Cross-border pollution

62. More radical measures, and a change in mindset, may be required, as the air pollution in Hong Kong and the Pearl River Delta, generally, has reached intolerable levels. The concern expressed internationally, as well in Hong Kong and also in the Mainland, about environment degradation, climate change and issues of energy efficiency, make it clear that these issues can no longer take a back seat to economic development. The two must go hand in hand. Both are essential elements of sustainable growth, which is a legacy that we should leave to next generation.

63. There is clearly pressing need to work closely with the Mainland authorities to take practical steps to alleviate the situation. If fiscal measures in Hong Kong can be of any assistance in these efforts, they should be considered, in order to facilitate the long-term sustainable development of the region and to protect public health on both sides of the border.

Preserving Hong Kong's culture and heritage

64. Preserving Hong Kong's history and maintaining symbols of the past and the community's so-called "collective memory", and developing Hong Kong's cultural life may help to foster a deeper sense of belonging amongst citizens of Hong Kong. More than this, however, they are also important considerations from the point of view of efforts to improve the quality of life, which is essential if we wish to continue to attract and retain talent and stimulate creativity and entrepreneurial skills in the community.

65. Measures that could be considered in this context:

- Set up body in Hong Kong along the lines of the National Trust or English Heritage in the UK.
- Allow owners to donate private buildings, landmarks, etc. to this body and these 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 through, e.g., a land swap for the remainder.
- Cash donations to this body should be treated as charitable donations.
- As in the UK, allow taxpayers to pass the benefit of their tax deductions arising from charitable donations to those charities to which they have donated.

Promoting the Olympic ideal

66. Hong Kong is regularly criticised for being concerned only about business. While the strength of the economy is the foundation upon which much else is built, it is not a sufficient condition for a thriving and healthy community. Art and culture are also important and so are sports and recreation. More effort should be devoted to encouraging participation in sports in Hong Kong, given the health, both physical and mental, and other benefits that this can bring. There also needs to be a change in the false perception that sport and fitness cannot offer a proper career for young people. One way to encourage greater participation in sport is to assist elite athletes to do better on the international stage and become "sporting heroes" for the community. The whole community was inspired and felt a sense of pride and joy when Lee Lai-shan, "San San", won the windsurfing gold medal at the 1996 Olympics in Atlanta. The year of the Olympics in China, in which Hong Kong will participate directly, provides a very good backdrop for doing more here.

67. As a start, we propose that, in the year of assessment 2008/09, donations to the Hong Kong Athletes Fund, which nurtures athletes under the management of the Hong Kong Sports Institute, or other approved sports development funds, should be treated separately from other tax-deductible donations. They should not

count towards the 25% ceiling of income or profits applicable to other tax-deductible donations and should not have any separate ceiling of their own.

Creating employment opportunities

68. We support the proposals in the Chief Executive's 2007 Policy Address on social enterprises but, in addition to this, other options for community development should also be explored.
69. There are examples overseas of incentives being offered to businesses to relocate (back) offices or particular functions from congested metropolises to cheaper satellite towns outside the centre. For example, in the UK many companies moved offices from London to satellite towns such as Peterborough, Milton Keynes, or even further afield. This included the relocation of some government offices. Similar measures should be explored in Hong Kong. This can help to improve employment prospects and encourage regeneration of older areas and/or more beneficial development in newer towns, which will help to boost the local economy. Such initiatives can also serve to reduce congestion and unrestrained urban expansion of the centre. Tin Shui Wai would be one potential target area. Offering incentives to relocate back office or other functions, and thereby creating new employment opportunities should help to alleviate some of problems currently faced in areas such as this.
70. Incentives could be in the form of tax holidays and/or reductions in water, electricity, rates charges etc.

B4) Addressing Hong Kong's narrow tax base

71. In February 2002, the Task Force on Review of Public Finances identified changes that had occurred on the revenue and expenditure side of the budget and concluded that Hong Kong was facing a structural fiscal problem. On the expenditure side, the cumulative growth of government expenditure in nominal terms started to outstrip growth in the economy from 1993-94 and the gap widened from 1997-98 onwards. This, coupled with the aging of the Hong Kong population, which meant that there would be increasing demand for social security payments, prompted the Secretary for the Treasury to state: "the directions indicate that the continuation of current revenue and expenditure policy is not an option". The Task Force recommended that the first priority was to control the growth of government expenditure. On the revenue side the Task Force recommended that the government should consider the recommendations of the Advisory Committee on New Broad-based Taxes.
72. Since the Task Force released its recommendations, there has clearly been a very significant improvement in the economy, which, in 2006/07 resulted in a surplus of HK\$58.6 billion in the consolidated account, compared with a 2006 budget forecast of a surplus of HK\$5.6 billion. In 2005/06, for the first time since 1997/98, both the operating account and the consolidated (overall recurrent and capital) accounts were in surplus. On the basis of forecast growth of 4.5%, the government anticipates achieving surpluses in both accounts for the period to 2011/12.
73. Nevertheless, larger than projected land premiums, issuance of bonds by the government and, more recently also, substantially greater stock turnover than expected, have been significant contributors to this turn around, which points to continuing reliance on potentially volatile sources of income. There remains a

question, therefore, as to whether, in the longer term, Hong Kong's taxation system is able to generate sufficient revenues from stable sources in order to pay for a broad range of community services and major capital projects. At the same time, proper control over government expenditure must be maintained to ensure that revenues raised are utilised as efficiently and effectively as possible.

74. In July 2006, the government issued a consultation document on tax reform, entitled, "*Broadening the Tax Base Ensuring Our Future Prosperity - What's the Best Option for Hong Kong?*" and launched a nine-month public consultation exercise. On 5 December 2006, the then Financial Secretary ("FS") announced that, due to the lack of public support for a goods and services tax ("GST"), GST would no longer be advocated as the only option for broadening the tax base and views were invited on other options.
75. In March 2007, the Institute made an extensive submission examining various possible options for broadening the tax base. This is not an issue that will go away given the challenges faced by Hong Kong including:
- Over reliance on volatile source of revenue
 - An aging population and low birth rate
 - Reducing work force (due to the point immediately above)
 - Increasing medical costs (due also in part to the aging phenomenon)
 - Need to improve to the environment and consider long term sustainability policies, not just economic growth
76. Although the economy is now in much better shape than it was in 2002, the continuing narrowness of the tax base reduces the government's room to manoeuvre and to offer incentives and concessions that could help to reinforce and entrench Hong Kong's position as an intermediary and base for regional offices and a springboard for doing business in the Mainland and elsewhere. We believe that the increasing competitiveness of other locations and the lack of productive and reliable, non-volatile sources of recurrent revenue, will in the long run pose a threat to Hong Kong's ability to address the economic challenges that it will inevitably face, some of which are already known and anticipated. Therefore, we urge the government to continue it explore options to broaden the tax base.
77. In its March 2007 submission to the government (the executive summary of which is copied at [Appendix 3](#)) whilst the Institute concluded that no single option would be better than a goods and services tax in meeting the various 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 either singly or in combination, including: payroll and social security taxes; a single stage retail sales tax; a surcharge on utility supplies and green taxes.

II. OPPORTUNITIES

78. In order to enhance Hong Kong's appeal as a financial centre and business hub, in addition to addressing some of the perceived problems with the tax system, opportunities should be taken to enhance incentives for investment.

B5) Enhancing Hong Kong's status as a business and financial centre and supporting key sectors

Tax Rates – profits tax

79. We support the measures in the Chief Executive's 2007 Policy Address to reduce the rate of corporate profits tax to 16.5% and the standard rate for salaries tax to 15%, which are largely in line with our previous proposals, based on the 2005/06 surplus, and the projections for continuing growth at the time, that a reduction in the rate of profits tax to the 2002/03 level, before the rates were increased following a series of fiscal deficits, would be appropriate. In 2006/07, the consolidated budget surplus was revised upwards from an estimated HK\$5.6 billion at the time of the 2006 Budget Speech to a final figure of HK\$58.6 billion, which further supports the case for a reduction.
80. Furthermore, the Institute notes the international trend towards lowering the rate of corporate taxes and, against this background, we believe that it is necessary to research the longer-term trends, particularly in competing markets. To this end, we suggest that a study be conducted, including international comparisons, with a view to reducing profits tax rates over a period, and securing Hong Kong's long-term, competitive position. In formulating an appropriate strategy, due consideration will need to be given to the following, amongst other factors:
- The fiscal position
 - The international trend
 - The effective tax rates, not merely the published rates, in competing jurisdictions, particularly for industries that are vital to Hong Kong's economy, e.g. service industries.

Tax rates - salaries tax

81. Proposals contained in our 2007 budget submission, to reduce the tax burden on middle-income earners by increasing the salaries tax bandwidth for the marginal rates from HK\$30,000 to HK\$35,000 and reducing the top two marginal rates from 19% and 13% to 17% and 12%, respectively, to bring the bandwidths and marginal rates back to their 2002/03 levels, were implemented in the 2007 budget.
82. The Institute also proposed reducing the standard rate of salaries tax by one percent from the present 16% to 15%, back to the 2002/03 level. We note that the Chief Executive announced in his 2007 Policy Address that this measure will be implemented. These are welcome changes.
83. Given the current fiscal position, we believe that there is further scope to reduce the marginal tax rates and increase the width of the tax bands. This will give additional support to lower and middle-income taxpayers at a time when rising inflation is beginning to erode the purchasing power of these groups, who are amongst those least able to afford it. We would suggest, therefore, reducing the marginal rates by 1% each and widening the tax bands from HK\$35,000 to

HK\$40,000. If accepted the comparison would be as follows (see [Appendix 4](#) for examples of the dollar and percentage tax savings):

<u>Actual 2007/08</u>		<u>Proposed 2008/09</u>	
First HK\$35,000	2%	First HK\$40,000	1%
Next HK\$35,000	7%	Next HK\$40,000	6%
Next HK\$35,000	12%	Next HK\$40,000	11%
Balance	17%	Balance	16%
Standard rate	16%	Standard rate	15%

84. The study proposed above in relation to profits tax should also cover salaries tax and personal allowances as well and the long-term aim should likewise be to reduce the burden of personal direct taxation. Hong Kong's system of taxation must remain competitive in all major respects with other major financial and business centers around the world. We cannot afford to be caught unprepared or to be quietly outdone by other jurisdictions, which may be more aggressive in seeking new investment.

Personal allowances

85. Increases in personal allowances introduced when the economy was stronger, in the mid-1990s, subsequently contributed to a narrowing of the salaries tax base. We note that, over the past few years, reductions in the basic personal allowance and the married person's allowance have been implemented partly to redress this situation. We suggest that there be a further look at personal allowances with a view to identifying an appropriate base year for calculations, so that any future adjustments in allowances take account of actual (e.g., inflationary) changes in the economy and there is no further narrowing of the tax base.

Development of intellectual property in Hong Kong

86. Consistent with Hong Kong's development towards an increasing focus on value-added services and a knowledge-based economy, the Institute proposes that the tax concessions in relation to intellectual property under the IRO be extended. The concessions under sections 16E and 16B should be reviewed to establish a tax framework that makes Hong Kong more attractive as a centre for the development of intellectual property. This should include providing for:
- 100% deductions for the cost of acquisition of trademarks and copyrights generally, not only patents;
 - deductions for the interest expenses incurred (for the period before the relevant property is used to produce assessable profits) in financing the acquisition of trademarks and copyrights generally, not only patents;
 - tax credits for any foreign tax paid royalty income;
 - suitable anti-avoidance provisions may also need to be considered.

Supporting Hong Kong's role as a logistics hub

87. In the past decades, the excellent port facilities and geographic location of Hong Kong have rendered it the primary port in South East Asia for tourism and exports to Europe and North America. In the 2002/03 Budget Speech, the logistics industry was identified as one of the four main strategic sectors in Hong Kong's economy. In recent years, however, the cargo business via the Hong Kong International Airport and the Kwai Chung terminals has encountered keen competition from neighbouring ports in the Pearl River Delta terms of costs.
88. The logistics industry provides significant job opportunities for various groups of our people, from professionals in high-end technology to semi-skilled and unskilled less labour. The profit margins of their customers, e.g. garment, toys electronic products manufacturers, are usually so thin that transportation costs take a substantial portion of their costs. Though the operational efficiency of our logistics industry is world class, our land costs and salary levels have pushed up the industry's costs, and hence prices, much above those of its competitors. For instance, the terminal charges of Guangzhou Baiyun Airport are only 18% of those of Hong Kong International Airport. The charges of Kwai Chung terminals are also significantly more than those of Shenzhen.
89. In order to support our logistics industry we recommend consideration of concessions for international/cross-border freight transportation business such as:
- Exemption from or reduction in rates for storage facilities used directly for the logistics business, e.g. warehouse, piers, etc;
 - 50% reduction in the rate of profits tax on income derived from the international freight forwarding business, initially for a three-year period; and
 - improvements in the rail infrastructure by e.g., building express lines connecting to main railways in Guangdong, to reduce the time and costs of transporting cargo to terminals in Hong Kong.

Regional headquarters and offices

90. Hong Kong remains a hub for regional headquarters and offices. However, while the overall number of offices may not be reducing, the number of new offices being opened is reducing and they appear to be employing fewer staff. For example, a survey recently quoted in the press, found that, in the first five months of the year, 63 companies opened offices employing 381 people, which, over a full year equates to about 150 offices, employing about 900 people. The number employed is more than 90 per cent and almost 30 per cent down from 1997 and 2006 respectively. New offices are also now smaller. There were 43 new regional headquarters employing 1,537 people in 2003 while two years ago, 46 regional headquarters opened with 404 employees. Up to May this year, just seven regional headquarters opened with only 25 employees¹. We have previously proposed certain measures to enhance Hong Kong's competitiveness as a location for regional offices, service centres and group companies.

¹ South China Morning Post, 11 November 2007, page A1 (with reference to the Census and Statistics Department)

91. A survey carried out recently by the Hong Kong General Chamber of Commerce found that a significant proportion of businesses were not confident about Hong Kong's future competitiveness. Meanwhile, in the Global Competitiveness Report 2007-08 published by the World Economic Forum, Hong Kong has dropped from 10th place to 12th place. Singapore, Japan and South Korea are among the economies rated higher than Hong Kong. We believe that that remedial action needs to be taken to counter this seemingly negative trend. Measures to be considered should include:
- Tax exemption for regional headquarters/ offices in respect of management and consultancy income derived by the Hong Kong entity from associated entities overseas (see below).
 - Tax exemption for interest income received by regional offices from loans made in Hong Kong to their overseas associates (see below).
 - Introduction of group relief (see above).
 - Offsetting of losses incurred in the current year of assessment against the assessable profits of one previous year (see above).
 - Unilateral tax credit for the amount of foreign withholding tax paid (in jurisdictions with no DTA with Hong Kong) on income sourced in Hong Kong, of up to a maximum of 50% of the amount of Hong Kong profits tax payable on such income (see below).

Tax exemption for management fees received from overseas associates

92. There has been a trend of globalisation whereby jobs have moved to locations with very low labour and land costs. The costs of land and labour in Hong Kong are significantly higher than those in many neighbouring locations and, therefore, low-skilled jobs have moved from Hong Kong to other areas. Hong Kong still remains competitive because of its infrastructure and human resources, including good legal and financial systems, and its well-trained professionals but there are signs of change.
93. In this highly competitive environment, cost efficiencies are important. Overall tax costs and benefits are certainly an important factor when selecting the location of a regional service centre.
94. We therefore reiterate our proposal for a full exemption from profits tax to be granted to regional headquarters/offices in Hong Kong in respect of management and consultancy income derived by the Hong Kong entity from associated entities overseas. This would encourage the establishment of regional headquarters in Hong Kong and create jobs for professionals and other personnel. We have also previously suggested possible anti-avoidance provisions to prevent abuse of this relief by ensuring that the term "associated entities overseas" is suitably defined.

Tax exemption for interest received on loans made to overseas associates

95. As regional service centre usually handles the financial management of other associated companies in the region. Hong Kong is well equipped to provide such services by virtue of its first-rate banking system and well-trained professionals. Yet financial margins are usually thin and so tax costs and benefits are highly relevant in the selection of suitable regional service centres.

96. Currently section 15(1)(f), IRO, deems the interest derived by a corporation on loans made to its overseas associates to be subject to profits tax the standard corporate rate if the provision of credit is made in Hong Kong. While, in practice, group companies may arrange for the provision of inter-company credit to be made outside of Hong Kong, we believe that if the interest received by regional offices from loans made in Hong Kong to their overseas associates were to be exempted from profits tax, this would provide a further incentive for international businesses to establish their treasury function in Hong Kong. This would, in turn, benefit the further development of the financial services sector.

Tax relief on withholding tax

97. The current tax law contains provisions for Hong Kong taxpayers to offset Hong Kong profits tax against overseas withholding taxes paid in those countries with which Hong Kong has concluded arrangements for the relief of double taxation. However, Hong Kong has so far only concluded three DTAs, with the Mainland, Belgium and Thailand, and therefore tax credits can only be claimed for withholding taxes paid in the Mainland, Belgium and Thailand.
98. Only limited relief is available for Hong Kong taxpayers on taxes paid in non-DTA 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 (e.g., withholding taxes). This in effect leaves the bulk of the withholding tax paid not relieved (at the current tax rate of 17.5%, 82.5% 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 (e.g., interest, royalties, and service/management/technical fees).
99. While further DTAs may be negotiated in future, it is not clear whether the government will be able to create a network of DTAs and, if it were able to, when this would happen. Therefore, in order to enhance Hong Kong as a regional services centre and knowledge-based economy, 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 withholding tax in another (non-DTA) jurisdiction, be addressed by introducing a unilateral tax credit in Hong Kong for the amount of foreign withholding tax paid, up to a maximum, initially, of 50% of the Hong Kong profits tax payable.

Cost of doing business

100. We appreciate that tax costs are only one, albeit potentially an important, factor, in relation to decisions on a location for investment. We believe that it would be very useful to conduct a survey amongst business community of Hong Kong's competitiveness, with a view to identifying key strengths and weaknesses, including the relative priority of the tax system and tax incentives and concessions and other factors.

B6) Promoting health and education

Health care expenditure

101. Against a background of an aging population, advances in medical technology and rising community expectations, health care expenditure is expected to continue to grow in the future, which is a similar trend to other advanced

economies. It is, therefore, critically important to determine how to maintain a financially sustainable public health care system over the long term.

102. One consideration would be to adopt the “user pays” principle to a greater extent for health care services above the basic level, e.g., for ambulance services other than in emergency cases.
103. The government should also consider introducing a tax deduction/incentives for individuals investing in medical insurance, or voluntarily setting aside monies in a dedicated fund that could be set up for medical expenses. The amount should be deductible upon contribution into a fund set up and independently administered for this purpose. A fund of this kind would also help the development of investment management industry in Hong Kong, in a similar way to the mandatory provident fund scheme (“MPF”).
104. The maximum deduction could be capped at a fixed amount and any amounts that were subsequently taken out for purposes other than medical could be subject to taxation.
105. It is suggested the government should investigate what incentives would be attractive enough to encourage more people to move away from reliance on public medical health care towards using private healthcare. Issues such as whether incentives should be extended to individuals who finance the medical insurance/funds for their non-working dependent family members, how the incentives could be recouped if monies were taken out from the investment funds for other reasons, etc. would need to be discussed. There should be a public consultation exercise
106. Other factors, e.g., whether the fund should be separately administered like the MPF, while remaining non-mandatory, would need to be considered carefully.
107. We note that the government is already planning to consult the public on a mandatory medical saving scheme, which may have some similarities to the Institute’s proposal. This is an important issue and we hope that a range of possible options will be open for discussion.

Education expenses and professional memberships

Self-education expenses

108. In view of the increasing costs of educational courses, we propose that the current limit of HK\$60,000 on the deduction for self-education expenses be increased to HK\$80,000, to encourage salaries tax payers to attend approved courses, including relevant undergraduate, postgraduate, professional training and language courses.
109. In response to the Institute’s Budget Proposals 2006/07, the government indicated that, with the average claim at HK\$13,000, it did not see the need to enhance the deduction ceiling for self-education expenses. Nevertheless, the deduction was increased from HK\$40,000 to HK\$60,000 in the 2007/08 budget, which we welcome. We believe that there is still scope for a further increase. As regards the figure of HK\$13,000, averages can be misleading. While many professionals, for example, may claim only HK\$10,000 or less for continuing professional development-type courses, students can quite easily incur costs of HK\$100,000 or more, but are limited to claims of HK\$60,000 in terms of relief. It

would be useful to know how many claims exceed HK\$60,000. Furthermore, if it the case that the average of HK\$13,000 is representative of the majority of claims, then increasing the amount will help needy students without any meaningful loss to government revenue.

110. The deduction for self-education expenses is available in respect of amounts actually paid in the year of assessment, irrespective of the period to which it relates. However, it should be noted that, in practice, these expenses could well be paid in a year of assessment when the taxpayer does not have any significant taxable income against which to offset the relevant expenses, particularly if the course involved is a full-time course, or if the person involved is unemployed at the time. It is proposed, therefore, that expenses on self-education should be able to be carried forward for up to three years to a time when the taxpayer concerned may be receiving sufficient income to be subject to salaries tax and so benefit from the deduction.
111. Given the importance of enhancing skill and knowledge levels in the working population in Hong Kong, we would also propose that, as with charitable donations, in the case of married couples, either spouse should be entitled to claim the deduction.

Higher education assistance to students

112. A review of the system is needed in relation to students' tuition fees. While it is noted that parents can claim child allowances for children who are still studying, up to the age of 25 years old, these cover only living expenses.
113. Education costs in Hong Kong are comparatively high in the region and it is noted that a lower proportion of students go on to tertiary education in Hong Kong than in a number of other jurisdictions in this region (e.g., Singapore and Malaysia). Consideration should be given to providing more assistance for students' tuition fees and other education costs. While loans are already available for low-income families, more extensive student loan arrangements are available elsewhere, e.g., in Australia and the United Kingdom. Students are required to repay the loans only when they start to earn a sufficiently high employment income. It is also noted that, for example, the Macau Government has started a substantial subsidy programme for student tuition. The system should be reviewed in Hong Kong to facilitate loans to students for tuition and other education costs. Repayment of these loans could, for example, be required once a working graduate's income reaches a certain level, and be tax deductible if the graduate repays voluntarily at income levels below that threshold.

Professional memberships

114. To provide a more certain tax environment and to further assist the service sector, we recommend that the deduction for professional membership subscriptions should be provided for under the IRO, and not merely as a matter of administrative discretion or concession. This deduction should be allowed for all professional membership subscriptions, and not only one as is currently allowed, subject to a ceiling of HK\$12,000 in aggregate per annum, if obtaining and maintaining the relevant memberships helps a taxpayer to keep abreast of and enhance his knowledge and his employability. This change will also provide the following benefits:

- (i) It will help enlarge the membership of many professional associations, which will, in turn, help invigorate those associations for the benefit of Hong Kong industries.
- (ii) As many professional associations are international in scope, participation in the activities of professional associations helps improve the international exposure of Hong Kong professionals, and is one type of self-education for them.
- (iii) As most professionals are middle-income earners, the proposed deduction can also go some way towards relieving the tax burden on this group.

B7) Government services

Maintaining control of government expenditure

115. Notwithstanding the significant improvement in the economy, and the package of infrastructure projects announced in the Policy Address, there is a need to ensure that there is not an unrestrained growth in government expenditure.

Privatisation of public services

116. In accordance with the principle of “big market, small government”, it is the objective of the government to encourage free competition and create business opportunities for the economy. In general, the government should not compete with the private sector in providing services to the public and, wherever possible, should consider privatising services and allowing them to operate on a commercial basis.

117. Privatisation subjects services to the disciplines of market and, in principle, enables them to operate in a more cost-effective, customer-oriented and flexible manner. The performance of the services could also be measured more accurately in terms of costs and benefits.

118. To enhance the efficient use of resources and the delivery of public services, the government should continue reviewing its existing services and monitoring market conditions to decide which services could be privatised, and the most appropriate time for doing so.

User pays principle

119. A detailed review of the level of duties and fees levied by the government should be undertaken and as far as possible, the “user pays” principle should be adopted. As indicated above, consideration could also be given to adopting the “user pays principle” to a greater extent for non-essential medical services such as non-emergency ambulance service.

III. OTHER PROPOSALS

B8) Additional technical proposals

Personal assessment

120. The requirement for spouses to be jointly assessed under personal assessment is an outdated provision on the tax system and should be reviewed. Individuals are responsible for their own taxes in Hong Kong. This applies to profits tax and salaries tax alike. Property taxes meanwhile are levied based on the relevant property.
121. 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.
122. 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 wives to work and so they would not often have income assessable to tax. Therefore, the tax impact was generally the same whether couples elected for personal assessment as married or as unmarried couples.
123. Society has changed since then. As both spouses are often working and generating income assessable to tax, electing for personal assessment as a legally married couple results in having to pay more tax than as an unmarried couple. This disadvantage arises due to the availability of marginal tax rates at lower levels of income. Married couples electing for personal assessment enjoy the benefit of the marginal tax rates on a single aggregated income only, while unmarried couples can benefit from the marginal rates on both their incomes. This inequality in the tax regime, in effect, amounts to discrimination against married couples.

Property related measures

Definition of "trading" in relation to taxation of property gains

124. 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.
125. 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 US uses a holding period of one year to distinguish short-term versus long-term capital gains.² Consideration should be given to adopting a similar clear cut off in Hong Kong. We would propose a holding period of two years in Hong Kong and that this should be applicable to both

² <http://www.irs.gov/newsroom/article/0,,id=106799,00.html>

commercial and residential property. In relation to new buildings, the two-year period should be counted from the date of completion. The family home should be exempted from this measure.

Stamp duty on real property

126. The flat HK\$100 fee for stamp duty was extended in the 2007/08 budget to properties of up to HK\$2 million in value. Given the continuing inflation in property prices, it is suggested that this figure be increased to HK\$3 million and that the ceiling be adjusted periodically in line with the property price index.

Property tax

127. Property tax is currently levied on the owner of land and/or buildings situated in Hong Kong ("the landlord"), at the rate of 16%, for the 2006/07 year of assessment, 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.

128. For private 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. The current policy, therefore, does not offer any encouragement to landlords to renovate the buildings they own. As many buildings in Hong Kong are aging and in need of remedial work, this policy should be reviewed.

129. To encourage the renovation of older buildings, which, left unrepaired, can potentially endanger public safety, 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.