9 December 2011

The Hon John Tsang Chun-wah, GBM, JP
Financial Secretary
25/F, Central Government Offices
2 Tim Mei Avenue, Tamar,
Hong Kong

Dear

Proposals for the FY2012/13 Budget

The conclusion of this administration's term of office, and the extremely dangerous global financial and economic situation, lead us to focus on the near term. While the Hong Kong General Chamber of Commerce continues to support a wide range of initiatives that need to be implemented over the course of several years, those are matters for the next administration, and ones that do not require an urgent and comprehensive response in the first half of 2012.

With that in mind, we have dropped from our annual Budget Submission the longer term policy positions that we continue to strongly support. These an early adoption of more stringent AQOs, as the Chief Executive has promised; the pressing need for significantly upgrading the quality of our primary and secondary education; long-standing concerns about the narrowness of our taxbase; uncertainty in the law as to what is taxable and what is not; the lack of deductions for investment in profit-making capital equipment used by sub-contractors across the boundary; the need to establish a Tax Policy Office independent of the IRD; and other, longer-term issues. We still believe these are important measures that must be addressed to ensure our long term competitiveness, but this year we simply don't have time.

Our top priority is minimizing the damage that will occur as Europe and the United States deal with their respective fiscal and sovereign debt crises. The likelihood of a managed reduction of risks on both sides of the Atlantic is rapidly fading, and we need to respond. For months, we have been inundated with dire reports of imminent threats to the sustainability of the euro as a viable currency and the stability of finances among the world's largest developed economies. The wealthiest half of the world is now in or bordering on severe recession for the second time in three years. Even if heroic solutions are found, there is little prospect that the next several years will be ones of normal global growth, let alone prosperity.

…/-2

We cannot affect change in global demand, but it most certainly will affect us. What we can do is lower the cost and complexity of doing business in Hong Kong, so as to ensure that the worst of the consequences do not undermine what we have built over these many years. Although we are likely to experience less of a direct impact from these crises than will New York or London, we cannot avoid the fallout altogether. Rising inflation and wage expectations, compounded by the introduction of the statutory minimum wage and generous civil service pay increases, are pushing up the cost of doing business. There is a very real threat facing us, and we cannot avoid taking immediate action to minimize the damage.

With this in mind, we strongly urge you to identify the following policies as your highest priorities in the remainder of this administration's term of office (details are in the appendix):

<u>SMEs</u>. Some three-quarters of our members are SMEs, and through our annual Business Prospects Survey they tell us their top concern is the cost of doing business. Many worry that their order books are thinning out as demand in the OECD fades, and as a result they may have to cut costs. As Hong Kong braces itself for yet another global economic downturn, we would urge that you think broadly about how to assist our smaller companies including reviving the Special Loan Guarantee Scheme, which ended in December 2010. Suspending collection of fees and charges (discussed below) is a positive and immediate step that would be particularly welcome by companies struggling to make any profit at all.

<u>Profits Tax Rate</u>. Headline tax rates matter to companies deciding where to establish a presence, and ours are still somewhat competitive. *Effective* tax rates, however, contribute to decisions as to where to expand, and where to reduce or close a company's presence. Given that we lack a large market, low cost labour or inexpensive land, our effective tax rate is too high.

We propose immediately reducing the Profits Tax rate to 15%. In support of SMEs, we propose instituting a two-tiered system whereby qualifying SMEs would be taxed at a lower rate of 10% in respect of its the first $2 million of taxable profits; allowing a longer lead time for paying final profits taxes; and simplifying the auditing and reporting requirements for SMEs.

<u>Effective Tax Rate</u>. One of the main reasons our effective tax rate is higher than that of Singapore and other competing jurisdictions is the lack of provisions for group loss relief and loss carryback. As we have argued in great detail before, there is no reason to believe that modernizing our tax regime through the adoption of these measures will either complicate filing for companies or reduce revenues to the government. Even if the latter were a concern, we have more money than we need, and this provision is hurting our competitiveness. It is past time to act.

Deductions. For companies seeking shelter from the global financial storm, the local bond market is an unattractive option. This is because we tax income from Hong Kong corporate bonds, but not those arising from foreign bonds. Aside from undermining the development of our bond market, it encourages companies to move capital out of Hong Kong. We believe this is both unwise and fiscally unnecessary.

Operating in Hong Kong is expensive, particularly when it comes to real estate. Companies that open a new office or retail outlet, or move from one place to another, incur significant restoration expenses as they leave one place for the next. We believe these are legitimate costs of doing business, and should be deductible.

Fees and Charges. An additional, temporary measure would be to suspend collection of all kinds of fees for licenses. Companies, and individuals, pay these fees regardless of their financial circumstances. Since, as we have pointed out, government does not need the money, we propose a one-year exemption for business-related fees, drivers licenses fees and other levies not related to safety, public interest or environmental protection. To this list we would add all fees and charges related to education for children up to secondary level. We would also suggest eliminating charges associated with advanced tax rulings.

Financial Secretary, the time has come to invest the fiscal reserves accumulated during better times, so as to ease the burden on our society, businesses and people. We hope you will agree.

Yours sincerely,

Anthony Wu
Chairman

Encl: Appendix

APPENDIX

Submission Details

1.0 The Profits Tax Rate

According to the World Bank, a company in Hong Kong pays 17.6% Profits Tax, more than the average for East Asia (16.8%) or the high-income OECD (15.4%). In Taiwan, the effective profits tax rate is 13.7%, in Korea 15.1%, in Malaysia 17%, and in Singapore just 6.5%.[1]

Clearly, we have some catching up to do to restore our decided advantage in attracting and keeping business operations. Moreover, the decision to increase the tax rate at a time when the government was running large fiscal deficits was specifically intended to be reversed once government restored a fiscal balance. Since then, we have run very large surpluses in almost every year, adding hundreds of billions to our reserves.

2.0 The Effective Tax Rate

Companies new to the region may give greater weight to headline tax rates when selecting a regional operating centre, but those already here know that it is the effective tax rate that matters. For Hong Kong, our simple and low (headline) tax rates are no longer as aggressively competitive as they have been in the past. In the face of global economic and financial uncertainty, we need to step up the quality of our offering.

2.1 Group loss relief and loss carryback

Having proven over the past several years that our revenues are enormously resilient, and with the understanding that group loss relief and loss carryback results in little (if any) foregone revenue, there seems no reason not to modernise our tax regime. We believe worrying about some small, theoretical loss of revenue misses the forest for the trees. This isn't about revenue; it is about competitiveness.

To alleviate the immediate financial burden of companies, especially those suffering under 'fair value' accounting rules, the loss carry-back measures should be introduced as soon as possible. Under 'fair value' accounting rule, the IRD taxes unrealized gains, but these gains may turn out to be losses when the underlying assets are disposed of. Without the loss-carry back provisions, an unfair situation arises when taxpayers must pay tax on profits they did not make.

<u>Background</u>: Businesses may function through separate legal entities but actually be a single economic unit. Due to legal, regulatory, commercial, economic and other reasons, it is not possible or advisable to carry out all transactions in a single legal entity. Governments around the world have progressively introduced group loss or other similar regimes such as group consolidated tax filing to reflect this economic reality. Singapore and Japan have done so in recent years.

---

[1] The World Bank, *Doing Business in 2012*, p. 74 [[http://www.doingbusiness.org/~/media/FPDKM/Doing%20Business/Documents/Profiles/Country/HKG.pdf]].

Hong Kong does not provide such tax relief, which places us at a global tax and economic disadvantage. This omission diminishes the attraction of Hong Kong as a base for holding companies and discourages Hong Kong enterprises from taking risks and innovation. We believe it is time to address this issue.

Refuting arguments against introducing Group Loss Relief. Upon closer examination, the problems often cited by the government for not introducing such tax relief do not appear to be valid. Where legitimate concerns are raised, there are measures that can be taken to resolve them. The objections are fourfold:

(1) *The introduction of group loss relief will encourage tax avoidance.* On the contrary, it is likely that such a measure will actually assist the IRD in improving its tax collection. The IRD will be able to collate information regarding a group for the first time, and such information will assist in the enforcement of the IRO.

(2) *Group relief is alleged to result in revenue loss.* However, when Australia and Singapore introduced loss relief, they estimated the loss in revenue to be in the order of a few percent of the total tax collections. The actual cost may be lower or higher as it is difficult to estimate the real impact of this measure. However, any loss will be partially offset by the improved enforcement as a result of a better understanding of the group companies and related party transactions, and increases in competitiveness which will lead to an increase in businesses being set up in Hong Kong, and ultimately, taxpayers.

(3) *We operate a simple tax regime, and group loss relief would be complicated.* It is true that certain types of loss relief measures such as a consolidation regime can be complex. However, the group loss transfer system such as that adopted by UK and Singapore is relatively simple. Singapore only added one section (Section 37C) to the Singapore Income Tax Act when it introduced the group loss transfer system. Under that section, a fellow group company may elect to transfer its loss to another group company by adding only one line to its tax computation.

(4) *We don't have adequate anti-avoidance provisions to deal with group loss relief.* On this point, we note that Singapore did not deem it necessary to enhance its own anti-avoidance legislation and, to the best of our knowledge, have not had to resort to application of even the existing regulations to any taxpayer. If, on the other hand, the argument is that Article 61A is inadequate, then that matter should be dealt with directly.

2.2 Loss carryback

Further, **there is a need to carry back losses**. To realize the full competitive advantage of group loss relief, it needs to be coupled with loss carry back. Under "fair value" accounting rules, the IRD requires gains or losses to be taxed (allowed) when the actual profit or loss is recorded in the accounts. The most obvious case where unfair taxation would likely occur is in securities trading, where a paper profit is taxable one year, but the subsequent loss cannot be carried back. We believe a three-year loss carry back would be appropriate.

2.3 A 10% tax rate on the first $2 million of taxable profits

Simple tax administration is as important as easily understood tax rates, but, it is no longer sufficient. Neighbouring countries such as Singapore, Malaysia, Thailand, Taiwan, Japan, Korea and even China have already adopted a tiered tax system to support SMEs or locally incorporated small companies. We live in a highly mobile, extremely competitive world and our members tell us Hong Kong has become too expensive for many kinds of business. They want to stay here, but cannot afford to do so. That needs to change.

We have the money necessary to forego a small portion of our profits tax revenue. To align Hong Kong with international practices for SMEs, we propose that a lower tax rate of 10% be applied to the first $2 million of taxable profits of qualifying SMEs. It adds no unfathomable complexity, benefits smaller companies more than medium sized ones and SMEs better than larger corporations. There is ample precedence to define and administer this pro-active step toward rebuilding our international competitiveness, including in Singapore and the Mainland of China.

2.4 Simplified reporting

Lower taxes help companies grow out of the need for such concessions, driving both employment and fiscal revenues over the longer period. But, if we make it too difficult, these vibrant businesses will either wither or leave. In addition to establishing a modest tax on the first dollars earned, we need to reduce the non-tax cost of compliance. Most smaller companies face additional red tape due to the pending imposition of a statutory minimum wage. Now, as that burden is imposed, it is time to lift some of the other weights bearing down on their shoulders.

Top of the list is to devise a very simple profits tax return document to be filed by SMEs. At present, the only tax concession afforded to a 'small corporation' (defined as one whose gross income does not exceed $500,000) is that it is not required to attach certain documentation to its annual tax return; but it is still required to prepare and retain such documents. If there is no need for such documents, there is no reason why companies should have to waste time on unnecessary paperwork. We are better than that, and this kind of useless red tape is an embarrassment.

2.5 Extended time for paying final Profits Taxes

Business seeks profit, but it needs cash flow. If the Government were scratching together revenue month by month, we would understand the need for a rapid collection of all available tax revenue. But, as we have an embarrassment of riches in the form of fiscal and other reserves, affording our SMEs a few extra months in which to pay what they owe just makes sense. We do not accept the argument that a company can ask for relief if it believes it has been over-assessed as the very steep penalties for erring in this calculation prohibit most businesses from taking such risks. Extending the time companies may pay the taxes they owe, without penalty or interest, is a no-cost way to encourage our SMEs to grow.

2.6 Exempt tax on income from local bond market

At present, if a Hong Kong corporation invests its funds in bonds issued by another Hong Kong corporation, the interest income is subject to Profits Tax. Effectively, Hong Kong corporations are encouraged to park surplus funds offshore, if they wish to earn non-taxable interest income from corporate bonds. Interest income from bonds issued in Hong Kong should be exempted from profits tax by extending the Exemption Order made in June 1998 to include such interest. This will encourage the development of Hong Kong's financial services and level the playing field for companies that raise finance locally.

2.7 Restoration depreciation

Every company that does not own its own premises (which includes most SMEs) periodically bears the cost of refurbishment. Unlike other legitimate business expenses, in this case there is no deduction for investment made to generate taxable profits. Moreover, tenants are frequently required to restore the premises back to the original position when the lease expires. For tax purposes, the restoration expenses are capital in nature, not deductible under Section 17(1)(c) of the IRO.

As the taxpayer is not entitled to any interest in the structure restored, no tax depreciation allowance is granted. As restoration requirement is a standard term in lease agreements and the expenses are sometimes quite substantial, it should be considered a deductible expense.