

TAXATION AND REVENUE RECOMMENDATIONS

The commitment by the Chief Executive in his recent Policy Address to reduce the profits and salaries tax rates has refocused attention on policy areas that have at least as much impact on our taxpayers as do rates. Although the “headline” tax rate receives a lot of attention, *what* is being taxed is frequently the main consideration, particularly for businesses deciding where to operate. Sadly, it has been nearly impossible in recent years to achieve any significant tax reform without running into objections from the Inland Revenue Department (IRD).

We think it is time for the Financial Secretary to reassert his authority over fiscal policy. We respect the professionalism of those who assess and collect taxes on behalf of the SAR Government, but we feel we must continually remind all concerned that the IRD’s role is strictly one of policy *implementation*, and not policy *making*. This simple distinction, if properly understood by all sides, will go a long ways toward eliminating the anti-competitive, income-oriented mentality that has hindered fiscal modernization for far too long.

Revenue is not the main issue. The previous Financial Secretary projected surpluses in excess of \$215 billion over five years, which renders revenue considerations a mere by-product of fiscal policymaking. While it is clear that we need to spend less and secure reliable – i.e., broader – revenue sources, the absolute sum of money coming into the government’s coffers each year is nearly \$50 billion more than is necessary to fund even the current high levels of expenditure.

It is now time to take strategic steps toward revitalizing our tax competitiveness for the medium and longer term. In doing so, we need to review what is taxed, where taxable transactions take place and the rates that apply. If we are successful, our closest competitors will find it ever more difficult to stay within range.

First and foremost is the issue of **group loss relief**. Our lack of group loss relief and loss carry back provisions continues to give Singapore and other jurisdictions a competitive edge. If the Profits Tax rate cannot be reduced to 15% immediately because of revenue concerns – which, given the previous budget, is difficult to believe – then **it is all the more imperative that nonrevenue factors such as group loss relief and loss carry back be implemented without delay.**

The second nonrevenue factor needing urgent attention is improved certainty and clarity. The lack of legislation clarifying what the IRD may consider to be taxable income has become problematic.

Third, we would seek to modify the IRD’s use of the six-year reassessment period. The problem is that tax returns from six years ago are routinely flagged for reassessment as the six-year deadline approaches, rather than being reviewed only if a question of accuracy arises. We believe significantly shortening the reassessment period (to perhaps four years as proposed in Singapore) would not only reduce the IRD’s workload but also prevent unnecessary delays that add to taxpayer uncertainty.

In the personal taxation area we would also call attention to the 1987 proposal of the then Financial Secretary, Piers Jacobs, to the Legislative Council to amend the Inland Revenue Ordinance to provide for the automatic granting of time apportionment where, in a year of assessment, an employee renders services outside Hong Kong for a period of more than 60 days in total. The then-FS estimated that this might cost 0.5% of salaries tax revenue. Although this proposal was made over 20 years ago, it is still unfulfilled. Today, the cost might be higher, but it would still be insignificant when compared to the benefit of tax certainty and the added attraction of Hong Kong as a place to base professionals active in several different jurisdictions around the region.

Each of the points listed above would significantly improve Hong Kong's tax competitiveness, and do so at a minimal cost. As mentioned, the most recent revenue projections should lay to rest the notion that preserving income is the main focus of our tax policy. Rather, we should be actively striving to fine tune the attractions of locating in Hong Kong so as to guarantee long-term and reliable revenues.

* * *

Review of the IRO

We recognize that removing the IRD from tax policy considerations is problematic. Therefore, we reiterate our call for the establishment of an independent review commission to examine specific issues related to the Inland Revenue Ordinance (IRO). Such a commission should focus on recommending a limited number of specific changes to the IRO that will improve its fairness, certainty and consistency while retaining the simple tax system for which Hong Kong is renowned. Lack of clarity under the IRO is detrimental to the planning of business investments, where a clear forecast of the likely tax cost to a business is often a deciding factor. Income tax uncertainties can also come as an unwelcome surprise to investors who may initially view Hong Kong's tax system in a positive light. In short, such uncertainties hamper Hong Kong's competitiveness and thereby its economic development.

The Chamber believes that a limited review of the IRO would be best conducted by a commission comprising one or more members with no prior involvement in drafting the existing legislation, and no vested interest, but who are nonetheless knowledgeable and well briefed. In the pages that follow, we have cited examples of some of the areas which would require the attention of the commission. These examples are not intended to be exhaustive. We have also commented on matters that are unrelated to the IRO.

1.0 Basic needs

1.1 Polluter Pays Taxes

Environmental pollution in Hong Kong is a major blight to the quality of life in Hong Kong, going far beyond air pollution. We would urge the government to consider to what extent environmental problems can be dealt with through the taxation system. A Task Force should be appointed to study the policies adopted in other countries, particularly Europe, where "green" taxes amount to approximately 8% of total taxes and social

contributions earned by government. Specific measures should be proposed based on the “polluter pays” principle, with a view to cleaning up the environment in Hong Kong.

By the same principle, we should also avoid discouraging positive behaviour. Lowering or eliminating the tax on ultra low sulphur diesel fuel would not only encourage drivers to switch away from dirtier fuels, but also contribute to reducing air pollution.

In principle, we believe measures taken to change unsustainable behaviour through taxation should be revenue neutral. By that, we mean that any income should be spent specifically on addressing the environmental concerns.

1.2 Healthcare Insurance

In principle, the Chamber strongly endorses the concept of user pays, but also recognizes that health care is a basic service that should not be denied to those who cannot afford it. With this in mind, we submitted our views on the healthcare reform consultation document “Building a Healthy Tomorrow” and look forward to the second stage consultation on financing options. We agree that the consultation paper’s basic premise – that primary healthcare should be pushed out of the public sector and into private hands – is sound, provided provisions are made for the most vulnerable members of society.

As one of the largest components of government costs, the healthcare industry is in need of serious attention. The user charges levied by the Hospital Authority are too low and cover even a fraction of the associated costs. Consequently, the government has to bear the brunt of the expenses, and this represents a serious drain on public resources. In recent years the subvention from the government to the Hospital Authority has amounted to approximately \$30 billion per annum, nearly 15% of total spending.

The healthcare system needs to offer the public greater choices and better services. At the same time we need to reduce dependence on public funding and increase private sector involvement. To achieve these goals will require a review of hospital and other charges, further development of private sector health care provision, the introduction of a system of private insurance, and strong encouragement that every citizen proactively look after his or her own health. While we recognize that financing has been the major stumbling block in previous reform efforts, we do believe that it is time to take the next step.

In financing healthcare, we believe that those who can afford to pay should do so; and that no person is left unattended. Our current 98% public funding may be simple and reasonably efficient, but it is also unsustainable. The narrowness of the tax base, our aging population and technological advances that will increase the demand for, and cost of, healthcare require a new financing regime.

All residents of Hong Kong who are entitled to Hospital Authority services should be covered by a mandatory health insurance system. Insurance would not, in our opinion, be linked to use of the available facilities or the payment of salaries tax in Hong Kong. It will require an imaginative and equitable premium payment system with suitable exemption to cater for the poor, perhaps linked to our “smart” identity cards.

2.0 Competitiveness issues

2.1 Group loss relief and loss carry-back

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.

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.

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 allegedly 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) Opponents cite the complexity of the tax law that may have to be introduced as a reason not to accept group relief. 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) The need for further anti-avoidance provisions is often cited as a further complication. 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.

Finally, **there is a need to carry back loss**. 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.

2.2 Tax concession on income from the local bond market

The current tax treatment continues to discriminate against corporations raising funds in Hong Kong as compared with authorized financial institutions who raise money in Hong Kong via deposits. 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.

We propose that interest income from bonds issued in Hong Kong be exempt from profits tax by extending the Exemption Order made in June 1998 to include such interest. This will be seen as an incentive to encourage the development of Hong Kong’s financial services sector and to level the playing field for Hong Kong companies that raise finance locally as compared with financial institutions that raise money via deposits.

2.3 Relaxing interest deductibility on loans from overseas associates

Current tax legislation on interest deduction discriminates against genuine borrowing from overseas shareholders and associates. This is also a disincentive to the establishment of regional headquarters in Hong Kong. We believe that a relaxation of the deduction rules on interest paid to foreign affiliates should be considered. We appreciate that in order to avoid possible abuses, it may be useful to restrict the deduction to cases where there are strong commercial grounds for this type of financing structure. In this connection, we also suggest that interest paid to foreign affiliates should only be deductible if the amount is calculated at a commercial rate of interest and that the Hong Kong borrower maintains an appropriate debt-to-equity ratio.

2.4 Small and Medium Sized Enterprises (SMEs)

SMEs are the backbone of any economy and the government should minimize the barriers to their successful development. The following are some suggestions:

(1) Simplify the tax administration system for SMEs. For example, introduce 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 does not need to attach certain documentation to its annual tax return; it is still required to prepare and retain such documents, for submission at a later date if

required. We may wish to consider not requiring audited accounts, or accepting certified management accounts, instead.

(2) Similarly, SMEs may be given a longer lead-time to pay the final tax, and not be required to pay provisional tax at all. This will give SMEs a cash flow benefit and avoid such headaches as applying for a holdover of provisional tax where the anticipated results for the current year are worse than in the previous year.

(3) **Establish an effective tax rate of 10% on the first \$500,000 of assessable income.** Singapore, for example, has a two tier tax system for SMEs which results in an SME receiving partial tax exemption on the first S\$300,000 of income.

2.5 Tax Depreciation for capital equipment used outside Hong Kong

This item relates to Hong Kong companies that purchase plant and machinery (P&M) and make them available to manufacturers in China at no charge to the Chinese companies. In a contract processing arrangement, the P&M is regarded as “leased” to the Chinese manufacturers. Technically, Hong Kong companies are not entitled to claim any tax depreciation in Hong Kong because the equipment is used wholly or principally outside Hong Kong (Section 39E).

In a subcontract manufacturing arrangement, the P&M are regarded as being contributed *in specie* to the Chinese manufacturers. The Hong Kong companies are denied any tax depreciation claim in Hong Kong as they no longer own and have in use the equipment (Section 37). Departmental Interpretation and Practice Note (DIPN) No. 15A issued in January 2006 has provided a concession for contract processing cases, but not for subcontracted manufacturing.

It is not reasonable that where a Hong Kong company buys goods from a separate factory in China, and makes P&M available at no charge to the Chinese factory as a condition of the purchase or in return for a lower purchase price, the Hong Kong company cannot claim depreciation allowances on the P&M even though the IRD tax the profits from the sale of the goods manufactured with that P&M.

This problem occurs frequently, and we believe the same concession should be given in the case of subcontracted manufacturing, or a special deduction should be allowed on the loss incurred on contributing the equipment at no charge to the Chinese factories.

3.0 Enhancing Certainty

3.1 Source of Profits

Hong Kong’s source-based tax system makes determination of the source of profits the defining issue. Recent court decisions have not helped clarify the rules for determining the source of profits, which we believe is necessary. In the case of trading profits, the IRD’s DIPN **21 needs to be amended without further delay** so as to specify the weight to be attached to various factors such as arranging letters of credit, issuing and accepting invoices, operating bank accounts and maintaining accounting records.

Our members tell us that IRD assessors take different views on the importance of certain factors, and then sought to re-assess companies as far back as six years. Uncertainty in relation to such a fundamental principle does real harm to the perception of Hong Kong having a certain, simple and fair tax system. **We urge early action on a legislative amendment that specifically defined the factors to be taken into account in determining the source of different types of income.**

3.2 Legislative clarification on the source of employment income

The IRD issuing revised DIPN 10 in June 2007 clarifying that the “three factors” are still the main factors which to be consider in determining source of employment income. At the same time, IRD has acknowledged that these cannot be the sole factors taken into account and in accordance with current case law, it has to consider the overall totality of facts. In essence, the revised DIPN 10 has put into writing the totality of facts approach adopted by individual assessors which appear to be inconsistent with the emphasis on only the three factors in the old DIPN 10.

The totality approach inevitably results in disputes between IRD and the taxpayers on the weights to be attached to each factor in determining whether a Hong Kong employment exists. The lack of clarity and consistency is damaging. It creates uncertainty in forecasting the tax liabilities of individuals and can impede and complicate their transfer to Hong Kong. In addition, where an employer will bear the salaries tax cost, there are doubts as to what that ultimate cost will be. This again complicates planning. Given Hong Kong's service based economy and the importance of facilitating the movement of individuals to meet business needs, any issues which impede that movement should be eliminated. Since IRD is handicapped by the current case law, the only way to remedy this situation is to amend the law by amending the IRO. **In this regard, the IRO should be amended to adopt a sourcing rule based on services rendered in Hong Kong (in line with international norm), to replace the existing sourcing rule of taxing an employee based on whether he has a Hong Kong employment which may have little correlation with the place of performance of services.**

3.3 Reduction in period of re-assessment

The IRO currently grants the IRD six years in which it can revisit tax assessments. Where a taxpayer has tax losses, this period is unlimited. This means that taxpayers have to keep their records indefinitely in order to discharge their burden of proof, even though under the Companies Ordinance a business is only required to keep records for seven years. The extraordinarily long period during which the IRD may revisit a case means that many taxpayers who fail to retain their records may be falsely assessed over issues considered resolved many years earlier. This does not assist taxpayers in reaching a certain or final result in relation to their Hong Kong tax affairs. **A review commission should consider reducing the period for reassessment (or assessment in the case of a loss making company) to three years from the date of lodgement of the relevant tax return.**

3.4 Deductibility of cost of share based compensation arrangements

For accounting periods beginning on or after 1 January 2005, Hong Kong Financial Reporting Standard (HKFRS) 2 requires the cost inherent in share-based compensation be measured and recognized in the profit and loss account when share options and awards are granted. The IRD should publish official guidelines to clarify when and whether such expenses would be deductible (in addition to the frequently asked Q&A published on its web site).

3.5 Taxation of Employee Stock Option Plans (ESOP) / Stock Awards

In order to assist corporations in attracting and retaining high calibre employees and making their ESOP and share awards more competitive with other countries, some jurisdictions have relaxed the timing of taxing income from such share-based compensation. Singapore, for example, allows employees to defer payment of tax on ESOP income for up to five years subject to an interest charge, as well as to enjoy tax exemption in certain cases. We would urge the government to consider similar measures.

In addition, the IRD has yet to issue official guidelines or introduce legislation on the taxation of stock awards. This should be expedited, to eliminate uncertainty.

3.6 High Value-added Industries

In order to maintain its competitive edge, the government should update the Inland Revenue Ordinance to permit tax deduction or tax depreciation of certain capital expenditure in order to develop technology-based and other high value added industries in Hong Kong and to keep up with new ways of doing business.

Deductions. In recent years, countries such as Singapore have introduced a series of tax changes to **provide for tax deduction or tax depreciation of certain capital expenditure which would otherwise be non-deductible and non-depreciable.** Such measures include permitting a five-year writing down allowance (equivalent to a five-year straight line tax depreciation) for expenditure incurred on the acquisition of the Indefeasible Rights of Use (IRUS) of international submarine cable system and the acquisition of a broad range of intellectual property rights including trade marks (Hong Kong restricts the deduction to patents and know-how). Government is urged to consider similar measures for Hong Kong.

Import processing. At present, certain Hong Kong manufacturing entities that enter into “contract processing” arrangements with Mainland-based entities pay tax on only 50% of their income. On the other hand, manufacturing entities that enter into “import processing” arrangements do not qualify for similar tax treatment. The dividing line between which manufacturing company qualifies for this concessionary treatment and which does not is blurred and a number of entities have had prolonged discussions with the tax authorities as to whether they qualify or not. This has needlessly created considerable confusion among manufacturing entities in Hong Kong. **The law should be amended to**

allow all manufacturing entities to benefit from the 50:50 treatment, regardless of whether they enter into contract processing or import processing arrangements, so long as they are heavily involved in the manufacturing process, for example, through the provision of design, know-how, technology, etc or performance of such activities as quality control, oversight of labour, etc in the Mainland or elsewhere outside Hong Kong.

3.7 Tourism Industry

A vibrant tourism industry invariably demands high quality service from hotels and restaurants. The level of capital expenditure incurred by hotels and restaurants on decoration and refurbishment has a direct impact on the quality of services delivered to tourists coming to Hong Kong.

At present, special deductions are available to all businesses whereby expenditure incurred on renovation and refurbishment is allowed for deduction in five consecutive years in equal instalments. For hotels and restaurants, five years may be too long in relation to the actual wear and tear of their decoration. By way of support to this important industry, we recommend that either the number of years be reduced to three years, or a 100% immediate write-off of refurbishment costs be allowed to hotels and restaurants.

A second major support measure would be to reduce the tax on alcoholic beverages to zero. While we welcome the reduction from 80% taxation that was enacted in the current fiscal year, we still believe that even a 40% tax is too high for Asia's World City.

In support of the tourism industry and the government's own revenues we urge that the 1994 ad valorem system be revisited, with an eye toward sharply reducing taxation on higher priced beverages. To stimulate tourism and the jobs this industry creates, it is desirable to substantially revise the high taxation policy.

Moreover, since the change to the ad valorem system in 1994, the government's revenue from duty collection has dropped as the tax system has pushed the market toward cheaper products at the expense of quality and premium products. In addition, there is a further loss of revenue as a result of increased smuggling activities in respect of imported European wine and spirits. As noted in multiple jurisdictions around Asia, when taxes on alcohol are reduced, income rises. It is therefore advisable that the government should revisit the issue.

Indeed, completely discontinuing tax on alcoholic beverages would very likely create a strong incentive for global conferences and exhibitions in a broad selection of fields to come to Hong Kong. Those in the beverage industry, in particular, may be expected to come here as a show of support, further boosting our tourism earnings and solidifying the SAR's status as "Asia's World City."

3.8 Support for Culture and the Arts

The Culture and Heritage Commission's vision of "Diversity with Identity" has the Chamber's support, and we believe that the best way of achieving the vision is to entrust the operation of our cultural and art resources to the community at large. By their very nature, cultural activities should be community-oriented, locally supported and free of overt 'official' guidance. In this context, the Chamber recommends that government reduce its managerial involvement in culture and art, while maintaining its financial backing. This is seen as the best means of promoting a vibrant cultural scene and a wealth of heritage that befits a world-class city.

Some of the **functions currently undertaken by the government (such as performance venues, museums or libraries) should be corporatized**, so as to capture the dynamism of the private sector in the management of our cultural facilities. The role of government would thus be limited to policy and regulation.

The Chamber also recognizes the potential for private sponsorship of both sports and the arts, which is largely untapped. **Policy change such as a matching grant system would be a positive step in this direction. Another would be to enhance the tax deductions available to corporations/business for expenses relating to sport, art and cultural sponsorship.** Apart from raising cash, such backing gives an added boost to business people's commitment to art, culture, sport and the city in which they live. A new approach to corporate sponsorship is likely to yield a multiplication of benefits without much additional pressure on the public purse.

3.9 Global Trading Operations

With the development of communications technology worldwide, we are seeing an increasing number of Global Trading Operations being formed in different industries, in particular the financial services industry. A typical set-up involves an international business establishing a fully integrated operation with a presence in different parts of the world covering targeted markets. Each local presence will have certain roles including executing trades in their markets. The trading transaction will typically be booked at one location in the world, say, London.

With its well-established telecommunication network and international business experience, Hong Kong is in a good position to attract these operations. The current tax regime could be simplified for such operations in order not to discourage their presence in Hong Kong.

Based on the current tax provision, if a Global Trading Operation has a presence in Hong Kong, the entity where the profits are booked will be deemed as carrying on a business in Hong Kong. Profits attributable to the business carried on in Hong Kong will be subject to Hong Kong profits tax. The said entity will have to file a Hong Kong profits tax return and will also have to keep a separate set of books for its operations in Hong Kong with sufficient details to enable it to compute the amount of profits generated for

Hong Kong tax purposes. We believe that this creates an unnecessary compliance burden for these businesses and will discourage them from using Hong Kong in their operations.

We suggest that such operations should be given an option to pay Hong Kong tax via a transfer pricing mechanism. Effectively, the Hong Kong operations should charge the profit-booking centre an arms length management fee and report such fee income for Hong Kong tax purposes. By simplifying the compliance burden and providing an easily calculable tax burden for the Hong Kong operation, we believe that it will encourage businesses to use Hong Kong.