

TAXATION AND REVENUE RECOMMENDATIONS

Helping SMEs survive

SMEs are the backbone of our economy and are now facing their most difficult challenges in living memory. To improve the odds that enough of them remain viable so as to enable them to avoid bankruptcy and the inevitable knock-on effects to employment and creditors and other stakeholders, we strongly urge that immediate steps be taken to shore up their cash flow. First and foremost is to stop taking money out of their pockets unnecessarily. Second, we endorse simplified procedures for dealing with government, from filing returns to paying taxes and other fees, should be seriously considered and, as appropriate, enacted without delay. Third, we believe matching the lower tax rates available in places such as Singapore will go a long way toward ensuring that those companies that do survive the coming year will continue to create jobs and profits here in Hong Kong:

On top of our priority list is the elimination of the provisional taxes on both profits and salaries. While we recognize the value of provisional tax payments in smoothing government's own flow of funds, it is impossible to justify unnecessarily tapping money that may mean the difference between survival and collapse. Those companies that do remain in the black will very likely see greatly reduced profits in 2009/10. Individuals not required to pay provisional taxes will be more inclined to spend. And, in both cases, those that cannot afford the services of tax professionals, will most greatly benefit from an across-the-board measure. For business, avoiding the need to reduce other expenses – including payroll costs – to pay taxes that will be refunded at a later date is vital. Even where this does not pose an insurmountable threat, there is every reason to believe that our highly volatile boom-and-bust cycle will continue, causing companies of all sizes to set aside cash for unforeseen contingencies. Government's claim on tax revenue is not in question. Rather, we seek to ensure that our tax base is not severely damaged through short-sighted measures designed for more predictable economies.

In addition, we would ask that SMEs in particular be granted a longer period in which to make their final tax payments without incurring penalties.

Over the longer term, a **greatly simplified tax administration system for SMEs** will encourage innovation and entrepreneurship. As is the case for Salaries Taxes, we envisage 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.

Finally, we believe that a pro-active, pro-competition step would be to **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.

Planning for a successful recovery

As the economy recovers from what is very likely to be our worst year in many decades, companies will be restructuring their operations. In the process, they will seek out the most efficient locations from which to operate, and they will do so in an environment characterized by very simple and inexpensive communications and inter-connectivity. Hong Kong's geographic role, while still extremely advantageous for the movement of goods and people, will not necessarily give us the edge we need.

Where we need to reevaluate our competitive package is in the tax and regulatory regime that companies actually experience. Low headline tax rates, while highly desirable, do not make the argument in favour of our city overwhelmingly compelling. Rather, the sophisticated advisers counselling companies on the most advantageous options have long looked at the effective tax rate companies must pay, as well as associated costs such as office space and professional staff. The overall cost of doing business needs to be understood, and managed, as one of the very few strategic assets we both possess and control.

As part of a broad benchmarking exercise that compares specific features of our cost structure to those of our nearest and most appropriate competitors, we should move quickly to introduce **group loss relief and loss carry-back**. If Profits Tax rates cannot be reduced to 15% immediately because of revenue concerns, then it is all the more imperative that nonrevenue factors such as group loss relief and loss carry back be implemented without delay.

We do not accept the poorly supported argument that group loss relief will significantly reduce revenues, nor do we accept that such a consideration should even be part of this decision. The available evidence points to a minimal loss of revenue, if any, that is quickly made up by newly established businesses, superior transparency and reduced operating costs. Because such a competitiveness enhancing adjustment will take time to implement, we believe that the earliest possible decision must be made so that our positioning in the recovery period is unassailable.

Credible competitiveness

The second major initiative to be undertaken during this period of crisis management is addressing the urgent attention to improve certainty and clarity. The lack of legislation specifically defining exactly what the IRD may consider to be taxable income, and what is explicitly outside of its jurisdiction, needs to be addressed.

Third, we would seek to modify the IRD's use of the six-year reassessment period. The problem is abuse: 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 three) 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.

At the corporate level, we recognize that the very rapid reversal of fortunes, from massive surplus to deep deficit, needs to be restored to balance. This year may not be the right time to ask that the **Profits Tax** rate be returned to 15%, but we would wish to see a firm commitment that rates will be reduced at the earliest possible juncture.

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.

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Review of the IRO

We think it is time to reassert the Financial Secretary's 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.

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 Competitiveness issues

1.1 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.

1.2 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.

1.3 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.

1.4 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. Under the IRO, 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). Departmental Interpretation and Practice Note (DIPN) No. 15 issued in January 2006 has provided a concession for contract processing cases, but not for subcontracted manufacturing.

In cases where 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).

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.

1.5 Financing MPF

We are becoming concerned that the Mandatory Provident Fund (MPF) inadequately provides the financial security our society needs. The narrow base of contributors, negligible contributory amounts, and the lack of tax incentives to encourage more savings are key examples of the shortcomings of the existing system. The present approach of conferring full redemption rights on those reaching 65 years of age should be reviewed with the objective of minimizing the likelihood of premature depletion of retirement funds. Measures such as capping monthly draw downs could be considered to promote prudent spending.

In addition, we would urge caution in expanding the cost of administration by means such as increased employee flexibility in selecting providers. While we accept that individual responsibility goes hand in hand with individual decision-making, companies will be made to bear the cost of providing a greater variety of options to their employees, and should be allowed to do so on a voluntary basis.

2.0 Enhancing Certainty

2.1 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, we await the amended DIPN 21, in anticipation that it will sufficiently 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 remain convinced that legislative amendment to enhance**

certainty as to the factors to be taken into account in determining the source of different types of income is urgently needed.

2.2 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.**

2.3 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 and the IRO 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.**

2.4 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).

2.5 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.

3.0 Encouraging Industry

3.1 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.

3.2 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.

3.3 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.

3.4 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 may not be subject to Profits Tax, as the ‘booked’ income was derived from transactions effected outside the SAR. 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 claim the booked profits were sourced outside of Hong Kong. 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.

4.0 Environmental Concerns

2.9 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 addition, we believe it is time for a much more forceful campaign to compel drivers to switch off their engines when idling for more than a few minutes.

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.

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