

Clarity, Consistency, Certainty, Opportunity

Budget Proposals 2006-07



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

Composition of the HKICPA Taxation Committee 2005

Chairman: Mr. Paul M.P. Chan

Deputy Chairmen: Ms. Yvonne Law
Mr. David Southwood

Members: Ms. Deborah Annells
Prof. Chan Koon Hung
Ms. Florence Chan
Dr. Daniel Cheung
Mr. David Cho
Mr. Peter Kung
Mr. Steven Kwan
Ms. Elizabeth Law
Mr. W. Ping Leung
Mr. Tim T.L. Lui
Ms. Ayesha Macpherson
Mr. Gary Poon
Mr. Tai Hay Yuen

Secretaries: Mr. Peter Tisman
Mr. John Tang

Composition of Budget Proposals 2006/07 Sub-committee

Convenor: Mr. David Southwood

Members: Prof. Chan Koon Hung
Mr. Peter Kung
Mr. Steven Kwan
Mr. Julian Lee
Mr. Gary Poon
Mr. Tai Hay Yuen

Secretaries: Mr. Peter Tisman
Mr. John Tang

Budget Proposals 2006/07

INDEX

A. Overview

- 1.1 Economic Outlook
- 1.2 Fiscal Position
- 1.3 Structural Deficit
- 1.4 Summary of Proposals

B. Detailed Proposals

B.1 Fundamentals

- 1.1 The Need for Certainty – Tax Administration
- 1.2 Hong Kong's Narrow Tax Base
- 1.3 Preparing for a Goods and Services Tax
- 1.4 Broad Based Tax Measures
- 1.5 Assess First Audit Later
- 1.6 Proposal for shortening Hong Kong's time-bar provisions
- 1.7 Technical amendments to the IRO

B.2 Opportunities

- 2.1 Regional Base
- 2.2 Group Relief
- 2.3 Utilisation of Tax Losses
- 2.4 Promoting Hong Kong as Two-way Platform for Doing Business with the Mainland and Other Markets
- 2.5 Profits Tax Rates
- 2.6 Promoting Manufacturing in Hong Kong
- 2.7 Salaries Tax Rates

B.3 Community

- 3.1 User Pays Taxes – Charges and Levies
- 3.2 Environmental Taxes
- 3.3 Recycling Measures
- 3.4 Employment
- 3.5 Property Tax
- 3.6 Interest on Student Loans
- 3.7 Self-education Expenses
- 3.8 Stamp Duty – Immovable Property
- 3.9 Mortgage Interest
- 3.10 Donations

B.4 Delivery of Community Services

- 4.1 Public Health Care
- 4.2 Privatisation of Government Services

C. **Appendices**

- 1 Preparing for the Introduction of a GST
 - 1.1 Proposed Key Basic Design Features for a GST
- 2 Period for Re-opening Tax Assessments in Other Jurisdictions
- 3 Submissions on Double Taxation Arrangement with the Mainland on 25 August and 2 September 2005

Budget Proposals 2006/07

A. OVERVIEW

1.1 Economic Outlook

Hong Kong's economy strengthened with GDP increasing by 8.2% in real terms in the third quarter of 2005 compared with a year earlier. This followed a 6.8% increase in the second quarter of 2005. As a result, the government revised its forecast of GDP growth for the year to 7%, compared with a figure of 4.5%-5.5% quoted in the 2005/06 Budget Speech. The growth impetus continued to come from the external sector although there was also strong consumer spending and rising machinery and equipment investment.

Following a long period of deflation starting in November 1998, overall consumer prices, measured in terms of the Composite Consumer Price Index (CPI(C)), have shown a slight year-on-year increase since July 2004. For the third quarter, the CPI(C) rose by 1.4% from a year earlier. The increase in the CPI(C) reflected the combined influence of an increasingly robust economic recovery, higher private housing rental and business costs, and the reflection of higher oil prices at the retail level. However, despite a figure of 1.8% in October 2005, the government has revised downwards its projected inflation figure for the year to 1.2%, compared with 1.5% in the 2005/06 Budget Speech.

The unemployment rate fell to 5.3% in the period of August-October 2005, down from 5.5% in July-September 2005, and this figure remained stable in the three months to November 2005. This translates to around 190,000 people out of work. The under-employment rate decreased from 2.5% in August-October 2005 to 2.4% in the three months to November 2005. Total employment rose to a new high of 3,418,000 in September-November 2005.

The financial markets have been fairly buoyant in 2005, particularly in relation to initial public offerings ("IPOs"). The Stock Exchange raised a record HK\$192 billion from 70 offerings during the year, significantly surpassing the previous high of HK\$132 billion in 2000. Recent offerings included the successful listing of the first real estate investment trusts in Hong Kong, commencing with the "Link Reit". At the end of 2005, the market's capitalisation was at an all-time high of HK\$8.26 trillion and annual turnover achieved a record HK\$4.44 trillion, up 22% and 10.5%, respectively, from a year ago.

Although, given its external orientation, Hong Kong's open economy is constantly vulnerable to factors beyond its control, including sentiment in the economies of the US, the Mainland and Europe, and the impact of global events and factors, such as oil prices, the threat of an influenza

pandemic, etc., the signs at present are positive. The US economy appears to remain strong with above-trend growth at 4.1% in the third quarter, despite the effects of hurricane Katrina, compared with 3.3% in the second quarter. The Mainland economy, meanwhile, continues to demonstrate a fundamental strength, achieving growth, according to official figures, averaging around 9.4% in the first three quarters of 2005. Recently-revealed information suggests that the Mainland's economy is actually significantly larger than previously believed.

1.2 Fiscal Position

The overall fiscal outturn in 2005/06 is now likely to be a good deal better than the HK\$10.5b deficit estimated in the 2005 Budget, with the improved state of the economy and consequently the increasing amount of revenue to be collected. Commentators are forecasting that the government will balance the books this year, and may even achieve a surplus

Fiscal reserves stood at HK\$283.5b on 30 November 2005, compared with HK\$272.3b as at 30 November 2004. If the year-end fiscal position is within the range now being predicted, the reserves will be in the region of HK\$ 300 billion.

As at 31 October 2005, the foreign currency reserves held by the Exchange Fund stood at US\$121.8 billion compared with US\$119.5 billion at 31 October 2004. Hong Kong is currently the world's seventh largest holder of foreign currency reserves, after Japan, Mainland, Taiwan, Korea, Russia and India.

The promising rate of economic growth notwithstanding, operating revenue still appears to be falling short of fully matching operating expenditure. Substantial income from volatile sources of revenue, such as land premiums, cannot be relied upon indefinitely to bridge the gap between operating expenditure and operating revenue and there remains a real need to address the ongoing mismatch between revenue and expenditure in order to ensure long-term confidence and stability in Hong Kong's economy.

1.3 Structural Deficit

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 demands 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.

Since the Task Force released its recommendations, there has been a significant improvement in the economy, which, in 2004/05 resulted in a surplus of HK\$21.3b in the consolidated account, the first surplus for five years, compared with a 2004 budget forecast of a deficit of HK\$42.6b. Nevertheless, much larger than projected land premiums and issuance of government bonds were major contributors to this change, which points to continuing reliance on volatile sources of income. There remains, therefore, a structural issue, which has still not been addressed. Hong Kong's taxation system needs to be 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.

1.4 Summary of Proposals

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

Fundamentals

1. It is critical for the restoration of certainty that certain specific areas of the Inland Revenue Ordinance ("IRO") be reviewed and amendments be introduced, e.g., legislation to counter the uncertainties arising from, and the adverse effects on taxpayers of, the Court of Final Appeal decision in *CIR v Secan Ltd and Ranon Ltd*. Other specific areas requiring clarification include:
 - the source of employment income under section 8 of the IRO;
 - the source of profits rules regarding, e.g. trading income and manufacturing profits under section 14, IRO; and
 - the concept of residence for profits tax purposes and for determining the source of Hong Kong employment for salaries tax purposes.
2. Given the structural fiscal problem previously identified by the Task Force on Review of Public Finances, and the weakness of Hong Kong's tax base, the government should focus on broadening the tax base, rather than continuing to rely on increases in direct taxes as a primary source of any future requirements for additional revenue. In particular, the government should move ahead with consulting on a goods and service tax (GST).

3. It is important for a successful and, as far as possible trouble-free implementation of a GST, that the government should conduct more detailed economic and fiscal modelling and forecasting and to thoroughly test the proposed system.
4. Pending a decision on introducing GST, it would be appropriate for the government to (a) review personal allowances by reference to the adoption of an appropriate base year, with a view to ensuring that there is no further narrowing of the tax base, and (b) re-examine the option of introducing a Boundary Facilities Improvement Tax in Hong Kong.
5. The implementation of the "Assess First, Audit Later (AFAL)" approach by the Inland Revenue Department ("IRD") has, in practice, led to increased uncertainty amongst taxpayers because their tax affairs may not be concluded for any particular year of assessment until the completion of the statutory time limit of six years. This needs to be addressed.
6. To provide more certainty to businesses, the time for re-opening tax affairs under the IRO should be shortened from six years to three or four years, which would be in line with a number of other jurisdictions.
7. The areas of uncertainty referred to in points 5 and 6 above should be resolved by amending the IRO.

Opportunities

8. We reiterate proposals made in previous budget submissions to introduce measures to enhance Hong Kong's competitiveness as a location for regional offices and group companies, e.g.,
 - 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;
 - group relief should be introduced; and
 - losses incurred in the current year of assessment should be permitted to be offset against the assessable profits of one previous year.

9. 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.
10. The Institute reiterates the suggestions put forward in its submissions to the IRD on expanding the DTA with the Mainland, with a view to enhancing Hong Kong’s attractiveness to investors from the Mainland and other jurisdictions, as a platform for business into and out of the Mainland.
11. Given the international trend towards lowering the rate of direct taxes, the profits tax rates in Hong Kong should be reduced at the earliest opportunity.
12. To improve the competitive environment for the local manufacturing sector, and provide employment opportunities, a 50% profits tax reduction should be granted to local manufacturers of goods, for a limited period of, say, five years.
13. The standard rate of salaries tax should be reduced at the earliest opportunity to reduce the tax burden on middle-income earners.
14. There should be a review of the progressive rates of salaries tax (undertaken in conjunction with the review of personal allowances (see point 4 above) with a view to reducing the burden on middle income earners.

Community

15. 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. At the same time, the government needs to be accountable for the services that it provides and should examine how services could be delivered more efficiently.
16. Fiscal measures, including environmental taxes and tax incentives, should be considered as a way of promoting and improving environmental awareness and protection, including the reduction of cross-border air pollution.
17. The Institute supports the idea of a proposed “product eco-responsibility law”, which the government has indicated will be put forward in 2006 to provide a legislative framework for regulations implementing various recycling measures.

18. Employees should not be taxed on any redundancy/severance payments from their employers of up to twice the statutory limits, as a measure to help mitigate the effects of Hong Kong's economic restructuring.
19. An extra deduction of 50% on the salary costs of employing unemployed persons (who have been actively seeking work in Hong Kong for one year or more) should be granted to employers in the year of assessment 2006/07.
20. Government rent, like rates, should be deductible against property tax, to better reflect the actual expenses borne by landlords.
21. Students should be allowed to claim a deduction for the interest they pay on their student loans from the government for a period of, say, five years after they begin work.
22. Self-education expenses should be able to be carried forward for up to three years so that they may be claimed when the taxpayer is generating sufficient income subject to salaries tax, and the current limit of HK\$40,000 should be increased to HK\$60,000 given the increasing costs of many educational programmes.
23. Stamp duty on property transactions should be reduced to enhance the affordability of property ownership for middle-income earners.
24. To help taxpayers, particularly the middle-income earners, it is proposed to remove the seven-year limit on the salaries tax deduction for home loan interest, or, at least, to extend the deduction to ten years, given that mortgages are generally long-term loans. An increase in the interest ceiling for which a salaries tax deduction can be claimed should also be considered.
25. To further encourage charitable donations, it is proposed that the existing ceiling for allowable deductions should be increased from 25% to 50% of assessable profits/income. Donors should also be able to carry-forward deductions where they have not made a profit in the relevant year, and donations in kind should be permitted where they are properly valued.

Delivery of community services

26. As health expenditure is expected to continue to grow in the future, it is critically important to determine how to maintain a financially sustainable public health care system over the long term.
27. To enhance the efficient use of resources and the delivery of public services, further studies should be carried out to identify suitable

public services for privatisation, which may include postal services and water supplies.

B. Detailed Proposals

B.1 FUNDAMENTALS

1.1 The Need for Certainty – Tax Administration

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") 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 and the belief that their affairs will be dealt with on a consistent basis.

These elements of clarity, certainty and consistency have been fundamental to Hong Kong's reputation as a place to do business. It is important, therefore, that in the future we continue to give priority to the maintenance of these "3 C's", as Hong Kong faces increasing competitive pressures from other international cities in the region.

Unfortunately in recent years a significant degree of uncertainty has been introduced into the administration of the tax system through various avenues, including court decisions and IRD practices that stray from the published position. As a result taxpayers and their representatives are unable to plan with certainty in relation to various fundamental areas, such as the source of employment income and the source of profits for profits tax purposes.

Taxation of unrealised profits and losses

In addition, we have seen further uncertainty following the decision of the Court of Final Appeal in *CIR v Secan Ltd and Ranon Ltd* (2005) 5 HKTC 266 ("*Secan*"), which has had an impact on the policy of the IRD and the interpretation of the Inland Revenue Ordinance (Cap.112)("IRO").

The government's response to these well-founded and well-documented concerns about uncertainty appears to have been to query whether there is any uncertainty to be concerned about.

The *Secan* decision is a case in point. Here, in answer to concerns addressed to the government by a business forum, the IRD stated that "the *Secan* case has not introduced any new principle". In fact, *Secan* is quoted by the IRD as authority that unrealised profits can now be taxed if they are recognised in the taxpayer's financial statements. This runs counter to the well-established taxation principle that income or profit should not be taxed before it is "realised". Clearly, therefore, there is uncertainty in this area.

In relation to the same issue, the IRD has also advised that:

"The accounting profession has seen fit, for certain items, to recognise a profit or loss before the item is sold. Such a profit or loss is recognised in the enterprise's financial statements as the profit or loss of the period concerned. Such financial statements are meant to present a true and fair view of the enterprise's profit or loss and financial position. The profit or loss so recognised should also form the basis for computing taxable profits or loss. Profits and losses are treated in the same way. Losses so computed can be used to set-off against other assessable profits of the enterprise, or be carried forward indefinitely."

The accounting profession in Hong Kong has adopted International Financial Reporting Standards (IFRSs), in line with Hong Kong's status as an international financial centre. In some cases, beyond the control of the local accounting profession, this has resulted in changes to accounting principles that do not mesh with normal tax principles.

The above concerns have been conveyed to the IRD by a number of business and professional bodies, including the Institute but, so far, no action has been taken.

The IRD's approach to *Secan* ignores the basic principle, discussed above, that income should not be taxed until realised, and also does not recognise the fact that other jurisdictions where IFRSs have been adopted may have, for example, tax loss carry-back provisions, which mean 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.

Source of profit

It has been suggested that the areas of uncertainty regarding source of profit can be dealt with through DIPNs issued by the IRD. However, it is a fundamental concept of taxation law that those who administer tax laws should not also set the tax policy. The present situation where significant parts of the existing IRO give rise to uncertainties, which are supposedly dealt with by DIPNs, is not satisfactory. The IRD states that DIPNs do not purport to provide a binding interpretation for taxpayers or the IRD and, in

practice, there has been an increasing and worrying trend in recent years for officers of the IRD to diverge from the published practice.

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, so that if the taxpayer adheres to the position in the DIPN, the taxpayer will have certainty as to the tax treatment afforded to him by the IRD. Unfortunately this is no longer always the case.

It is noteworthy that the explanatory note on the front of DIPNs has changed in recent years. Previously this read:

"These notes contain a summary of the Departmental Interpretation and Practice [our emphasis] and are issued for the information and guidance of taxpayers. They have no binding force and do not affect a person's right of objection and appeal to the Commissioner, the Board or the Courts."

These notes current read:

"These notes are issued for the information and guidance of taxpayers and their authorised representatives. They have no binding force and do not affect a person's right of objection and appeal to the Commissioner, the Board of Review or the Courts."

Tellingly, perhaps, DIPNs no longer claim to be a summary of the practice adopted by the IRD.

In particular, one needs only to look at the problems associated with DIPN10 *The Charge to Salaries Tax*. Most taxpayers and their representatives accept that the existing DIPN10 reflects the correct interpretation of the legislation. However, increasingly, officers of the IRD have not been following this practice note, suggesting, instead, that each case has its own facts, and applying uncertain and, at times, seemingly unrealistic tests – thus leading to an increasing lack of clarity in this area.

Similar, problems have arisen with regard to DIPN 21, *Locality of Profits*.

If DIPNs are not representative of the IRD's practice and/or are not followed by officers of the IRD, then they cannot be relied upon to provide certainty of interpretation for taxpayers and, where this is the case, they serve little purpose.

This points to the need to legislate for greater clarity in key areas of our tax laws. It is clear that legislation to address perceived difficulties resulting from court decisions or other uncertainties can be introduced quite quickly, where it is considered necessary or desirable. We note, for example, that, when the decision on royalties in the case of *Emerson Radio Corporation v*

CIR [1999] (1 HKRC 90-095) was handed down in favour of the taxpayer, amendments to the IRO were put forward in fairly short order.

Therefore, whilst we do not advocate a full review of the IRO, we consider it important for the restoration of certainty in our tax legislation that specific areas of the IRO be reviewed and amended by legislation. These include:

- (i) The clarification of the source of employment income in section 8 of the IRO. We understand that the Joint Liaison Committee on Taxation (“JLCT”) is drafting a proposed legislative amendment in this area and we fully support the Administration’s move to consider legislating on this matter.
- (ii) The clarification of the source of profits rules regarding, e.g., trading income and manufacturing profits in section 14, IRO.
- (iii) Legislation to counter the adverse effects of the *Secan* decision and the adoption of IFRSs, which have resulted in the taxation of unrealised profit, as explained above.

These are technical areas, further details of which are contained in a separate letter to the Financial Secretary (FS). We urge the FS to set up an ad hoc working group to review these and other problematic areas of the IRO, on a one-off project basis.

If a separate, ad hoc committee is not established to review these specific areas of the IRO and advise the FS on where the IRO needs to be amended, we believe the JLCT should be requested with specific mandate to undertake this review, identify areas of concern and propose draft legislation. However, it would not be sufficient for either the JLCT or a separate, ad hoc working group simply to identify the legislative changes required: this must be supported by a commitment to introducing the required changes to the IRO in a timely manner.

1.2 Hong Kong's Narrow Tax Base

As indicated above (section A1.3), the Task Force on Review of Public Finances concluded in 2002 that Hong Kong was facing a structural fiscal problem and recommended that the government should consider the recommendations of the Advisory Committee on New Broad-based Taxes, which was to report shortly afterwards. On 1 March 2002, the Advisory Committee presented its report and, among the various option considered, recommended a goods and services tax (“GST”) as an option that would broaden the tax base and generate approximately \$6 billion annually for each percentage point at which GST was levied.

In its report the Advisory Committee stated:

"Of all the options surveyed by the Advisory Committee, [GST] is the only one that fits the primary criteria of being broadly-based and highly revenue-productive even when the tax is set at a level which, when compared with other economies, is low."

"... the aging of the population will place an upward pressure on social security expenditure and medical and health services. The Advisory Committee has noted that many other mature taxation jurisdictions have all implemented GST (or a variant of it) to reform their tax system in the face of aging populations. With changing demographics, increasing community expectations for government services and the adverse effects on direct tax revenues of cyclical downturns in the economy, it has become increasingly untenable for governments to continue their heavy reliance on income taxes as the predominant revenue source... Taxing private domestic consumption provides an alternative form of revenue that is considerably better shielded from economic and demographic changes within the community."

Despite the study carried out subsequently by an internal committee set up by the government, no further steps appear to have been undertaken to engage the public in this debate.

The temptation in times of an improving economy is not to tamper with the tax system. However, in view of Hong Kong's acknowledged structural deficit, a public discussion on the broadening of Hong Kong's tax base is not only important but essential.

The background provided by a strengthening economy is the ideal time for such public consultation, as any remedial action identified can be implemented before the next cyclical downturn in the economy and thus be in place when the measures are most needed, i.e., in times of fiscal shortfalls.

We, therefore, consider that the government should now be focusing on broadening the tax base in Hong Kong, rather than continuing to rely on increases in direct taxes as the primary source of any future requirements for additional revenue in terms of deficit.

1.3 Preparing for a Goods and Services Tax

Given the differences between Hong Kong's economy and other economies that are sometimes quoted as examples of existing GST systems, it is important for a successful and, as far as possible, trouble-free implementation, that the government should conduct more detailed economic and fiscal modelling and forecasting and should thoroughly test the proposed GST system. The objective would be to evaluate the

revenue and other implications of introducing the system, so as to avoid any significant unforeseen effects that could have an adverse impact on its smooth implementation.

We set out in Appendices 1 and 1.1 our detailed discussion on the introduction of a GST and the relevant technical matters. The following are amongst our key recommendations:

General points

- GST in Hong Kong should be kept simple to enhance certainty;
- exemptions and zero-rated items should be kept to a minimum;
- appropriate compensatory measures should be built into the system, including allowances for lower-income groups and students;
- reductions in direct taxes should be introduced in parallel; and
- to provide medium to long-term predictability, the government should consider giving an undertaking not to increase the initial rate of a GST for 5-10 years.

Other key design features

- GST in Hong Kong should be a credit-invoice type;
- a single positive rate of, we suggest, below 5%, should be adopted;
- the destination principle should be adopted but, for practical reasons, consideration should be given to excluding goods in transit;
- consideration should be given to zero-rating exports (including tourist purchases);
- financial services should be taxed, where explicit fees are charged (except for exported services);
- residential rental payments should be exempt in order to maintain parity with owner-occupied residential buildings;
- to enhance cost-effectiveness, in view of the substantial number of small businesses in Hong Kong, the registration threshold should be set at a fairly high level, e.g., HK\$5 million turnover, with an option to register below that level.

1.4 Broad-based Tax Measures

The Advisory Committee recognised the need for Hong Kong to change the composition of its revenue-raising activities with a shift away from direct taxes towards a GST. However, recognising that the introduction of GST could take some time, it made three recommendations of possible measures to broaden Hong Kong's narrow tax base in the short term, i.e., increasing rates on tenements, reducing personal allowances and the introduction of the previously-proposed Boundary Facilities Improvement Tax.

Of these three options, consideration has been given in previous budgets to the reduction of personal allowances and the Boundary Facilities Improvement Tax, but only personal allowances have been reduced.

Pending a decision on the introduction of GST, the Institute considers it would be appropriate for the FS to establish a basis for future adjustments of personal allowances (as suggested below) and to consider again the merits of introducing the Boundary Facilities Improvement Tax.

(a) Personal Allowances

The Advisory Committee concluded that, by international standards, personal allowances given to salaries taxpayers and other concessionary deductions were high in Hong Kong. They also contributed to the narrowness of the salaries tax base. A reduction in personal allowances would bring new taxpayers into the tax base. We note that, in previous budgets, the FS has already adopted this proposal by reducing the basic personal allowance and the married person's allowance in the last two years. We suggest that a further review of personal allowances be undertaken with the aim of adopting an appropriate base year to facilitate consideration, in future, of adjustments in the relevant allowances in line with the changes in the economy, and to ensure that there is no further narrowing of the tax base.

(b) Boundary Facilities Improvement Tax

The Advisory Committee considered that a land and sea departure tax (subsequently called the Boundary Facilities Improvement Tax) would provide a steady source of revenue for the public purse. In our view the proposed tax would have advantages, as identified clearly by the Advisory Committee. We, therefore, propose that the option of introducing this form of tax should be re-examined by the government.

1.5 Assess First Audit Later

In recent years the IRD has adopted a policy of tax collection, which is commonly known as "Assess First Audit Later (AFAL)". 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 any time up to six years from the end of the basis period.

We consider that the legal basis of the AFAL approach may be questionable and, even if there is a valid legal basis for the AFAL, the practice is unsatisfactory as a means of administering the tax system, as it

creates fundamental uncertainty in that a taxpayer cannot be sure that his tax liabilities have been finalised at any time for up to six years after the end of a particular basis period. Such an approach is contrary to the concept of certainty. We address this in more detail in a separate letter to the FS.

1.6 Proposal for shortening Hong Kong's time-bar provisions

Certainty and predictability are important factors for business and time is often of the essence. Hong Kong's current provisions for re-opening tax affairs create considerable uncertainty for businesses in the finalisation of their tax affairs. This is also a major factor in exacerbating the uncertainty for taxpayers arising from the AFAL approach adopted by the IRD. We consider that shortening the period under Hong Kong's statutory provisions for re-opening tax affairs would provide additional encouragement to businesses currently operating, or considering operating, in Hong Kong.

Section 60 of the IRO currently allows IRD assessors to raise additional assessments within six years from the end of the year of assessment, which can be further extended to 10 years in cases of fraud. In contrast, the corresponding timeframes in other jurisdictions for the re-opening of tax affairs tend to be relatively shorter. Some examples are set out in Appendix 2.

Given the number of developed and developing jurisdictions that currently offer more favourable (i.e., shorter) timeframes for re-opening tax affairs, we feel that Hong Kong should similarly endeavour to improve the level of certainty provided to businesses in relation to their Hong Kong tax affairs, by reducing the period for re-opening assessments from six to three or four years. This should be subject to an extension to 10 years in cases of fraud.

1.7 Technical amendments to the IRO

We believe that the above areas of uncertainty can be resolved by technical amendments to the IRO. Simply leaving these matters to be dealt with by DIPNs has proved not to be satisfactory and, ultimately, has contributed to the uncertainty.

B.2 OPPORTUNITIES

2.1 Regional Base

2.1.1 Tax exemption for management fees received from overseas associates

In order to enhance Hong Kong's status as regional base for multinational companies, we reiterate a proposal that we have made previously 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, which could then recharge their expenses to associated entities in the region and receive that income free of tax in Hong Kong.

It is recognised that anti-avoidance provisions would be required to prevent abuse of this relief and this could be provided for by ensuring that the term "associated entities overseas" was suitably defined, for example by reference to the common beneficial ownership of at least 50% in each of the companies that charges/pays the management or consultancy fees.

2.1.2 Tax exemption for interest received on loans made to overseas associates

Currently section 15(1)(f) of the IRO deems the interest derived by a corporation on loans made to its overseas associates to be subject to profits tax if the provision of credit is made in Hong Kong. While it may not be a problem in practice for group companies to 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 an incentive for international businesses to establish their treasury function in Hong Kong. This in turn would benefit the development of the financial services sector in Hong Kong.

Similar accompanying anti-avoidance provisions to those referred to in section B2.1.1 above may also need to be considered.

2.2 Group Relief

Corporations often organise themselves into holding companies, subsidiaries and associated companies to reflect the structure of their business and to limit liabilities. Under Hong Kong tax system each company within a group is considered a separate legal entity and is currently taxed separately. Companies within a group are not allowed to offset the tax losses of one company against the taxable profits of another. As a result, the setting up of separate companies within the group can effectively raise the tax rate for the whole group, where one or more group companies have taxation losses.

This offset of losses by companies within the same group, commonly known as "group relief", is common in many developed tax jurisdictions and we have, in previous submissions, advocated that some form of group relief should be introduced in Hong Kong.

We note that with effect from the year of assessment 2003, the Singapore Government introduced a loss transfer system of group relief in Singapore. The Singaporean authorities have adopted a definition of a group as consisting of a Singapore-incorporated parent company and all of its Singapore-incorporated subsidiaries. Two Singapore-incorporated companies will be members of the same group if one is 75% owned by the other or both are 75%-owned by another Singapore-incorporated company. The Singapore-incorporated companies must have the same accounting period to qualify for group relief.

As Singapore operates its taxes on a territorial basis, similar to that in Hong Kong, we consider that the adoption of group relief in Singapore demonstrates that such an arrangement is workable under a territorial system.

The need for group relief has become more apparent following the decision in *Secan* with its clear implications that unrealised profits can be subject to profits tax, although those gains may not be finally received until a later period, or even not received at all. An example of this would be an unrealised gain on a hedging arrangement. As indicated in section B1.1 above, the suggestion that unrealised gains should be taxed is contrary to the accepted principles of taxation law in Hong Kong and, if legislation to minimise the more unfavourable implications of the decision in *Secan* is not introduced, there will be inequity in the tax system. The adoption of group relief in Hong Kong may enable such unrealised gains to be offset by losses incurred by other group companies.

As in previous submissions, we propose that, if full group relief is not introduced, arrangements should be introduced to allow the transfers of losses within a group of companies in the event of the loss-making companies going into liquidation. Under the proposal, all relevant companies should be chargeable to profits tax in Hong Kong, although they need not be locally incorporated. Procedures relating to notification, etc. would need to be formulated. We would propose that only losses occurring after the introduction of such relief and upon the liquidation of a company should qualify.

2.3 Utilisation of Tax Losses

Loss carry-back

The present law (Section 19D of the IRO)

1. The present law is simple and straightforward and imposes no time restriction for the absorption of losses.

2. If the loss is not fully deducted it is carried forward, without time restriction, to be deducted against the assessable profits of the corporation in future years of assessment.
3. There is no choice for the corporate taxpayer to select the particular year of assessment in which a loss carried forward may be absorbed.

Inequitable tax treatment

The economic benefit of the losses incurred in a year of assessment is lost if the loss has to be carried forward to a future year for offset. This is particularly damaging in cases of cessations of business and adds to the cost of doing business in Hong Kong.

As discussed in section B1.1 above, following the decision in *Secan*, the IRD maintains that tax treatment must follow accounting treatment. This means, for example, that unrealised gains in investments that are required to be reflected in the profit and loss account will be taxable even though ultimately no gain may be realised at all. In principle, unrealised losses, would also be able to be set off against other profits or carried forward. However, in the situation 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 the unrealised losses, even though it may previously have been taxed on its unrealised gains. This appears to a situation that is likely to arise more often following the *Secan* decision and it seems to be inequitable.

Proposal

The ability to carry back losses for a given year of assessment against the assessable profits of a previous year would be a very useful benefit in this period of economic transition for Hong Kong. We have previously proposed an arrangement for loss carry-back, in particular for single companies upon cessation of business in Hong Kong, which, for the sake of administrative simplicity, could be limited to one year's carry-back only. We believe that such a measure would help to ensure that equitable tax treatment for all companies by reducing the likelihood that an individual company would, in practice, be required to pay more than the standard rate of profits tax over the life-time of the company. As such we suggest that loss carry-back should be available to single companies regardless of whether or not group relief, or arrangements for the group transfer of losses, are introduced.

In order to counter trafficking of losses, appropriate anti-avoidance measures would need to be introduced.

Loss carry-back is adopted by many countries with advanced taxation systems. The most notable of these are Germany, Japan, the United States and the Netherlands.

In the Netherlands, for example, a company may set off its losses against its taxable profits for the three preceding years. In Germany, a net operating loss is automatically set off against the non-distributed pre-tax income (including capital gains) of the previous year, up to a maximum amount of €511,500 (assessment year 2003).

2.4 Promoting Hong Kong as Two-way Platform for Doing Business with the Mainland and Other Markets

2.4.1 Tax Relief on withholding tax

The IRO contains provisions for Hong Kong taxpayers to obtain tax credits for overseas withholding taxes paid in those countries with which Hong Kong has concluded arrangements for the relief of double taxation. However, Hong Kong has only concluded two double taxation agreements (“DTAs”) with Belgium and Thailand and, therefore, tax credits can only be claimed for withholding taxes paid in Belgium and Thailand.

Only limited relief is available for Hong Kong taxpayers on withholding taxes paid in those countries that do not have a DTA with Hong Kong. In such cases, a deduction is available to the Hong Kong taxpayer when the overseas tax is an expense, which must be borne regardless of whether a profit is derived (e.g., withholding taxes). However, 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).

In the light of the government’s commitment to creating a network of DTAs with various countries, we propose that the current problem of double taxation of income that is deemed to be sourced in Hong Kong, and which also suffers 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 of 50% of the Hong Kong profits tax payable.

2.4.2 Double Taxation Arrangement with the Mainland

The Institute takes the opportunity to reiterate the suggestions put forward in its submissions to the IRD (of [25 August](#) and [2 September 2005](#)) with respect to expanding the DTA with the Mainland (Appendix 3), with a view to enhancing Hong Kong’s attractiveness to investors from the Mainland and other jurisdictions as a platform for business development into and out of the Mainland.

2.5 Profits Tax Rates

In its report, the Advisory Committee on New Broad-based Taxes considered the case for increasing profits tax rates. However, the Advisory Committee noted that increasing profits tax rates does not broaden the tax base as the resulting increased tax burden falls entirely on existing taxpayers.

Accordingly, the Advisory Committee indicated that it could not advocate a significant increase in profits tax rates and further indicated that any such increase would go against the international trend of lowering income tax.

Since 2003/04, the rate of profits tax for unincorporated businesses has risen from 15% to 16% in two stages, in line with the standard rate of salaries tax. However, the rate of profits tax for corporations has arisen from 16% to 17.5%. These increases in profits tax run counter to the international trend of lowering tax rates, identified by the Advisory Committee.

In view of the international trend to lower the rate of corporate taxes, we believe that the rates of profits tax for both individuals and corporations should be reduced at the earliest opportunity.

2.6 Promoting Manufacturing in Hong Kong

Consideration should be given to granting a time-limited 50% profits tax reduction to local manufacturers of goods, for a period of, say, five years. The rationale for this is to create a competitive taxation environment for the local manufacturing sector, as well as to provide employment opportunities to a range of workers, e.g. the low-skilled sector, which should help alleviate unemployment and under-employment.

2.7 Salaries Tax Rates

2.7.1 Standard rate

In line with the rate of profits tax for unincorporated businesses the standard rate of salaries tax has been increased to 16% from its historical level of 15%.

As discussed in section B2.7 above, increasing the standard rate of salaries tax does not broaden the tax base, as the resulting increased tax burden falls entirely on existing taxpayers.

In line with our comments in section B2.7 we believe that the standard rate of salaries tax should be reduced at the earliest opportunity.

2.7.2 Progressive rates

We propose that in addition to the reduction of the standard rate of salaries tax, there should be a review of the progressive rates of salaries tax with a view to reducing the tax burden on middle-income earners. This review should be undertaken in conjunction with the review of personal allowances proposed in section B1.4(a) above.

B.3 COMMUNITY

3.1 User Pays Taxes – Charges and Levies

We propose that a detailed review of the level of duties and fees levied by the government should be undertaken and that, as far as possible, the "user pays" principle should be adopted. It is reasonable, in principle, that fees and charges should be reviewed each year and brought into line with changes in the price index, and that the public should have a greater appreciation of the real costs of providing the relevant services. However, the quid pro quo should be a high degree of transparency and accountability on the part of the government in relation to its costs, and a willingness to examine possible means of delivering services more efficiently and economically.

3.2 Environmental Taxes

The FS in his 2004/05 Budget Speech acknowledged the need to enhance public awareness of environmental protection and that the adoption of fiscal measures may effectively achieve that objective.

We support the recent announcement regarding the government's municipal solid waste management strategy, with its proposals for the introduction of charges on solid waste through legislation to be introduced in 2007.

Whilst those proposals, once implemented, may serve as an effective encouragement to help minimise certain types of waste, the following additional forms of environmental protection measures should also be considered:

- Emission taxes
- Taxes on polluting inputs
- Credits for emission reduction
- Permits to emit a specified amount of a pollutant
- 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.

Cross-border pollution

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 an intolerable level. This is increasingly likely to affect the business environment, with fewer key staff being willing to transfer here with their families and others considering whether or not to stay.

There is clearly pressing need to work closely with the Mainland authorities to identify the sources of cross-border air pollution and 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.

3.3 Recycling Measures

We support the idea of a proposed "product eco-responsibility law" which the government has indicated will be put forward in 2006 to provide a legislative framework for regulations to require, e.g., computers and tyres to be recycled, retailers to charge for plastic bags and the banning of excessive packaging.

3.4 Employment

3.4.1 Non-taxability of redundancy payments

Lump sum redundancy/severance payments within the statutory limits under the Employment Ordinance (Cap. 57) are non-taxable. However, amounts above these limits may be treated by the IRD as potentially taxable, which can result in uncertainty and lead to prolonged exchanges.

The statutory limits meanwhile are not particularly generous and where employees have previously suffered salary cuts due to the business climate, they may be hit with the double blow of having their tax-exempt redundancy money, which is based on their final salary, correspondingly reduced.

We propose therefore that it be made clear that employees' redundancy/severance payments from their employers of amounts up to twice the statutory limits will automatically not be taxed. This will be of benefit not only to provide a greater cushion if such persons remain unemployed for an extended period, due to, e.g., the effects of economic restructuring, but it could also help to provide some unemployed persons with financial wherewithal to consider starting up a business of their own. Consideration could in fact be given to allowing even larger amounts of redundancy money to be tax-exempt where a certain proportion of it is invested in a new business.

3.4.2 Employers' tax concession to encourage hiring of the long-term unemployed

Although the rate of unemployment in Hong Kong has reduced from the highs experienced in recent years, there is still a concern about long-term unemployment among some sectors of the community. As a measure to help deal with this problem, we suggest that an extra deduction of 50% on the salary costs of employing unemployed persons, who have been actively seeking work in the job market in Hong Kong for one year or more, be granted to employers in the year of assessment 2006/07. Measures to prevent abuse would need to be introduced, e.g., any new employees should be additional to the existing workforce.

3.5 Property Tax

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 2005/06 year of assessment, 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 for repairs and outgoings.

While the IRO provides for a specific deduction for rates paid by the landlord against the net assessable amount subject to property tax, no specific deduction is granted for the government rent levied on landlords by the government. We propose that the section 5(1A) of the IRO be amended to allow a specific deduction for government rent in the calculation of the net assessable value subject to property tax, so as to provide for reasonable deductions for actual expenses incurred by landlords for property tax purposes.

3.6 Interest on Student Loans

At the present time, students attending tertiary education who receive student loans are required to repay those loans with interest once they take up employment. However no relief is given for the interest on those loans. Consistent with the objectives of encouraging a highly educated workforce in Hong Kong we propose that students should be allowed to claim a deduction for the interest they pay on their loans, using a system similar to that for home loan interest, namely that a deduction will be permitted for a certain number of years only, say five years, with the students being able to elect in which five years they wish to claim the expense. As it is recognised that many students may not necessarily become employees and may, instead, enter professional or business life, or become a sole proprietor, it is proposed this relief be available both for salaries tax and profits tax purposes.

3.7 Self-education Expenses

3.7.1 Carry forward of expenses incurred

Currently, 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, self-education expenses are often paid in a year of assessment where the salaries tax payer may not necessarily 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 therefore proposed that there should be a form of carry forward of these expenses for up to three years, so that these expenses may be claimed at a later date when the salaries tax payer is generating sufficient income that is subject to salaries tax.

3.7.2 Increase in relief

In line with the increasing costs of education courses, we propose that the current limit of HK\$40,000 be increased to HK\$60,000 to encourage salaries taxpayers to attend approved courses, including relevant undergraduate, postgraduate, professional training and language courses.

3.8 Stamp Duty – Immovable Property

We believe that stamp duty on property transactions should be reduced to enhance the affordability of property ownership to middle-income earners.

The property market saw a substantial fall between its 1997 peak and 2003. Although there has been something of revival over the past two years, some doubt has begun to set in again as a result of rises in interest rates and uncertainties in the global economy, including volatile oil prices, etc.

Lower property prices per se are not necessarily a bad thing if they mean that property becomes more affordable for the average middle-income family. However, when uncertainty sets in, even though property may be more affordable, there are fewer interested buyers due to concerns about possible future declines in prices.

We believe that negative sentiment and lack of confidence in the property market can spread to the wider economy and that it is important to encourage stability in, and the longer-term sustainability of, the market. Under the circumstances, the increases in stamp duty introduced in the 1999 budget may now be seen as a dampener on market activity and we propose that consideration be given to reducing the duty. The following revised rates are suggested:

<u>Property consideration</u>	<u>Present rate</u>	<u>Proposed rate</u>
Up to HK\$1M	HK\$100	No change
HK\$1M - \$2M	0.75%	0.5%
HK\$2M - \$3M	1.50%	1.0%
HK\$3M - \$4M	2.25%	1.5%
HK\$4M - \$6M	3.00%	2.25%
HK\$6M and above	3.75%	3.0%

3.9 Mortgage Interest

3.9.1 Period of relief

We proposed that the current seven-year limit on the salaries tax deduction for home loan interest should be extended to at least ten years. This would recognise that mortgages normally involve a long-term commitment and involve interest payments over a longer term than seven years. This would help middle-income and other taxpayers, who may not have been able to derive the maximum benefit during the period of low interest rates.

3.9.2 Quantum of relief

As a longer-term measure, consideration should be given to removing the restriction on the period during which a salaries tax deduction can be claimed for home loan interest, and also increasing the ceiling amount of interest for which a salaries tax deduction can be claimed.

3.10 Donations

In recent years, due to the economic downturn and to the competing needs of global natural disasters, etc., local charities have found it difficult to raise funds to support their activities. Furthermore, funding for universities, cultural activities and other social services provided by the government has been reducing because of budget deficits. We believe that charitable

donations should be further encouraged in order to develop a more socially-conscious community and ensure that the level of donations can be sustained, even during difficult economic times. We suggest increasing the existing ceiling for allowable deductions from 25% to 50% of assessable profits/income, with a view to removing the ceiling altogether as a longer term objective (possibly in conjunction with introduction of a stronger framework for the regulation of charities).

We propose, in addition, allowing the carrying forward of deductions that the donor has not been able to be set off against tax because the donor has not made a profit during the relevant period. We also propose that the term “approved charitable donation” should be defined for the purposes of the IRO to include donations in kind, such as donations of equipment for medical research, if the goods are valued by a qualified third-party.

B.4 DELIVERY OF COMMUNITY SERVICES

4.1 Public Health Care

Against a background of an aging population, advances in medical technology and rising community expectations, health expenditure is expected to continue to grow in the near future, a trend in line with other advanced economies. It is, therefore, critically important to determine how to maintain a financially sustainable public health care system over the long term. One option would be to adopt the “user pays” principle for health care services above the basic level, e.g., for ambulance services other than in emergency cases.

4.2 Privatisation of Government Services

To enhance the efficient use of resources and the delivery of public services, further studies should be carried out to identify suitable public services for additional privatisation exercises, which could include postal services and water supplies.

Hong Kong Institute of Certified Public Accountants
9 January 2006

Preparing for the Introduction of a GST

In the last Budget, the Financial Secretary (“FS”) highlighted the narrowness of Hong Kong’s tax base and the need, in the long run, to broaden the base in order to secure a steady source of revenue. We believe there is a clear need to broaden the tax base and for the government to stabilise its future sources of revenue. We also believe that action must be taken sooner rather than later, in view of the continuing fiscal deficit on the operating account.

As part of the strategy for returning to a fiscal balance, continuing efforts on reducing public expenditure must remain a priority for the government. In this regard, we are encouraged by the government’s forecast that the share of public expenditure in GDP is expected to fall below 20 per cent in 2006/07, thus meeting its aim of containing public expenditure at 20 per cent of GDP or below by 2008/09. However, we do not believe it is sufficient to rely solely on expenditure cuts. Given the structural changes in the economy and the consequential effects they have had on the traditional sources of revenue of the government, it is clear that defects on the revenue side must also be remedied. Thus, we must adopt a two-pronged approach in arriving at a long-term solution for our persistent fiscal deficit problem.

The Advisory Committee on New Broad-based Taxes considered a number of alternatives to widen the tax base. In its 2002 report, the Advisory Committee recommended the introduction of a goods and services tax (“GST”) as the only alternative capable of meeting the objectives of broadening the tax base as well as producing a significant stable source of revenue for the government. The Advisory Committee’s recommendation was echoed by the FS in the 2004/05 Budget, when he reiterated that the government had set up an internal committee to conduct a detailed and comprehensive study on the implementation of a GST in Hong Kong. The committee was to draw on the practical experience of other jurisdictions and come up with a proposed GST framework suitable for Hong Kong and an implementation timetable, as a basis for discussion.

In our proposals for the 2005/06 Budget, we set out the Institute’s views on the key basic design features on a GST for Hong Kong. Our views on this issue are reproduced as Appendix 1.1.

In the 2004/05 Budget Speech, the FS stated that “according to a rough estimate, each single percentage point in the rate of GST will yield revenue of about \$6 billion a year, assuming that no exemption is granted. Depending on any exemptions, a GST of 5 per cent would generate around \$20 - \$30 billion revenue for the government in a full year”.

The above statement seems to indicate that the government is considering the granting of exemptions under the GST system proposed for Hong Kong.

In terms of design, we believe that the GST should be kept simple. By keeping it broadly-based, a GST would provide certainty which would minimise administrative costs for the

government and compliance costs for business. Exemptions and zero-rating, on the other hand, could create problems to the GST system including the following:

- Exemptions and zero-rating would introduce administrative complexities and disputes about exactly which items should qualify for special treatment.
- Exemptions would lead to cascading (i.e. tax on tax) and would increase total tax where the goods and services were supplied to another business rather than to the final consumer.
- Exemptions could distort economic activities as they could encourage exempt businesses to acquire their inputs from suppliers that were also exempt. Exemptions could also create an incentive for vertical integration or for self-supply, as exempt suppliers might wish to secure their goods and services for themselves in-house, rather than purchasing them in the marketplace, to the extent that the result would be to remove tax from those inputs.
- Exemptions could undermine the integrity and self-policing advantages of the GST system, as an exempt person has an incentive to pay its suppliers under the table.
- Zero-rating would lower the total revenue take produced by the tax and could require a higher standard rate to cover the shortfall. It is also not an effective method of compensation, as zero-rating particular items would have the effect of benefiting everyone in the community and not just the truly needy.

We therefore recommend that any zero-rating or exemptions should be kept to a minimum in a GST for Hong Kong.

We appreciate that a GST, as a broad-based tax on general consumption, could add to the burden of low-income families. Therefore, we recommend that appropriate compensations for low-income households should be incorporated in the GST design. Options for targeted compensations are set out in Appendix 1.1.

Another common concern relating to a GST is that it would provide an easy source of revenue for the government. The rate of GST could be incrementally increased over time, which could reduce the incentive for the government to curb wasteful spending and enhance efficiency. We urge the government not to relent in its efforts to control and curb expenditure, as this could be a crucial factor in obtaining public acceptance of the GST. In addition, the government should consider providing an undertaking not to increase the rate of GST for a reasonable period, say five, or even ten, years, after the date of its introduction.

In conjunction with the introduction of a GST, adjustments to other taxes should be considered. This approach would be consistent with the strategy adopted by overseas jurisdictions on the introduction of GST-type taxes. Tax offsets could also be used as targeted compensations for the low-income group. Possible tax offsets would include the following:

- Reductions in excise duty rates;
- reduction or abolition of existing indirect taxes (e.g. vehicle first registration tax, hotel accommodation tax);
- reductions in profits tax and salaries tax rates;
- increases in personal allowances;
- abolition or changes to stamp duty;
- reductions in property rates;
- changes to profits tax system (e.g. introduction of group relief).

Proposed Key Basic Design Features for a GST

Set out below are the Institute's views on the key basic design principles on a GST for Hong Kong.

Basic Structure

We recommend that a GST adopted in Hong Kong should be the credit-invoice type. That is, GST is collected at each stage of the chain of production and distribution. Each party charges GST on its outputs (known as "output tax") but can claim credits for all tax paid on the goods and services when received (known as "input tax"). Although the collection of GST is via businesses, because of the credit-invoice offset mechanism, the burden of the GST falls on the final consumer. Due to the multi-stage taxing and crediting, it is relatively difficult to evade the tax. Further, a credit-invoice type GST should avoid cascading in the system.

Rate of GST

A well-known competitive feature of Hong Kong is our low and simple tax regime. If we are to maintain our position as a low tax regime, the GST rate to be adopted should be at the lowest end of the GST rates adopted by other economies.

Prior to its rate increase on 1 January 2003, Singapore at 3%, was the lowest rate in the world. On 1 January 2003, the Singapore GST rate was increased to 4%, which was further increased to 5% on 1 January 2004. Even after the increase, the Singapore GST rate of 5% is still the lowest in the Asia Pacific region, alongside that of Taiwan and Japan.

The GST rate will also depend on the fiscal position and revenue needs of the government at the time of introduction. As stated in the 2004/05 Budget, each percentage point of GST will raise roughly HK\$6 billion in additional revenue a year, assuming no exemption is granted. Given the recent international developments, Hong Kong should be able to protect its position as a low tax regime if the GST rate adopted is below 5%.

As regards the number of GST rates, although there is a debatable equity argument for the adoption of multiple rates, from the simplicity and efficiency perspectives, a single positive rate should be adopted. It is worthy of note that the vast majority of countries that have introduced a GST / VAT over the past decade have opted for a single rate.

Destination versus origin principle

The "destination principle" of GST is adopted by almost all countries that have a GST as part of their tax regime. Under this principle, imports are taxed and exports are zero-rated.

An alternative to the destination principle is the origin principle, under which imports are exempt but exports are taxed.

As the international norm is the destination principle, logic dictates that Hong Kong should follow this principle. However, the adoption of this principle will require radical changes to Hong Kong's existing customs administration. The amount of work in this area should not be under-estimated. It may be possible to reduce the impact by introducing a "temporary import regime", where goods in transit through the territory would not be reflected for GST purposes.

Zero-rating and exemption

The international norm is to zero-rate or exempt certain goods and services. When goods are zero-rated, output tax will be nil as the rate is set at 0%, but input tax can be reclaimed. When goods are exempt, no output tax needs to be charged by the vendor but the input tax cannot be reclaimed.

In a simple system, usually only exports (including tourist purchases¹) are zero-rated. International transportation would be included in this category because the consumption technically does not take place in the jurisdiction of supply. Given the importance of trade and tourism to Hong Kong, we support zero-rating of exports.

Similar to the experience of other jurisdictions, it is likely that interest and political groups will lobby for specific categories of goods to be zero-rated or exempt from GST. As a political issue, arguments will likely be put forward for certain goods, for example food, to be zero-rated for equity reasons. However, zero-rating and exemption will introduce administrative complexities and will drive up compliance costs. Classification of items can lead to confusion and debate; for example, how should food items be defined?

In terms of design, we believe that the GST should be kept simple. By keeping it broadly-based, a GST would provide certainty that would minimise costs for business. However, it would be important for the additional tax burden from the GST on low-income groups to be alleviated. This could be achieved more effectively by targeted compensations (see further comments below) rather than seeking exemptions for particular industries or categories of consumption.

Financial services

The basic problem with a GST on financial services is that their values are often incorporated into interest rate spreads and cannot be easily ascertained on a transaction-by-transaction basis.

¹ In general, a tourist refund scheme requires initial payment of GST as part of the purchase price to the retailer, with the tourist reclaiming a refund on departure. Some countries (e.g. the United Kingdom, Korea) also allow retail shops to make arrangements for the goods to be picked up by tourists after they have gone through immigration; in this case, tourists do not have to pay GST upfront, but there will be additional cost for the shops (e.g. arranging for the handover of goods at the airport).

In Singapore, most financial services with explicit fees are taxed (except when the services are exported, in which case they are zero-rated), and all others are exempt. Singapore then allows financial institutions to reclaim a large portion of their input taxes on the basis of a fixed percentage that is specific to the type of the institution, but is independent of a particular institution's actual composition of output (i.e. no account needs to be taken of proportion of taxable, exempt, or export supplies).

The International Monetary Fund ("IMF") has suggested that Hong Kong could follow Singapore's example or go one step further to allow full input tax recovery by financial institutions. The latter approach would be equivalent to taxing all financial services for which explicit fees are charged (except for export services which are zero-rated) and zero rating all other supplies. We support the IMF's suggestion.

Property sector

In practice, taxing the implicit rental values of owner-occupied buildings is not feasible. Even if a value could be imputed, it would still be administratively infeasible to subject owner-occupied residential properties to tax, since this would require the owners of such properties, who are, themselves, the final consumers, to register for and collect GST. In view of this, it would be necessary to exempt residential rental payments so as to avoid creating a distortion between rental and owner-occupied residential properties.

The implications for other property-related transactions should be carefully considered to ensure that the framework is suited to conditions in Hong Kong.

Registration threshold

A characteristic of a GST is that the bulk of its revenue is normally collected from a relatively small proportion of taxpayers. In the interest of cost-effectiveness, it has been suggested that the registration threshold should be set at quite a high level. The Advisory Committee estimated that, with the threshold set at HK\$5 million, 50,700 businesses would need to register for GST, based on March 2001 figures. This represented 25% of all businesses filing tax returns in 1999/2000, or 8% of all entities with a business registration, i.e. including dormant businesses and shelf companies.

Exempt businesses that fall below the threshold, and which transact mainly with taxable businesses, may be put in a disadvantageous position relative to their taxable competitors. Therefore, the option of GST registration should be available for businesses below the threshold, with a minimum registration period to be imposed. This would be consistent with the international norm.

Compensations

A major political argument against the introduction of a GST is likely to be its perceived regressivity, in other words it bears more heavily on those that are less well off. Therefore, appropriate compensations for low-income households should be incorporated in the GST design.

As explained above, we believe that targeted compensations are superior to introducing zero-rating or exemptions for particular items of consumption. There are a number of directly targeted compensations that could be considered, including the following:

- i) Adjustments to salaries tax rates or allowances for lower-income groups;
- ii) increases in CSSA payments;
- iii) reductions in rentals for public housing; and
- iv) reductions in rates.

Appendix 2

Period for Re-opening Tax Assessments in Other Jurisdictions

Countries	Timeframe for re-opening tax affairs
United States	Three years from due date of tax return, or the date of filing, whichever is the later. (Unlimited timeframe where no return filed, or a false or fraudulent return is filed with the intent to evade tax.)
Canada	Four years from date of original notice of assessment, except in certain circumstances when the period can be extended to seven years (e.g., where the taxpayer has exercised their statutory right to carry back an amount (e.g., tax losses or foreign tax credits) to a prior year return). In cases of fraud or misrepresentation due to neglect, carelessness, or wilful default, a taxpayer's tax affairs can be re-opened at any time.
New Zealand	Four years after the end of the year in which the tax return is filed. (Unlimited timeframe for omitted income, fraudulent or wilfully misleading returns.)
Australia	Four years after the end of the year of assessment. (Unlimited timeframe where there is an avoidance of tax due to fraud or evasion.)
Mainland China	Three years from the end of the year of assessment (for revising the amount of tax assessed where an error has been made by the tax authority). Five years from the end of the year of assessment (for revising a return where a "computational type" error has been made by the taxpayer). Unlimited timeframe for returns involving tax evasion or fraud, or where no return has been lodged.
Taiwan	Five years after the return has been accepted as final. (Seven years after the due date for filing a return where a return has not been filed or taxation has been evaded due to fraud.)
Thailand	Five years after the date of filing of a return. (Ten years after the due date for filing a return where a return has not been filed.)
Philippines	Three years after the date of filing of a return. (Ten years in cases of false and fraudulent returns or failure to file a return.)
United Kingdom	Five years and ten months after the end of the tax year (for the tax authorities to make an assessment in the absence of a self-

Countries	Timeframe for re-opening tax affairs
	assessment), or 22 months after the end of the tax year (for amending a self-assessment). In cases of fraud or negligence, the timeframe for re-opening tax affairs is extended to 20 years and 10 months.
South Africa	Three years after the date of the assessment. (Unlimited timeframe for cases of fraud, misrepresentation, or non-disclosure of material facts.)