



29 July 2005

**By fax (2840 0569) and by post**

Our Ref.: C/TXP(4), M36281

The Hon. Henry Tang, G.B.S., J.P.  
Financial Secretary  
The Government of the Hong Kong SAR  
12/F, West Wing  
Central Government Offices  
Lower Albert Road  
Hong Kong

*Dear Henry*

### **The Budget 2005/06**

I wish to convey the Hong Kong Institute of Certified Public Accountants ("the Institute")'s broad support of the HKSAR Government's budget proposals for 2005/06. We regarded the proposals as prudent and we concurred with them and your view that the recent signs of improvement and stability in the economy should not be used as a reason to make extensive tax concessions, which could have long-term implications for revenues. The Institute also welcomed the indications that greater control was being exercised over the growth in public expenditure.

At the same time, in our own budget submissions to your office in recent years, we have pointed to potential problem areas in the Hong Kong tax system that are of increasing concern to practitioners and businesses and which, many believe, are adversely affecting the investment environment. In our view, if steps are not taken to address certain fundamental problem areas, there could be a significant and damaging impact on Hong Kong's continuing ability to attract new investment and retain existing business.

A low tax regime is frequently referred to as one of the significant advantages offered by Hong Kong, yet the tax rates cannot be dissociated from other key features of the tax regime, which include its inherent level of certainty and predictability. We believe that some of the other benefits of Hong Kong's tax system are being eroded.

Although the effect on investment may not be easy to quantify at this stage, there may already be indications that investors are scaling down some of the traditional forms of investment here. For example, figures for the number of regional offices set up in Hong Kong are often quoted as a sign of Hong Kong's continuing ability to attract business, but there is a perception amongst tax practitioners that



regional offices are commonly smaller and employ fewer persons than before. While there may be various factors behind this, the economic and tax environment is likely to be a significant factor.

Under the circumstances, the Institute would like to draw your attention to some of the more important issues currently facing the tax system. These would include:

- The effect of the decision in *CIR v. Secan Ltd. and Ranon Ltd.*
- The lack of any arrangements for group relief or loss carry back
- Uncertainty over the source of profits
- Uncertainty over the source of employment income for salaries tax purposes
- Problems with the "Assess First Audit Later" policy and procedure for tax assessment
- The need for a broader base of taxation

--- Further information on these items is contained in the Attachment.

We have expressed similar concerns on various occasions in the past, most recently in our Budget Proposals 2005/06 document (*In FOCUS – The Core Strengths of Hong Kong's Tax System*), a copy of which was sent to your office in December 2004.

We wish to have the opportunity to explain the Institute's concerns in more detail and, to this end, would like to request a meeting with you. I look forward to receiving a positive response to our request, subject to which, we will contact your office to arrange a mutually convenient time. I can be reached by telephone, on 2287 7037, or by email, at [winnie@hkicpa.org.hk](mailto:winnie@hkicpa.org.hk).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Winnie C.W. Cheung', written in a cursive style.

Winnie C.W. Cheung  
Chief Executive & Registrar

WCC/PMT/ay  
Encl.

c.c. Mrs. Alice Lau Mak Yee-ming, Commissioner of Inland Revenue  
Mr. Frederick Ma Si-hang, Secretary for Financial Services and the Treasury

### Issues Facing the Hong Kong Tax System

#### *Certainty of interpretation*

One of the strengths of Hong Kong's tax system has traditionally been the fact that the legislation has been relatively straightforward and easy to understand. From time to time, contentious areas have arisen in interpretation of tax law, but clarification has been obtained by reference to court decisions, the use of Departmental Interpretation and Practice Notes ("DIPNs") issued by the Inland Revenue Department ("IRD") or, if necessary, changes to the legislation. This certainty of interpretation has enabled taxpayers to have greater confidence in their dealings with the IRD and has encouraged disclosure in compliance matters and the belief that taxpayers' affairs will be dealt with on a consistent basis.

#### *Effect of the Secan case and the taxation of unrealised gains*

Recently, the IRD has referred to the decision in *CIR v Secan Ltd. and Ranon Ltd.* [5 HKTC 266] as authority for adopting the approach of determining the assessable profits or allowable losses of a company based on the accounting disclosure or treatment of such items in the company's audited accounts (in accordance with generally accepted accounting principles). As you will be aware, Hong Kong Financial Reporting Standards (HKFRS) are now converged with International Financial Reporting Standards (IFRS).

Although we would question whether the IRD is correct to give such a broad interpretation to the *Secan* decision, nevertheless, the decision and the interpretation given to it are creating potential difficulties for taxpayers. Adopting the concept of "fair value accounting", IFRSs may require the recognition of certain items as profits or losses in audited accounts, even though they have not been realised at the time that the accounts are prepared (e.g., marked-to-market investments in financial instruments or annual revaluations of property holdings) and may continue to be unrealised for an indefinite period. As a result of *Secan*, a taxpayer may be assessed for tax on these unrealised amounts. This also means that, whereas, if an unrealised loss eventually turns into an actual gain, it can still be taxed at that time, in the case of unrealised "profits", although tax may be levied on them when they are recognised in the profit and loss account, if ultimately these accounting profits turn into actual losses, those losses may not be available to be offset against subsequent profits, because the taxpayer may, by that time, have already ceased business. One effect of this is that a taxpayer could end up paying significantly more than the standard rate of profits tax over the lifetime of the business.

The situation is exacerbated in Hong Kong because, unlike the UK, for example, Hong Kong does not have loss carry-back or group relief provisions. The taxation of unrealised profits could, therefore, create cash flow problems and undue hardship for taxpayers in Hong Kong, particularly if they are not able to obtain any

tax relief when actual losses are incurred in subsequent years before ceasing business.

The Institute has suggested (see section B1.4 of our submission on the 2005/06 budget (“budget submission”)) that legislation should be introduced to address the uncertainty that has arisen following the *Secan* decision, and the application of it, and make it clear that the accounting treatment and the tax treatment of “profits” and “losses” should be regarded as separate matters. Given that accounting standards are intended to serve a different purpose and not to provide for the computation of assessable profits and losses for tax purposes, and tax implications are not a primary consideration when they are drawn up, there is no reason why accounting and tax treatment should be inextricably linked.

#### *Carry back of tax losses*

The Institute has been proposing for several years (see, e.g. section 2.3 of the budget submission) that losses incurred in the current year of assessment should be able to be “carried back” for one year to be offset against assessable profits in the previous year.

#### *Group relief*

Group relief, i.e., the ability to offset profits against losses incurred by other companies within the same group, is common in many developed tax jurisdictions. The Institute has long advocated some form of group relief in Hong Kong (see, e.g. section 2.2 of the budget submission).

#### *Profits tax and salaries tax – source of income*

There is a perception amongst tax practitioners and businesses that there is considerable uncertainty regarding the source of trading profits and manufacturing profits. While under, section 14 of the Inland Revenue Ordinance (“IRO”), businesses are taxable on their assessable profits “arising in or derived from Hong Kong”, the legislation does not set out any general tests or rules for ascertaining the source of profits. Instead, reference has to be made to case law and to DIPN No. 21 (*Locality of profits*). Recent court decisions (e.g., *Consco Trading Company Ltd. v CIR*) have introduced uncertainty in this fundamental area of our tax regime, which, in turn, has been reflected in the interpretation of DIPN No. 21 by the IRD, especially in respect of offshore manufacturing claims and the use of import/export trading companies. As suggested in section 4.2 of the Institute’s budget submission, we believe that clear tests should now be prescribed to determine the major sources of income that are subject to profits tax.

The source of employment income is also a significant problem area. When the current version of DIPN No. 10 (*The charge to salaries tax*) was first issued, following the case of *CIR v Goepfert* [2 HKTC 210], this resolved much of the confusion and inconsistency prevailing at that time in relation to the issue of the

source of employment income. However in recent years, there has been a trend to depart from the tests laid down in DIPN No. 10 and for questions to be raised over whether those tests reflect an accurate interpretation of the law. Again, this is leading to an increasing number of inconsistencies and conflicts. We believe that the relatively straightforward and understandable tests for determining the source of employment income laid down in DIPN No. 10 are in line with the decision in *Goepfert*, and that they should be reaffirmed and applied clearly and consistently.

#### *“Assess First, Audit Later” programme*

As indicated in section 4.5 of our budget submission, the “Assess First, Audit Later (AFAL)” policy of assessing taxpayers’ liability to tax has led to uncertainty and concern amongst taxpayers, who, as a result, are more likely to be unable to confirm that their tax affairs have been finalised for any particular year of assessment until the expiry of the statutory time limit of six years from the end of the year of assessment in question. In our view, there is some doubt as to whether there is a valid legal basis for the policy of AFAL, as it is unclear how or where it is provided for in the IRO (see, for example, section 59(2)). In any event, we believe that the current AFAL arrangement, which may have been adopted as a response to manpower constraints in the IRD, is harmful to Hong Kong’s reputation as a business-friendly location.

#### *Consultation on the implementation of GST*

Unless the tax base is broadened in Hong Kong, there will continue to be a structural mismatch between revenue and expenditure, in that, over the long term, the government does not have adequate, stable income streams to support its spending, even if the growth in public expenditure is, as far as possible, kept under control.

The Institute urges the government to provide a clear timetable for the introduction of a goods and services tax (“GST”) with a view to broadening the tax base in Hong Kong. Reductions in direct taxation should also be considered at the same time. As the next step, we would urge the government to proceed with consulting the public on proposals for a GST.