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BY HAND AND BY E-MAIL

The Honourable Mr. Henry Tang
Financial Secretary
Central Government Office
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Dear Mr. Tang

2005/06 Budget Proposals

This year our Institute's proposals for the 2005/2006 budget are written against the backdrop of a recovering economy. We believe it is time for the government to focus on fiscal policies with long-term benefits for Hong Kong. Whilst balancing the books by 2008-09 and broadening Hong Kong's tax base remain important on the list, we strongly believe that the government's strategy should focus on enhancing Hong Kong's role as Asia's prime service centre and investing in our human capital in order to maintain the competitiveness and attractiveness of Hong Kong.

A. INTRODUCTION

1. Economic Situation

Hong Kong's economy has seen an obvious pick-up since the first quarter of 2004 with 7.0% growth in real terms. This is followed by an accelerated growth of 12.1% in real terms in the second quarter and 7.2% growth in the third quarter. The overall economic growth for 2004 is expected to be 7.5%.

The overall composite consumer price index (CPI) in July 2004 registered the first year-on-year increase after 68 consecutive months of decline since November 1998. The CPI continues to rise since then and that reflects the influence of a reviving economy and an increase in consumer demand.

The unemployment rate fell from 7.2% in the period January – March 2004 to 6.7% in the period September – November 2004. The number of unemployed persons decreased from 249,000 in January – March 2004 to 236,000 in September - November 2004. We believe that the downward trend in unemployment rate is expected to continue as long as the economy's growth momentum remains strong.

While the rate of the economic recovery is promising, the performance of our economy is still reliant on many external factors which are beyond our control - the oil price, the political situations in the Middle East and the performance of the economies of the U.S., the EU and the Mainland. To sustain the momentum of economic growth and to stay competitive, we believe the government should formulate long-term fiscal measures which are beneficial to Hong Kong.

2. Fiscal Situation

With the recovery of the economy and an increase in revenue, it is expected that the actual deficit for 2004-05 would be lower than the estimated HK\$42.6 billion and the target of balancing the fiscal deficit by 2008-09 would be met with a surplus of HK\$6 billion. For the first eight months of the fiscal year 2004-05, government expenditure amounted to HK\$158.6 billion and revenue to HK\$155.6 billion, resulting in a deficit of HK\$3 billion.

The fiscal reserves stood at HK\$272.3 billion at 30 November 2004. They have been depleted by 40% over the past six years from HK\$457.5 billion at 31 March 1998. Based on the government's current forecasts, fiscal reserves would run down by a further 24% of the March 1998 level in the coming five years to 2008-09. It is expected that there

would be about HK\$167.3 billion remained at 31 March 2009, which is equivalent to only eight months of government expenditure.

Hong Kong has been facing a structural fiscal deficit problem. We agree with the government's commitment to restore fiscal balance by 2008-09, to continue controlling its expenditure and to broaden Hong Kong's tax base.

B. MEASURES TO PROVIDE A HEALTHY, STABLE AND CERTAIN FISCAL ENVIRONMENT

A healthy, stable and certain fiscal environment will not only boost potential investors' confidence in Hong Kong, there are more immediate benefits, for example, investment instruments (for example, notes or bonds issued by corporations or sovereigns) issued during a backdrop of a heavy government deficit will probably receive a lower credit rating than when the same are issued at the time when the books of a government are balanced and there is a stable fiscal environment. Indeed, what we have suggested in this section B below could be achieved without incurring high social or economic costs.

1. Broadening our tax base

We have covered this point in our 2004/2005 budget proposal before, but because of its significance, we think it is appropriate for us to reiterate briefly here.

With the growing trend of a smaller number of taxpayers (both corporations and individuals) shouldering a substantial portion of our profits tax and salaries tax burden, we believe the government should tackle this structural fiscal problem as a priority. Since the major source of our tax revenue is from profits tax, (as its name infers, a company only needs to pay profits tax only when it makes a profit), the yield from profits tax would very much depend on the economic performance of Hong Kong which, as discussed before, is dependent on a number of external factors. Whenever there is an economic depression, the yield from profits tax would drop substantially and the variance could be as great as over HK\$15 billion¹ in a financial year.

In the light of the reasons outlined, we believe that there is a need for the government to address the structural fiscal problem and conduct detailed study and extensive

¹ Total profits tax revenue collected for financial year 1997/1998 = HK\$54.3 billion; 1999/2000 = HK\$37.3 billion. Figures from page 10 of Inland Revenues Department Annual Report 1999/2000.

consultation to ascertain whether a broad based tax system such as a Goods and Services Tax (GST) should be introduced in Hong Kong, and if so, when.

2. Certainties and fair treatment to taxpayers

Hong Kong's territorial source based tax regime has long been viewed as one of the unique features of Hong Kong's tax system which attracts foreign investors into Hong Kong. Since the source rules are mostly case based and the Inland Revenue Department (IRD) seems to be more reluctant recently to treat a taxpayer's booked profits with very limited activities performed in Hong Kong to be wholly offshore profits, it is time to review whether our case based source rules can provide certainty to taxpayers. Admittedly the review of the source rules is a long term project, we have though identified a couple of source related issues below which we believe the IRD could provide the taxpayers with a speedy clarification.

2.1 *Exclusion of certain activities from being regarded as carrying on of a business*

The taxation system of Hong Kong operates on a territorial source concept. This means that only profits which arose in or derived from business carried on in Hong Kong are subject to Hong Kong taxes. Under the territorial source concept, a company is liable to profits tax in Hong Kong only when its profits are derived from businesses carried on in Hong Kong. Unfortunately, what constitutes business carried on in Hong Kong is not defined in the Inland Revenue Ordinance (IRO) and this has often caused disagreements between the IRD and taxpayers. The IRD has issued a Departmental Interpretation and Practice Note No. 21 (DIPN 21) which, amongst other things, specifies that certain activities performed in Hong Kong will not, of themselves, constitute the carrying on of a business in Hong Kong. These are:-

- issuing or accepting an invoice (not order) to or from a customer or supplier outside Hong Kong (whether related or not) on the basis of contracts of sale or purchase already effected by an associated company situated outside Hong Kong;
- arranging letters of credit;
- operating a bank account, making and receiving payments; and
- maintaining accounting records

To ensure a consistent application of DIPN 21, we suggest that these "exempted activities" should be carved out from being regarded as business activities (carried on in Hong Kong) and that should be stated clearly in the IRO rather than a DIPN.

2.2 *A clear "apportionment of profit" policy*

With the globalisation of business operations, it is possible that profits disclosed in the accounts of a company may comprise a portion attributable to activities carried on outside of Hong Kong. A typical example of this may involve a Hong Kong taxpayer selling goods to overseas customers and has his goods manufactured by a subsidiary or an associated company in the Mainland. If the goods so manufactured are transferred to the Hong Kong company at cost, then the profits shown in the Hong Kong taxpayer's accounts will comprise a portion attributable to manufacturing activities carried out outside of Hong Kong. The IRD has, in practice and by extra-statutory concession, allowed 50% of those profits to be exempted from profits tax in Hong Kong. Since profit apportionment is only an extra-statutory concession, its application may become arbitrary and erratic, we suggest that this practice be formalised by either changing the IRO or by the issue of a departmental interpretation and practice note.

3. Transparency

This point has been covered in our 2004/2005 budget proposal. However, we believe it is worthwhile to mention it again here.

We believe that in order to create a certain fiscal environment, tax laws should be consistently interpreted and applied by the IRD. The issue of departmental interpretation and practice notes alone may not be adequate in this respect as practice notes in general do not deal with procedural matters or specific situations. In line with the practice of many other tax authorities (including the United States or United Kingdom), we suggest that the IRD should publish its assessor's manual in order to increase its transparency and taxpayers' trust and confidence in their dealings with the IRD.

C. TAX INCENTIVES

Although one of the main themes of our budget proposal this year is to enhance Hong Kong as a prime service centre in Asia, many of the measures suggested below may also benefit a wider spectrum of the business sector.

1. Extension of tax relief to initial refurbishing costs for commercial buildings

Under section 16F of the IRO, renovation or refurbishment costs of commercial buildings would generally be amortized over five years for tax purposes commencing from the year in which the expenditure is incurred, i.e., an annual tax write-off of 20% of the costs incurred over a 5-year period.

However, first-time or initial refurbishing costs of commercial premises would not qualify for the tax relief under section 16F. Instead initial refurbishing costs would only be eligible for commercial building allowances of 4% per annum.

Service industries like restaurants, hotels, entertainment, retail, financial and many other businesses incur large sums of expenditures on refurbishing and they contribute tremendously to the prosperity and employment situation of Hong Kong. To give further tax incentive for these businesses to expand, we propose that the 5-year tax write-off under section 16F be extended to initial refurbishing costs incurred on commercial buildings.

2. Deduction for initial acquisition costs incurred on implement, utensil and article

Rule 2 of the Inland Revenue Rules lists the items which shall be deemed to be included under the definition of "implement, utensil and article". They include, among others, crockery and cutlery, kitchen utensils, loose tools, and carpets and curtains. These items are indispensable assets for the start up of a hotel or restaurant business and in many cases would take up a substantial portion of the initial capital of such business. However, costs incurred on the initial purchases of these items are not tax deductible and tax deductions will only be granted when the items are replaced.

We propose that instead of only granting a deduction for all replacements for such items all acquisitions, no matter they are initial acquisition or subsequent replacement, should be granted full deductions when the expenses are incurred.

3. Full tax deduction for business equipment

From 1 April 1998 onwards, expenditure incurred during a basis period on computer equipment and manufacturing plant and machinery are fully allowable under section 16G. To encourage service industries to upgrade their operating apparatus, we suggest that business equipment such as fax machine, copiers and telephone systems etc should also rank for a 100% deduction.

4. Amortisation of capital expenditure on franchise or licence etc.

Certain capital expenditure for service industries is as important as plant and machinery for manufacturing industries.

Such capital expenditure includes for example, acquisition costs of franchise, concessionaire or licence. We do not see the rationale of granting depreciation allowances to plant and machinery but ignoring the capital expenditure on those capital expenditure items involving franchise, concessionaire or licence which we believe an amortisation allowance should be granted.

5. Review of allowances for cross-border leasing activities

The amendment of section 39E (1) (b) of the IRO in March 1992 was intended to stop the use of leveraged leasing structure of assets principally used outside Hong Kong to obtain a tax benefit via depreciation allowances. This has the effect of deterring genuine international investors from setting up companies in Hong Kong to lease machinery and equipment to users in other countries.

We are of the view that the law, as it stands, is too sweeping and has created some unintended consequences. Therefore, we propose that the law be amended to make room for the granting of depreciation allowances to genuine overseas leasing transactions to make Hong Kong a more attractive place for cross-border leasing businesses.

6. Tax deduction for interest expenses paid to associated companies

Many trading and service oriented companies in Hong Kong pay interest expenses to their overseas holding or associated companies on inter-company loans used to finance their operations in Hong Kong. The interest expenses incurred will not be tax deductible in Hong Kong under section 16 (2)(c) of the IRO if the overseas recipients are not chargeable to tax in Hong Kong in respect of the interest income.

A rule forbidding a company from making a tax deductible interest payment to an overseas holding or associated company is not common since in most jurisdictions (including most Asian countries) withholding tax is levied on the interest payments to recoup the tax lost on deduction granted to the payer. From the viewpoint of an international investor, the rule under section 16(2)(c) is rather strange since it does not allow a holding company to arrange the capital and financing structure of a group in Hong Kong with the usual tax benefits. Hong Kong has no withholding tax on interest

payments to a non-resident and we do not recommend such a levy because it is at odds with our simple and territorial based tax system.

We propose that consideration be given to allow deduction of interest paid by a Hong Kong company to its holding company or associated company in certain encouraged industries, (for example, film making, recycling and other industries to improve the environment) provided that it is proved to the satisfaction of the Commissioner of Inland Revenue that income tax has been paid by the recipient of interest in its country of residence or incorporation at a rate not lower than the standard rate of tax in Hong Kong.

7. Unilateral tax credit should be granted for overseas withholding tax on royalties and interest income

Hong Kong taxpayers who grant the use or the right to use of their intellectual properties to persons outside Hong Kong would normally suffer overseas withholding tax in respect of the royalty income received, as the income would likely to be regarded as being sourced in the overseas countries.

However, following the source rule for royalties adopted in Hong Kong after the *TVBI* case, the royalty income of the Hong Kong taxpayers would probably also be liable to tax in Hong Kong under section 14 as income derived from their business carried on in Hong Kong.

Similarly, the interest income of Hong Kong taxpayers, in particular, financial institutions, may also be subject to overseas withholding tax as well as profits tax in Hong Kong in respect of their loans granted to persons outside Hong Kong.

Currently, Hong Kong taxpayers would probably obtain a tax deduction in Hong Kong in respect of their overseas withholding tax paid on royalties and interest, under either section 16 (1) or section 16 (1)(c) of the IRO. That means there is no full tax credit of the overseas tax paid against the Hong Kong profits tax payable on the same income since Hong Kong has not entered into any comprehensive tax treaty arrangements with any other countries (except with Belgium) which may grant full tax credit on overseas tax suffered to avoid double taxation.

Unlike full tax credit claims, the tax deduction for overseas tax paid is only a partial tax relief and does not fully eliminate double taxation. As such, in the absence of any comprehensive tax treaty arrangements, we propose that Hong Kong should grant unilateral tax credit to its taxpayers under the IRO in respect of their overseas

withholding tax suffered on royalties and interest. We believe this would give further tax incentives for Hong Kong businesses to exploit fully the overseas markets.

8. Tax concessions on setting up regional head-quarter companies in Hong Kong

Hong Kong has always been a popular city for multi-national companies to set up their regional head-quarters. Hong Kong should make use of its natural advantage and continue to enhance its position as a prime service centre in Asia.

With the rapid development of and Hong Kong's increased interaction with the Mainland's economy, the signing of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) and the integration of the Pan-Pearl River Delta Economic Zone, more multi-national groups are being attracted to set up head-quarters in Hong Kong because of its geographical proximity to the Mainland. However, the operating costs in Hong Kong (such as rent, remuneration and transportation) are still high compared with other countries in the Asia-Pacific region.

Therefore, we propose granting tax concessions to those foreign companies which set up its regional head-quarter in Hong Kong. The concession can be in form of a reduction of corporate profits tax rate from 17.5% to 10% for those head quarter companies set up in Hong Kong.

We believe that certain criteria should be satisfied for granting such a tax concession, say, for example, the head-quarter companies should employ a number of local employees. In addition, these companies should meet a minimum capital requirement of say, HK\$ 5,000,000, and with the presence of the key management / professionals in Hong Kong. Furthermore, the parent companies of these head-quarter companies should be able to provide good track record of operation in their home country and can produce good projection of their sales and service for future periods.

9. Group loss relief

The system of taxation in Hong Kong provides few alternatives for the use of the tax losses suffered by resident corporations carrying on business in Hong Kong. Although this has been a topic raised for discussion on many previous occasions, it is hoped that new legislation expanding the use of losses for groups of companies may be introduced at some stage in the future.

Currently, a company is able to carry forward its losses and offset the losses against the assessable profits of future years without any time limit. In addition, where a company is

a partner in a partnership and the partnership suffers an allowable loss, the company is able to set off its share of the loss against its own assessable profits.

Unlike countries with sophisticated tax systems, Hong Kong does not provide for the use of losses within a group of companies. In the UK for example, companies which are substantially under the same ownership are able to transfer to one another tax losses sustained in a particular period. The Australian tax system also provides for group relief via the transfer of both revenue and capital losses. This has the advantage of reducing the group's effective rate of tax.

Like Hong Kong, some countries in Asia have excluded group loss relief from their tax legislation. However, the introduction of group relief may provide Hong Kong with a significant competitive advantage in attracting foreign investment when compared to other countries in the region. Singapore has introduced a group loss relief mechanism in its 2002 budget and group loss relief has been available from year of assessment since 2003. Japan has been reported to be considering introducing a relief of this type. Therefore, for this incentive to be promoted by Hong Kong as a benefit in the region, we need to consider this issue seriously as soon as possible.

Obviously, the advantages of implementing such a system in Hong Kong need to be weighed against the possible loss of revenue in introducing such a change. However, assuming that a loss making company is able to return to profits in the future, the company will make use of the losses it has carried forward in sheltering future assessable profits. The introduction of group relief provisions, therefore, would simply have the effect of accelerating the use of those losses. The loss to the Treasury is likely to be confined to an element of the time value of money on the accelerated losses utilized, and potentially a small amount of tax where business may previously have ceased trading prior to making use of their accumulated losses. The benefit of attracting new businesses which may be brought to Hong Kong as a result of the change is likely to outweigh this cost.

The introduction of group relief within the tax legislation is certainly a feature which would differentiate the tax system in Hong Kong from others in the region, and would assist in attracting foreign investments into Hong Kong. It would also be welcomed by investors already established in Hong Kong and go some way to securing their business for the future.

10. Carryback of tax losses

Following the 2000 Hong Kong Court of Final Appeal's decision in *Secan* and other relevant UK tax cases, the IRD has been more prone to taxing a company based on its profits as reflected in its audited accounts. As a result of this approach, the accounting profits of a company would often be taxed without any adjustments for tax purposes.

Audited accounts are prepared for measuring the performance of a company for the purposes of different users - primarily the shareholders, but also include creditors, potential investors and various regulatory authorities. It may therefore be said that audited accounts are not prepared primarily for tax purposes.

Given that the accounts of a company are prepared for different needs of users, it has generally been recognised that some of the accounting profits of a company should not be treated as profits for tax purposes, for example, unrealised gains on the translation of foreign exchange differences and revaluation gains of assets.

However, in response to the recent release of International Accounting Standards IAS 39, the IRD has, against the views of many taxpayers and practitioners, indicated that all revaluation gains of financial instruments held on trading account that have to be marked to market at the year end under IAS 39 would be taxed - even though the instruments have not been sold or settled by a taxpayer.

In addition the IRD has further indicated that the established practice of allowing taxpayers the option to be taxed on foreign exchange differences on realisation basis (instead of on accounting basis) would be withdrawn.

In justifying their proposed practice of taxing all unrealised revaluation and translation gains as reflected in the accounts (before the transactions of instruments are settled or realised), it is understood that the IRD is making reference to the UK Inland Revenue that it is adopting the same practice.

However, we are of the view that the policy considerations for taxing unrealised revaluation or translation gains in the UK may be different from those of Hong Kong - notably there are provisions in the UK tax laws for allowing the carryback of tax losses.

This means that financial instruments or foreign exchange transactions may suffer losses on settlement (although book profits may have been booked in the past) and where there are no other taxable profits in the year of settlement to offset the losses, can be carried back to offset the taxable profits of a taxpayer of the earlier years.

We are of the view that, regardless of the tax treatment eventually adopted for IAS 39 transactions and foreign exchange translation differences, Hong Kong should amend the IRO to allow taxpayers to carryback tax losses for a certain number of years (say, two to three years).

11. Taxation of offshore funds

Although the government has somewhat changed the approach in seeking to grant profits tax exemption for offshore funds in the second consultation paper released on 31 December 2004, we still consider that the exemption is still too restrictive and the reporting burden placed on the resident investor is somewhat quite difficult to implement. Details of our response to the second consultation paper will be set out separately in a paper to be addressed to the FSTB.

D. INVESTING IN HUMAN CAPITAL

Hong Kong has very scarce natural resources apart from its people. The release of the study by the "Task Force on Population Policy" has prompted us to give further thoughts on this topic. We need a pool of educated, flexible and motivated workforce to sustain Hong Kong's success and this pool has to be replenished from time to time. Although tax policy may not have a very significant effect on the overall population policy, it does have a part to play.

1. More generous deduction of expenses incurred for education/training courses under the salaries tax regime

Costs of operation in Hong Kong are still high compared with other countries and regions, such as Singapore, Korea and Taiwan. While cost reduction may not be achievable in the short run, Hong Kong has to upgrade the quality of its workforce. Staff training and continuous education should be encouraged as a long-term policy. Fees paid for attending educational courses and examinations should be afforded a more generous treatment under the salaries tax regime. The nature of the courses should not be "strictly" related to the existing employment or profession of an employee. The course fee paid for "recognised" education institutions or professional bodies should be allowed as deduction provided the courses are fully attended by the taxpayer. In addition, we suggest granting a super deduction of 150% for all education/training fees in the hope that our workforce will upgrade themselves broadly and continuously.

2. More generous deduction for membership fees of professional bodies under the salaries tax regime

Under the existing salaries tax regime, membership fee paid can be deductible for only one recognised professional body. As our economy is becoming more knowledge-based, our professionally trained workforce will have to acquire additional skills, knowledge and qualifications.

It is not uncommon that professional accountants nowadays may also have acquired professional qualifications in the fields of company secretarial administration, taxation, financial planning and law. We should encourage all professionals to become members of recognized professional bodies in order to broaden their skills and knowledge. Thus membership fees (including entrance fees) of various professional bodies (and not just for one professional body) should be allowed as deductions under the salaries tax regime. We hope that a more generous deduction can encourage our professionals to upgrade themselves continuously.

3. Personal assessment – married couples be allowed to elect separately on their own right unless they opt for joint personal assessment

Many women in Hong Kong are high flying professionals or business executives and they would like to see their financial independence and privacy preserved after marriage. Under the present salaries tax regime, a husband and wife are separately assessed on their own if they do not elect to be jointly assessed in order to get further tax relief.

An unmarried individual is also eligible to elect for personal assessment under Part VII of the IRO to have his/her total income assessed as a means of getting tax relief.

However, a married person is not permitted to elect for personal assessment on his own where his/her spouse also has taxable income; in such a case the married couple will have to elect for personal assessment jointly.

Such joint personal assessment would in most cases reduce or wipe out the tax relief that the married couple would otherwise have enjoyed had they been allowed to elect for personal assessment separately and individually.

We believe that a married person should not need to obtain consent from his/her spouse before he/she is permitted to elect for personal assessment in respect of his/her total income. The present law undermines the financial independence of married couples and disregards the fact that a couple may have different considerations in terms of tax

arrangements and their desire to keep their tax and financial affairs separate and confidential from each other. There does not seem to be any justification for not allowing a married person to elect to have his/her total income assessed under personal assessment.

We therefore propose that a married person should be allowed to elect for personal assessment in his/her own right without requiring the consent of his/her spouse. This is consistent with the treatment of an unmarried taxpayer. However, in line with salaries tax treatment, married couples should also be allowed an option to elect for joint personal assessment if this enables them to get further tax relief.

4. Increase in child allowance

Hong Kong has one of the lowest fertility rate in the world. In 2001 Hong Kong's total fertility rate reached an extremely low level of 927 children per 1,000 women, well below the replacement level of 2,100 children per 1,000 women². In order to maintain a pool of talented workforce and to encourage working women with children to stay with their job, we suggest that child allowance be increased from the current level of HK\$30,000 per child to HK\$60,000 per child (in order to cover increased expenses for domestic help which a working mother may need) and that this same level of allowance should be applicable for the 3rd to the 9th children as well.

E. MISCELLANEOUS

1. Reform of Estate Duty

Estate duty is a deterrent to free flow of foreign capital. We believe that high net worth individuals may transfer their money and assets to Hong Kong if Hong Kong is completely free of capital taxation of any kind. We believe that estate duty should be abolished as there is a recent trend of abolition or adjustments made to the estate duty/inheritance tax regimes in various countries. The total revenue generated from the levy of estate duty is not large. In addition, informed individuals can by legitimate means arrange their tax affairs so that most of the estate duty could be avoided when they decease. For the reasons stated above, we support the idea of abolishing estate duty in the long run.

² Paragraph 2.7, Report by Taskforce on Population Policy published in February, 2003.

We are somewhat concerned that if the estate duty is to be abolished now, it may worsen our current fiscal deficit. We therefore suggest a gradual reform of the estate duty regime with a view to its ultimate abolition entirely. At present, estate duty accounts for 4% of the government's total revenue with an average of HK\$1.5 billion revenue per annum. It is difficult but not impossible to abolish estate duty in conjunction with other tax reforms to broaden our tax base.

We suggest to exempt from estate duty not only bank deposits but also portfolio investment accounts managed by licensed financial institutions or branch of a licensed financial institutions carrying on a business in Hong Kong. Besides, we propose to exempt from estate duty shares listed on the Hong Kong Stock Exchange. Furthermore, we believe that exemption should be granted to matrimonial home of a widow or widower currently residing with immediate family members.

2. Tax rates

Apart from what has been suggested above, we do not think it is the right time for the government to reduce the tax rates or other government charges in general despite a rapidly recovering economy.

We trust the above can assist you in formulating the budget for the forthcoming year.

For and on behalf of

The Taxation Institute of Hong Kong

Li Man Fai

President