Study on the Competitiveness of the Hong Kong Tax System

January 2014
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### Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>BoR</td>
<td>Board of Review</td>
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<tr>
<td>CCPC</td>
<td>Canadian controlled private corporation</td>
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<tr>
<td>CFA</td>
<td>Court of Final Appeal</td>
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<tr>
<td>CIR</td>
<td>Commissioner of Inland Revenue</td>
</tr>
<tr>
<td>DIPN</td>
<td>Departmental Interpretation &amp; Practice Note</td>
</tr>
<tr>
<td>EDC</td>
<td>Economic Development Commission</td>
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<tr>
<td>FSDC</td>
<td>Financial Services Development Council</td>
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<tr>
<td>GST</td>
<td>Goods and services tax</td>
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<tr>
<td>HKICPA</td>
<td>Hong Kong Institute of Certified Public Accountants</td>
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<tr>
<td>IPR</td>
<td>Intellectual property right</td>
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<tr>
<td>IRAS</td>
<td>Inland Revenue Authority of Singapore</td>
</tr>
<tr>
<td>IRD</td>
<td>Hong Kong Inland Revenue Department</td>
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<tr>
<td>IRO</td>
<td>Inland Revenue Ordinance</td>
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<tr>
<td>JLCT</td>
<td>Joint Liaison Committee on Taxation</td>
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<tr>
<td>OEIC</td>
<td>Open-ended investment company</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>Research and development</td>
</tr>
<tr>
<td>SDO</td>
<td>Stamp Duty Ordinance</td>
</tr>
<tr>
<td>SEZ</td>
<td>Special economic zone</td>
</tr>
<tr>
<td>SFC</td>
<td>Securities and Futures Commission of Hong Kong</td>
</tr>
<tr>
<td>SFO</td>
<td>Securities and Futures Ordinance</td>
</tr>
<tr>
<td>SFST</td>
<td>Secretary for Financial Services and the Treasury</td>
</tr>
<tr>
<td>SME</td>
<td>Small and medium sized enterprise</td>
</tr>
<tr>
<td>TIHK</td>
<td>Taxation Institute of Hong Kong</td>
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<tr>
<td>TRC</td>
<td>Tax reserve certificate</td>
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Executive Summary

Traditionally, Hong Kong has been regarded as a unique and attractive location for foreign investment due to, among other things, its simple tax system and low tax rate. While some of the distinctive features of Hong Kong (e.g. its proximity to mainland China) may still give it a competitive advantage over the other major economies in Asia, questions have been raised as to whether Hong Kong can maintain its competitive edge in the longer term as various jurisdictions in the region are consciously improving their business environment to compete for foreign investment. An important aspect of the business environment is tax. Therefore, the competitiveness of a jurisdiction’s tax policy and system, as well its tax administration, play a key role in attracting investment.

Against the above background, a study on the competitiveness of the Hong Kong tax system was carried out by the Institute during March to December 2013. The study reviewed Hong Kong’s existing tax system with the objective of identifying ways of enhancing its competitiveness. The study identified three specific areas through which the competitiveness of the Hong Kong tax system can be enhanced:

1. modernising the tax law and tax system to improve certainty, fairness and tax administration;
2. enhancing tax competitiveness; and
3. future direction for tax reform.

As part of the study, a survey was conducted with the business community and tax profession between September and October 2013 through the distribution of a questionnaire. The questionnaire consisted of 24 specific questions on various aspects of Hong Kong’s existing tax system and one open-ended question for the respondents to express their additional views or opinions. From the 8,119 questionnaires distributed, a total of 578 responses were received, representing a response rate of around 7%. Overall, the survey results indicated a clear need for a comprehensive review of Hong Kong’s current tax legislation and tax administration to make them keep pace with the changing business environment and in line with international practices (see page 11). While no clear preference for reducing the corporate tax rate emerged from the survey results, there is strong support for introducing tax incentives for specific industries. As for long-term tax policy, the majority of the respondents took the view that the existing tax base in Hong Kong is too narrow and will need to be broadened in the long run.

**Modernising the tax law and tax system** - Hong Kong’s tax legislation (i.e. IRO) has not undergone a comprehensive review since 1976. Some of the provisions therein are considered to be outdated and incompatible with the modern business environment (e.g. restrictions imposed by section 39E on claiming tax relief for plant or machinery used outside Hong Kong). On the other hand, certain essential provisions (e.g. specific legislation on transfer pricing) are not currently included in the IRO. Apart from the tax law, some of the long established tax administrative practices in Hong Kong are also seen as inefficient (e.g. the case stated procedures) or causing unfairness to taxpayers (e.g. not allowing the purchase of a TRC on a group basis). Thus, there is a need to modernise the current tax law and tax system.

**Enhancing tax competitiveness** - For decades, very limited tax incentives have been provided by Hong Kong to promote the development of specific industries. In contrast, concessionary tax rates, tax holidays, and/or super tax deductions are often used by other countries in the region (e.g. mainland China, Singapore) to promote the development of selected industries or designated areas. In order to support the development of certain industries/activities that present opportunities for the further economic growth of Hong Kong (e.g. the maritime industry, the financial services industry and the intellectual property trading business), the introduction of tax incentives for those industries/activities should be considered. In addition, certain existing provisions of the IRO are not conducive to the development of Hong Kong into a regional intellectual property trading hub and therefore should be modified.

**Future direction for tax reform** - A narrow tax base has long been a notable defect of Hong Kong’s tax system. In the consultation document for the 2014 Policy Address and the 2014/15 Budget published in October 2013, the HKSAR Government pointed out that Hong Kong’s tax base is narrow and government
revenue is sensitive to economic fluctuations resulting from broader economic changes beyond its control. The document further states that the volatility of government revenue poses challenges to the management of public finance. The problem of fiscal volatility is of particular concern given Hong Kong’s aging population. In order to cope with the soaring public expenditure and decelerated economic growth brought about by the aging population in the long run, Hong Kong has to identify new sources of government revenue that are broad based and stable. In this regard, indirect taxes such as a sales tax on luxury goods, green taxes and a GST appear to be the possible options that should be considered for broadening the tax base in Hong Kong in the long run.

On the basis of the survey results and the study carried out by the Institute, the Institute has made 13 recommendations in respect of the three specific areas mentioned above for enhancing the competitiveness of Hong Kong’s tax system. The 13 recommendations are summarised in the table below. For a detailed discussion of the issues identified and the recommendations, please refer to Section 3 (Discussions and Recommendations) of this report.

### Area 1: Modernising the tax law and tax system to improve certainty, fairness and tax administration

#### Improving certainty:

**Recommendation 1.** Shorten (i) the general statutory time bar period for the IRD to issue an assessment / additional assessment from 6 years to 5 years and (ii) the time frame for taxpayers to reopen a prior year assessment from 6 years to 5 years *(see p.15)*

**Recommendation 2.** Accord a statement of loss the same legal status as an assessment, thus subjecting it to the statutory time bar period *(see p.16)*

**Recommendation 3.** Introduce specific and comprehensive transfer pricing legislation in Hong Kong *(see p.17)*

#### Improving fairness:

**Recommendation 4.** Amend section 39E of the IRO to grant depreciation allowance for plant or machinery used outside Hong Kong under an import processing arrangement *(see p.22)*

**Recommendation 5.** Allow (i) carry back of tax losses for 2 years and (ii) group loss relief in the form of transfer of tax losses between group companies *(see p.24)*

#### Improving tax administration:

**Recommendation 6.** Abolish the case stated procedures and allow a direct appeal by taxpayers or the CIR against a BoR decision to the High Court *(see p.25)*

**Recommendation 7.** Carry out a comprehensive review of the current (i) tax assessment process; (ii) interest and penalty regime and (iii) administration of field audit and investigation cases *(see p.28)*

### Area 2: Enhancing tax competitiveness

**Recommendation 8.** (a) Maintain the general corporate tax rate of 16.5% and (b) introduce a 10% corporate tax rate for SMEs that meet all of the following three conditions: (i) annual turnover below HK$20 million; (ii) net assessable profits below HK$2 million; and (iii) not part of a group *(see p.29-31)*

**Recommendation 9.** Introduce tax incentives for (a) the maritime industry (i.e. shipping-related support services); (b) the financial services industry (i.e. (i) aircraft leasing; (ii) the fund industry; and (iii) the local bond market); and (c) the green industry (i.e. waste management / recycling and resources recovery businesses) in the forms of a wider scope of tax exemption for funds, a concessionary tax rate, a tax holiday, a super tax deduction, etc. *(see p.33-38)*
Recommendation 10. Revamp the current tax regime for IPRs to make Hong Kong a more attractive place for the licensing and sublicensing of IPRs, including (a) expanding the current scope of IPR deduction; (b) using the place of use / exploitation to determine the source of IPR licensing income; (c) exempting non-residents from withholding tax in Hong Kong in respect of royalty income received from Hong Kong sublicensing companies in certain circumstances; and (d) granting unilateral tax credit to Hong Kong taxpayers for overseas withholding taxes paid on royalties in a non-treaty context. (see p.39-42)

Recommendation 11. Introduce tax incentives for R&D activities in the forms of (i) a tax credit for R&D expenditure, (ii) a concessionary tax rate on profits when R&D expenditure reaches certain thresholds, (iii) a 150% super tax deduction for R&D expenditure, (iv) a tax holiday for companies providing R&D services, (v) allowing a tax deduction for subcontracted out R&D expenditure under section 16B(1)(b) of the IRO (see p.44)

Recommendation 12. Charge a fixed nominal amount (i.e. HK$5) of stamp duty for the transfer of non-listed Hong Kong shares to create a simpler, more efficient and less costly tax environment for investors to perform share transactions in Hong Kong. (see p.45)

Area 3: Future direction for tax reform

Recommendation 13. Consider the possibility of introducing new type(s) of indirect tax to broaden the tax base in Hong Kong in the long run, such as (i) sales tax on luxury goods, (ii) green taxes, (iii) GST. (see p.47)
1. Introduction

1.1 Background

For years, the Hong Kong economy has benefited from various competitive advantages such as the HKSAR Government’s free trade policy, the rule of law, a simple tax system, world-class business infrastructure, a well-developed talent pool and close economic ties with mainland China. While some of these advantages may still well position Hong Kong as a unique and attractive place for foreign investment, questions have been raised in recent years as to whether Hong Kong will be able to maintain its status as an international financial and business centre in the long run in light of the rapid economic growth and development taking place in other major economies in Asia. Examples of such developments include the launch of the Shanghai pilot free trade zone in China, the development of the Pearl River Delta area, the growth of emerging markets such as Indonesia and Vietnam, and the ongoing efforts of Singapore in improving its business environment. In order to cope with the potential challenges and the increasingly competitive environment, Hong Kong will have to look out for new growth opportunities while consolidating its existing strengths.

Although it is unlikely that taxes will be the sole parameter determining the flow of investment, the tax environment is one of the major considerations for investors when deciding where to invest their capital and locate their operations. According to World Bank Enterprise Surveys jointly conducted by the World Bank and its survey partners since 2002, in the majority of the 135 economies covered by the survey, businesses consider tax rates to be among the top five constraints facing them and tax administration to be among the top 11. The competitiveness of the tax policy and tax system of a jurisdiction therefore plays a key role in attracting investment to that jurisdiction.

1.2 Study on the competitiveness of the Hong Kong tax system

Against the above background, a study was carried out by the Institute during March to December 2013 to review Hong Kong’s existing tax system. The study aimed to identify ways of enhancing the competitiveness of the Hong Kong tax system and provide recommendations to the HKSAR Government on any necessary changes. The study covered three specific areas:

1. modernising the tax law and tax system to improve certainty, fairness and tax administration;
2. enhancing tax competitiveness; and
3. future direction for tax reform.

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2 The last comprehensive review of the Hong Kong tax system was conducted by the Third Inland Revenue Ordinance Review Committee in 1976.
2. **Survey on the Competitiveness of the Hong Kong Tax System**

As part of the study, a survey on the competitiveness of the Hong Kong tax system was conducted between September and October 2013 to solicit views and opinions from the business community and tax profession.

2.1 **Design of the questionnaire**

The six-page questionnaire consisted of 24 survey questions related to the three specific areas identified. The respondents were requested to (i) express their degree of agreement/disagreement to the statement in a question by means of a 1 to 5 scale (1 being strongly agree and 5 being strongly disagree) or (ii) indicate their choice(s) from a list of options provided in a question on a particular tax issue. There was also an open-ended question at the end of the questionnaire for the respondents to provide additional comments or suggestions on the tax system in Hong Kong.

2.2 **Distribution of the questionnaire**

The questionnaire was distributed mainly through the TIHK, business chambers, the Hon Kenneth Leung (who is a member of the Legislative Council representing the Accounting constituency) and other professional bodies. From the 8,119 questionnaires distributed, a total of 578 responses were received, representing a response rate of around 7%.

2.3 **Profile of the respondents**

Diagram 1 below shows the profile of the survey respondents. It reflects that there was a good mix of respondents, with the majority (59%) being in professional practice, 16% working for multinational companies and 11% working in domestic SMEs. In other words, over 85% of the respondents were from the business or professional field.
Diagram 2 shows that the majority of the respondents had substantial work experience: 93% had 5 or more years of work experience, and 77% had over 10 years.

In addition, the majority of the respondents (83%) were required to handle tax-related functions in their daily work.

The good mix of respondents from the business and professional fields with substantial tax-related work experience should add value to their responses, which can be regarded as well thought out and relevant views worthy of consideration.

### 2.4 Overall findings

Diagram 3 on the next page illustrates the survey results on the following five fundamental questions about Hong Kong’s current tax system:

**Question 1:**
Should the current tax law and tax system in Hong Kong, which have not undergone a comprehensive review for more than 30 years, be modernised in light of the modern business environment and regional best practice?

**Question 2:**
Should the current tax objection and appeal procedures in Hong Kong be reviewed to make them more equitable and better serve taxpayers’ needs and expectations?

**Question 3:**
Should tax incentives be introduced in Hong Kong to promote the development of certain specific industries?

**Question 4:**
Should Hong Kong follow the other major economies in Asia in reducing the headline corporate tax rate?

**Question 5:**
Is the tax base in Hong Kong too narrow and does it need to be broadened in the long run?
Diagram 3 – Survey results on the five fundamental questions

Analyses of the survey results on the five fundamental questions are set out below:

1. Modernising the tax law and tax system to improve certainty, fairness and tax administration

- **Q1. Need for tax reform** - 76% of the respondents strongly agreed or agreed that Hong Kong’s current tax law and tax system should be modernised in light of the modern business environment and regional best practices. On the other hand, only 4% of the respondents held the opposite view.

- **Q2. Improving tax administration** - 71% of the respondents strongly agreed or agreed that the current tax objection and appeal procedures in Hong Kong should be reviewed to make them more equitable and better serve taxpayers’ needs and expectations.

2. Enhancing tax competitiveness

- **Q3. Need for tax incentives** - 84% of the respondents strongly agreed or agreed that Hong Kong should introduce tax incentives to promote the development of specific industries.

- **Q4. Reducing the corporate tax rate** – Less than half (i.e. 49%) of the respondents strongly agreed or agreed that Hong Kong should follow in the steps of the other Asian countries and reduce the headline corporate tax rate; 28% of the respondents were neutral on this, and 23% were against a reduction in the tax rate.

3. Future direction for tax reform

- **Q5. Tax base too narrow** - 71% of the respondents strongly agreed or agreed that the tax base in Hong Kong is too narrow and needs to be broadened in the long run.

The above survey results indicate a clear need for a comprehensive review of Hong Kong’s current tax legislation to make it keep pace with the changing business environment and in line with international practices. The existing tax administration system (in particular the tax assessment process, the objection and appeal procedures and the interest and penalty regime) also needs to be revisited to promote greater fairness to taxpayers. While no clear preference on reducing the current corporate tax rate emerged from the survey
results, there is strong support for the HKSAR Government to introduce tax incentives for specific industries. As for the long-term tax policy, the majority of the respondents took the view that the existing tax base in Hong Kong is too narrow and will need to be broadened in the long run.

The finding that most respondents believed that the tax law and tax system in Hong Kong need to be modernised was echoed by the clear preference shown in the feedback from the majority of the respondents (83% strongly agreed or agreed) that a committee comprising of members from the profession and the business sector should be set up to carry out a comprehensive review of Hong Kong’s tax policy and system in order to enhance competitiveness.

![Diagram 4 – Survey results on the need for a comprehensive review of Hong Kong’s tax policy and system](image)

Other findings of the survey, including responses to questions on specific tax issues, are discussed in Section 3 (Discussions and Recommendations) of this report.
3. Discussions and Recommendations

The study identified 13 tax issues (see the table below) in the three specific areas mentioned in the Introduction section. Detailed discussions of these 13 tax issues, together with our recommendations on how to address them, are set out in this section.

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<thead>
<tr>
<th>Area 1: Modernising the tax law and tax system to improve certainty, fairness and tax administration</th>
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</thead>
<tbody>
<tr>
<td>Certainty:</td>
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<tr>
<td>Issue 1. The statutory time bar period</td>
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<td>Issue 2. Status of a statement of loss</td>
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<tr>
<td>Issue 3. The transfer pricing legislation in Hong Kong</td>
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<tr>
<td>Fairness:</td>
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<tr>
<td>Issue 4. Tax relief for plant or machinery used outside Hong Kong</td>
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<tr>
<td>Issue 5. Tax loss relief</td>
</tr>
<tr>
<td>Tax administration:</td>
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<tr>
<td>Issue 6. The case stated procedures</td>
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<tr>
<td>Issue 7. Other tax administration issues</td>
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<table>
<thead>
<tr>
<th>Area 2: Enhancing tax competitiveness</th>
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<tbody>
<tr>
<td>Issue 8. Reduction of corporate tax rate</td>
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<tr>
<td>Issue 9. Tax incentives for specific industries</td>
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<tr>
<td>Issue 10. Promoting Hong Kong as an intellectual property trading hub</td>
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<tr>
<td>Issue 11. Encouraging research and development activities</td>
</tr>
<tr>
<td>Issue 12. Stamp duty on the transfer of non-listed Hong Kong shares</td>
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</table>

<table>
<thead>
<tr>
<th>Area 3: Future direction for tax reform</th>
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<tbody>
<tr>
<td>Issue 13. Broadening the tax base in Hong Kong</td>
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</table>

3.1 Modernising the tax law and tax system to improve certainty, fairness and tax administration

The seven issues identified in respect of improving certainty, fairness and tax administration, together with our recommendations, are discussed below.

3.1.1 The statutory time bar period (Issue 1)

The issue is whether Hong Kong should shorten the time period within which the IRD can raise an assessment or an additional assessment so as to provide greater tax certainty for taxpayers.

Discussion

Under section 60 of the IRO, the IRD can generally issue an assessment or an additional assessment on a taxpayer in respect of a year of assessment within 6 years after the end of the year concerned. However, where the non-assessment or under-assessment is due to fraud or wilful evasion, such assessment or additional assessment can be made within 10 years after the expiration of the year concerned.

Internationally, there is an increasing trend to shorten the time period for the finalisation of tax affairs. The table below sets out the time period for the finalisation of tax affairs in a selection of major developed economies.
<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Statute of limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Generally speaking, corporate tax returns are subject to a limited review period of 4 years from the date of assessment (including in the case where there is no taxable income or tax payable) for the relevant year of income. An unlimited review period applies in the case of fraud or evasion, or to give effect to a decision on a review or appeal, or as a result of an objection made by the company, or pending a review or appeal. The unlimited period of review of an assessment to give effect to a transfer pricing adjustment has recently been changed to a 7-year period of review.</td>
</tr>
<tr>
<td>Canada</td>
<td>A reassessment of the tax payable by a corporation that is not a CCPC may be made within 4 years from the date of the mailing of the original notice of assessment, usually following a detailed field audit of the return and supporting information. The limitation period is 3 years for CCPCs. The 3-year and 4-year limits are extended a further 3 years to permit reassessment of transactions with non-arm's-length non-residents. Generally, reassessments are not permitted beyond these limits unless there has been a misrepresentation or fraud.</td>
</tr>
<tr>
<td>France</td>
<td>The time limit for assessments of corporate income tax expires at the end of the third calendar year following that for which the tax is due. Under certain circumstances (e.g. fraud, undisclosed/hidden activity), the statute of limitations can be extended.</td>
</tr>
<tr>
<td>Germany</td>
<td>The regular period for the statute of limitations is 4 years. The period is extended to 5 years in cases of taxpayer negligence and to 10 years in the event of evasion.</td>
</tr>
<tr>
<td>Ireland</td>
<td>The tax authorities may undertake an audit of a company's tax return within a period of 4 years from the end of the accounting period in which the return is submitted.</td>
</tr>
<tr>
<td>Italy</td>
<td>The tax authorities are entitled to make an assessment in relation to direct taxes up to the end of the fourth calendar year following the year in which the tax return was filed. Under certain circumstances (e.g. no return filed or fraud giving rise to criminal law penalties), the above deadline may be extended.</td>
</tr>
<tr>
<td>Japan</td>
<td>The statute of limitations for requesting a downward correction of prior year tax liabilities is 5 years (6 years for transfer pricing) from when the original tax return was filed. The statute of limitations with regard to upward corrections by the tax authorities is also 5 years (6 years for transfer pricing).</td>
</tr>
<tr>
<td>Korea</td>
<td>The statute of limitations is 5 years from the statutory filing due date of the annual tax return. However, the statute of limitations is extended further to 10 years if a taxpayer evades taxes by fraud or unjustifiable means and to 7 years if a taxpayer does not file its tax base by the statutory due date.</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>The tax authorities may reassess or request more information on a return within the period of 5 years that follows the receipt of the tax return. However, the period may extend to 10 years in the case of incomplete or inexact information, with or without the intention of fraud.</td>
</tr>
<tr>
<td>Malaysia</td>
<td>The statute of limitations is generally 6 years from the end of the year of assessment (proposed to be reduced to 5 years effective from 1 January 2014). But no time limit for cases related to investigation, false declaration, wilful late payment and negligence.</td>
</tr>
<tr>
<td>Jurisdiction</td>
<td>Statute of limitations</td>
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<td>------------------</td>
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</tr>
<tr>
<td>Netherlands</td>
<td>The statute of limitations for making an assessment is 3 years from the end of the fiscal year, extended by the granted extension for filing the tax return. Under certain conditions, the tax administration can impose an additional assessment within 5 years from the year in which the tax debt originated (if the filing due date was extended on request, this period is added). In the case of income from abroad, the period for additional assessment is extended to 12 years.</td>
</tr>
<tr>
<td>New Zealand</td>
<td>Generally, the statute of limitations is 4 years from the end of the New Zealand income tax year (31 March) in which the return is filed unless the return is fraudulent, wilfully misleading or omits income of a particular nature or source.</td>
</tr>
<tr>
<td>Singapore</td>
<td>The statute of limitations is 4 years from the year of assessment (if the year of assessment is 2008 or a subsequent year of assessment) or 6 years (if the year of assessment is 2007 or a preceding year of assessment). It does not apply where there has been fraud or wilful default by the taxpayer.</td>
</tr>
<tr>
<td>Taiwan</td>
<td>The statute of limitations is 5 years from the tax return filing date if the return is filed on time. Where a taxpayer fails to file an annual tax return within the statutory deadline or evades tax by fraud or any other unrighteous means, the statute of limitations is extended to 7 years.</td>
</tr>
<tr>
<td>Thailand</td>
<td>The statute of limitations is 10 years.</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>For companies that are members of medium or large groups, there is generally a period of 1 year after the statutory filing dates for the tax authorities to start an enquiry into any aspect of the return. For other companies, enquiries can be started up to 12 months after the date of actual filing. These periods are extended for returns that are submitted after the filing deadline or amended by the taxpayer or where an issue is subsequently discovered that was not sufficiently disclosed within the standard period.</td>
</tr>
<tr>
<td>United States</td>
<td>The tax authorities generally have 3 years after an original return is filed to assess income taxes. A return will be deemed to have been filed on its due date even if the return is actually filed on an earlier date.</td>
</tr>
</tbody>
</table>

In the survey conducted by the Institute, 74% of the respondents took the view that the time bar provision in Hong Kong should be less than 6 years; out of this 74%, the percentages that considered 3 years, 4 years and 5 years as the appropriate time bar period were respectively 24%, 22% and 28%. 
Recommendation 1:

Having regard to the international trend and the results of the survey conducted by the Institute, we recommend that (i) the general time bar period for the IRD to issue an assessment or an additional assessment under section 60 be shortened from 6 years to 5 years, while maintaining the current 10-year time bar period for fraud or wilful tax evasion cases; and (ii) the time frame for a taxpayer to reopen an assessment on the grounds specified in section 70A of the IRO be correspondingly shortened from 6 years to 5 years.

3.1.2 Status of a statement of loss (Issue 2)

Another related issue is whether a statement of loss should be accorded the same status as an assessment, thereby subjecting such a statement of loss to the same time bar provision as that applicable to an assessment.

Discussion

Where a taxpayer incurs tax losses for a year of assessment, the IRD may issue a statement of loss to the taxpayer for the year concerned. However, unlike a tax assessment, which becomes final and conclusive if not objected to or appealed against within a statutory time frame, the IRD can revise a statement of loss any time after it is issued. The following example illustrates the issues involved with a statement of loss.

Example

The IRD issues a statement of loss indicating that a taxpayer incurred tax losses of HK$100,000,000 some 15 years ago. As a result of the tax losses then so agreed by the IRD, the taxpayer has sufficient tax losses to offset against its assessable profits for the next succeeding 14 years. However, in such case, the IRD can still revise the previously agreed loss figure of HK$100,000,000 to a lower figure in the current year, thus enabling the IRD to raise assessments on the taxpayer for the last 6 years of assessment.

In practice, in order to protect its tax position, the taxpayer in such a situation has to keep its books of record for all 15 years, despite the fact that the law only requires taxpayers to keep books of record for 7 years.
In general, under the current provisions of the IRO, a statement of loss would only become final and conclusive 6 years after the tax losses involved are subsequently fully utilised to offset against the relevant assessable profits of the taxpayer. As a result, when compared with a taxable position, taxpayers could face a much longer period of uncertainty and record keeping as regards their tax position when they incur tax losses.

Our survey results show that 73% of the respondents agreed that a statement of loss, like an assessment, should also be subject to the statutory time bar provision.

<table>
<thead>
<tr>
<th>Strongly agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>14%</td>
<td>30%</td>
<td>10%</td>
<td>3%</td>
<td>43%</td>
</tr>
</tbody>
</table>

**Diagram 6 - Survey results on subjecting a statement of loss to the statutory limitation period**

**Recommendation 2:**

We recommend amending the provision of the IRO such that a statement of loss is accorded the same legal status as an assessment.

**3.1.3 The transfer pricing legislation in Hong Kong (Issue 3)**

Absence of a comprehensive transfer pricing regime in Hong Kong has cast doubts on the statutory basis for the IRD to deal with transfer pricing issues in certain circumstances. The issue is whether Hong Kong should introduce specific and comprehensive legislation on transfer pricing.

**Discussion**

With the ever increasing cross-border transactions and the expansion of Hong Kong’s tax treaty network, transfer pricing has become one of the major concerns of taxpayers and foreign investors.

Although DIPN 46 issued by the IRD has set out the provisions in the IRO and case laws that are, in the IRD’s view, relevant to transfer pricing, we consider that the following deficiencies exist in the current transfer pricing regime in Hong Kong:

- DIPN 46 states that sections 16(1) and 17(1)(b) of the IRO provide the statutory basis for disallowing payments made to an associated enterprise that are not on an arm’s length basis. However, the CFA indicated in its July 2009 judgment in the *Ngai Lik* case\(^3\) that sections 16(1) and 17(1)(b) do not require the

\(^3\) *Ngai Lik Electronics Company Limited v CIR [2009]* 8 HKTC 87.
CIR to compare the costs incurred by a taxpayer against the market prices and to disallow deductions that are considered excessive.

- Section 20 of the IRO can be viewed as a transfer pricing provision, but it only applies to transactions with non-residents.
- DIPN 46 also states that section 61A of the IRO can be invoked in abusive profit shifting transactions. However, section 61A is a general anti-avoidance provision and can only be applied where the sole or dominant purpose of a transaction is to obtain a tax benefit. The IRD therefore cannot rely on section 61A in making a transfer pricing adjustment in cases where tax avoidance is not the sole or dominant purpose.
- There is currently no provision (except section 61A) in the IRO that provides a legal basis for the IRD to make an upward transfer pricing adjustment on the profits of a Hong Kong taxpayer.
- Finally, the IRO does not currently provide any mechanism for a corresponding adjustment in the case where a primary adjustment is made to the transfer pricing of a domestic-to-domestic transaction between two Hong Kong group companies. For example, in the case where a primary adjustment is made by the IRD to reduce a payment made by a Hong Kong payer, there is no mechanism in the IRO to correspondingly reduce the amount received by the Hong Kong recipient. This possibly results in double taxation of the adjusted amount and causes undue hardship to taxpayers. The IRD indicated in the 2012 annual meeting with the HKICPA that it would give more thought to other possible ways of relieving the hardship suffered by taxpayers as a result of a lack of corresponding adjustment. However, no developments in this area have taken place so far.
- Although DIPN 46 does state the IRD’s views and practices with respect to transfer pricing, it is not law and is not legally binding on either the IRD or taxpayers.

Internationally, many major economies in the Asia Pacific region and other parts of the world have enacted specific transfer pricing legislation to deal with transfer pricing related issues: examples include Australia, Canada, Malaysia, Netherlands, Taiwan, the United Kingdom, the United States and Vietnam.

**Recommendation 3:**

To address the above deficiencies, we recommend that a review of the existing transfer pricing regime be performed and specific and comprehensive transfer pricing legislation be introduced in Hong Kong.

### 3.1.4 Tax relief for plant or machinery used outside Hong Kong (Issue 4)

In recent years, the IRD has interpreted sections 16G and 39E of the IRO such that costs incurred for the acquisition of plant or machinery used by a Hong Kong taxpayer outside Hong Kong under certain contract manufacturing arrangements would not qualify for any tax relief in Hong Kong.

The issue is whether the relevant tax law or practice in Hong Kong denying such tax relief should be amended, thus enhancing Hong Kong’s tax competitiveness.

**Discussion**

**Background**

For Hong Kong taxpayers who arrange for their goods to be manufactured in mainland China, there are generally two types of manufacturing arrangements: (i) a contract processing arrangement and (ii) an import processing arrangement.
Under a typical contract processing arrangement, the Hong Kong taxpayer would consign its raw materials to a processing factory entity in mainland China. In addition to paying processing fees, the Hong Kong taxpayer would also offer the factory in mainland China technical know-how, supervision of the manufacturing process and use of plant or machinery provided at no consideration. The factory in mainland China would then process the raw materials into finished goods specified by the Hong Kong taxpayer. The finished goods would be exported out of mainland China to the Hong Kong taxpayer.

In this type of situation, the IRD would generally regard the Hong Kong taxpayer as a manufacturer and 50% of its profits as being derived from its manufacturing activities in the factory in mainland China. As such, under Hong Kong’s source-based tax regime, only 50% of the profits made by the Hong Kong taxpayer from the sales of the goods so manufactured are chargeable to profits tax in Hong Kong.

Furthermore, the IRD takes the view that the provision of plant or machinery by the Hong Kong taxpayer to the factory in mainland China constitutes a “lease” arrangement. As such, because the plant or machinery is principally or wholly used outside Hong Kong by a person other than the Hong Kong taxpayer under a lease arrangement, the IRD could apply section 39E(1)(b) of the IRO to deny the Hong Kong taxpayer’s claim for tax depreciation allowances in respect of the plant or machinery. However, as a concession, the IRD would grant the Hong Kong taxpayer 50% of the tax depreciation allowances in respect of the plant or machinery they provided to the factory in mainland China.

For contract processing arrangements, the outcome of the above tax treatment is that the Hong Kong taxpayer would get tax relief for costs incurred on the plant or machinery commensurate with the extent to which such assets are used to generate profits which are chargeable to tax in Hong Kong.

Under a typical import processing arrangement, the Hong Kong taxpayer would place orders to a manufacturing factory entity in mainland China requiring the latter to manufacture certain goods. Furthermore, in order to enable the factory in mainland China to manufacture goods to their specification, the Hong Kong taxpayer would often need to provide certain plant or machinery, in particular moulds, to the factory in mainland China on a rent-free basis.

Typically, raw materials for the manufacture of the goods ordered are sold by the Hong Kong taxpayer to the factory in mainland China, which sells back the finished goods so manufactured to the Hong Kong taxpayer. Similar to its stance on contract processing arrangements, the IRD takes the view that the provision of plant or machinery by the Hong Kong taxpayer to the factory in mainland China constitutes a “lease” arrangement. But in contrast to the concession granted to a contract processing arrangement in this regard, the IRD would strictly apply section 39E(1)(b) of the IRO to deny the Hong Kong taxpayer’s claim for tax depreciation allowances in respect of the plant or machinery. Furthermore, as a result of the IRD taking the view that the relevant plant or machinery is under a lease arrangement, the IRD would likewise deny any claim by the Hong Kong taxpayer for a tax deduction under section 16G of the IRO.

For import processing arrangements, the outcome of the IRD interpreting sections 39E and 16G in this way is that the Hong Kong taxpayer would not be entitled to any tax relief for costs incurred for the plant or machinery provided to the manufacturing factory entity in mainland China. This is the case despite the fact that the profits of the Hong Kong taxpayer from the trading of goods so manufactured are generally fully chargeable to tax in Hong Kong.

The HKSAR Government rejects calls from professionals and legislators to amend the relevant laws

In response to complaints made by the industry that the IRD’s tax treatment above is unfair to taxpayers engaged in import processing arrangements, the Panel on Financial Affairs of the Legislative Council held a special meeting on 14 December 2009.

The main complaints made were that section 39E is only enacted as an anti-avoidance provision targeting certain sale-and-lease back and leveraged leasing arrangements but not import processing arrangements,
which are commercially driven and do not have any of the anti-avoidance elements targeted by the legislative provision of section 39E. As such, even if import processing arrangements fall within the literal meaning of the provision, they are only caught unintentionally; thus, section 39E should be amended accordingly.

The Panel invited all relevant stakeholders to make submissions or attend the meeting to express their views and concerns on the issue. At the end of the meeting, the Panel passed a non-binding motion urging the Government “to activate immediately the relevant mechanism for legislative revision to review and amend section 39E according to actual circumstances, in order to modernise the provision and avoid impacting on blameless enterprise”.

In response to the calls for a legislative review made by the Panel and subsequently by many other stakeholders, in March 2010, the SFST asked the JLCT to advise him on how section 39E could be amended in order to allow Hong Kong taxpayers to claim tax depreciation allowances in respect of plant or machinery used outside Hong Kong under import processing arrangements.

In June 2010, the JLCT made its submission to the SFST proposing to amend the definition of the term “lease” as defined in the IRO. Under the proposed amendment, the definition of the term “lease” would exclude instances where a Hong Kong taxpayer provides plant or machinery on a rent-free basis to its subcontractor outside Hong Kong so as to enable the subcontractor to manufacture goods ordered by the taxpayer. The reason for the JLCT making this proposal was that the IRD’s application of section 39E to deny claims by taxpayers for tax depreciation allowances hinges on the view that the relevant plant or machinery used outside Hong Kong under import processing arrangements constitutes a lease term. Therefore, once such arrangements were excluded from the definition of the term “lease”, section 39E would have no such application.

However, in November 2010, the SFST stated that his Bureau had completed the legislative review of section 39E (including seeking the views of tax experts such as the JLCT) and after due consideration had concluded that there was no justifiable grounds for relaxing the existing restrictions of section 39E. The reason cited by the SFST for his Bureau’s conclusion was that it had formed the view that the JLCT’s proposal was against the “territorial source principle”, the “tax symmetry principle” and the “transfer pricing principle”.

Tax experts reject the technical arguments used by the HKSAR Government to refuse to amend the law

It appears that the Bureau (and, under it, the IRD) was the only stakeholder who was against amending section 39E so as to grant tax depreciation allowances to taxpayers engaged in import processing arrangements; all of the other stakeholders, including tax experts, supported the move to appropriately amend the relevant legislative provision.

The reasons cited by the SFST for refusing to amend section 39E were all technical in nature, generally only being understood by tax experts, not by lay persons. In this regard, it should be noted that the JLCT, comprising many tax experts in Hong Kong, has strongly rejected the technical reasons given by the SFST for refusing to amend section 39E. The JLCT’s stance in this regard is reflected in its subsequent submission made to a Bills Committee of the Legislative Council in 2011 opposing the enactment of section 16EC(4)(b) of the IRO.

The wording of section 16EC(4)(b) mirrored that of section 39E(1)(b), and the section 16EC(4)(b) legislation was then justified by the Government on the basis of the same three principles mentioned above and used by the SFST to refuse to amend section 39E. As such, the reasons for the JLCT opposing the section 16EC(4)(b) legislation also reflected the JLCT’s rejection of the reasons put forward by the SFST for refusing to amend section 39E.

4 The JLCT’s submission opposing the section 16EC(4)(b) legislation can be accessed via the following link: http://www.legco.gov.hk/yr10-11/english/bc/bc04/papers/bc040707cb1-2687-e.pdf
In short, the territorial source and tax symmetry arguments of the SFST involved the issue of whether the relevant plant or machinery is only used in the production of the profits of the manufacturing factory entity in mainland China which are not chargeable to tax in Hong Kong or in the production of the profits of the taxpayer in Hong Kong which are fully chargeable to tax in Hong Kong: If the former, then logically no tax depreciation allowances should be granted to the taxpayer in Hong Kong; if the latter is the case, tax depreciation allowances should be granted.

Given that the relevant plant or machinery is provided rent-free by the Hong Kong taxpayer to the factory in mainland China in order to enable the factory in mainland China to manufacture goods to the specification required by the Hong Kong taxpayer, there is clearly a case that the plant or machinery is used by the Hong Kong taxpayer to generate its own profits which are chargeable to tax in Hong Kong.

As regards the transfer pricing argument, it is indeed quite convoluted. The SFST argued that instead of providing the relevant plant or machinery rent-free, the Hong Kong taxpayer should charge the factory in mainland China an arm’s-length rental for the provision of the same. Furthermore, the SFST argued that since any rental income so charged would be offshore income not chargeable to tax in Hong Kong, the Hong Kong taxpayer should not be entitled to any tax depreciation allowances in respect of the relevant plant or machinery. However, given that any “notional rent” charged by the Hong Kong taxpayer to the factory in mainland China could be said to be closely tied to the taxpayer’s trading of goods so manufactured in mainland China, such notional rental could be treated as part of the trading operations of the taxpayer in Hong Kong. This would render the notional rental taxable onshore income in Hong Kong and thus avoid the quagmire of the territorial source and tax symmetry principles espoused by the SFST.

In fact, treating any notional rental as part of the Hong Kong sourced operational income of the Hong Kong taxpayer would also facilitate the taxpayer’s claim for a tax credit in Hong Kong in case such notional rental is also charged to tax in mainland China.

Under the transfer pricing argument, the SFST further hinted that if Hong Kong does not adhere to the principle of transfer pricing, the tax authorities of mainland China could accuse Hong Kong of undermining their taxing right in terms of levying withholding tax on the Hong Kong taxpayer in respect of rental which should have been charged to the factory in mainland China.

In this regard, one should bear in mind that the issue of whether to grant tax depreciation allowances to the Hong Kong taxpayer is primarily a matter of how Hong Kong interprets and administers its own domestic tax laws, a matter within the prerogative of Hong Kong.

Regardless of the correctness of the so-called transfer pricing principle in question, which has been disputed by many, including the JLCT, Hong Kong can as a matter of tax policy enact, interpret and administer its own tax laws in a way that offers tax relief for costs incurred by its taxpayers at its own revenue cost. This would not undermine the taxing right of the tax authorities of mainland China in any way because the decision as to whether to charge the factory in mainland China rental for the provision of plant or machinery is a commercial one, unaffected by whether the taxpayer is granted tax depreciation allowances in Hong Kong in respect of the same or not.
**Hong Kong versus Singapore**

The prerogative of a jurisdiction to grant tax relief to its taxpayers according to its own tax or other policy initiatives can be seen in what Singapore has done in respect of manufacturing activities outsourced to places outside Singapore.

The following is a comparison, between Hong Kong and Singapore, of taxpayers’ entitlement to tax relief in respect of costs incurred for a rent-free provision of plant or machinery to their contract manufacturers (import processing type) located outside the taxpayers’ jurisdiction.

<table>
<thead>
<tr>
<th>Costs incurred on plant or machinery</th>
<th>Hong Kong</th>
<th>Singapore</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal tax depreciation allowances</td>
<td>No</td>
<td>Yes</td>
<td>Since July 2011, following the decision in ATG v CIT, the IRAS has accepted that costs for plant or machinery provided rent-free by a Singapore taxpayer to its subcontractors located outside of Singapore are incurred by the Singapore taxpayer as part of the trade or business carried out in Singapore by the Singapore taxpayer. As such, the IRAS has granted Singapore taxpayers normal depreciation allowances in respect of the relevant plant or machinery used in such outsourced manufacturing operations under the tax laws in Singapore.</td>
</tr>
<tr>
<td>Other special incentives</td>
<td>No</td>
<td>Yes</td>
<td>To encourage Singapore taxpayers to globalise and venture overseas, the Singapore government has rolled out an Integrated Investment Allowance scheme (IIA scheme) which will run for 5 years commencing from the year of assessment 2013. Administered by the Economic Development Board of Singapore, the IIA scheme grants an additional allowance, on top of the normal tax depreciation allowances, for capital spending on productive equipment placed overseas on approved projects.</td>
</tr>
</tbody>
</table>

In the survey conducted by the Institute, 76% of the respondents agreed that costs incurred for the provision of plant or machinery in a manufacturing process outside Hong Kong should under all circumstances be tax deductible provided that profits from the sales of goods so manufactured are chargeable to tax in Hong Kong.
Recommendation 4:
In order to be equitable to taxpayers regardless of whether they engage in contract processing or import processing arrangements and enhance Hong Kong’s tax competitiveness so as to minimise the risk of businesses relocating to a more tax competitive regime such as Singapore, we recommend that Hong Kong amend section 39E of the IRO so as to grant tax depreciation allowances to taxpayers for costs incurred for the provision of plant or machinery under import processing arrangements.

3.1.5 Tax loss relief (Issue 5)
The issue is whether Hong Kong should allow (i) carry back of tax losses and (ii) group loss relief so as to enhance the competitiveness of the its tax regime.

Discussion
Under the current provisions of the IRO, a corporation can generally carry forward the tax losses it suffers in a year of assessment indefinitely to offset against its assessable profits in subsequent years. The tax losses cannot however be carried back to offset against the assessable profits made by the corporation in previous years, nor can the tax losses be transferred to offset against the assessable profits made by other group companies (commonly known as group loss relief).

The case for allowing the carry back of tax losses is one based on fairness and equity, because the inability of a corporation to carry back the tax losses it suffers in a year of assessment to offset against the assessable profits it made in previous years could result in that corporation effectively paying taxes on profits which, overall, it has not made. This would happen when a corporation had paid taxes on assessable profits it made in earlier years and then suffered tax losses in subsequent years before it ceased its business; such a corporation could have sustained overall losses during the whole lifetime of its business.

The case for allowing group loss relief is based on the view that a corporate group is essentially an economic entity and individual corporate entities within such group are more akin to divisions within a single company.

To address the above issues, the tax regimes of many advanced economies allow the carry back of tax losses and various forms of group loss relief; the table below provides some examples.
<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Tax loss carry-back</th>
<th>Mechanism for group loss relief ¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>2 years</td>
<td>Yes</td>
</tr>
<tr>
<td>Canada</td>
<td>3 years</td>
<td>Not available</td>
</tr>
<tr>
<td>France</td>
<td>1 year</td>
<td>Yes</td>
</tr>
<tr>
<td>Germany</td>
<td>1 year</td>
<td>Yes</td>
</tr>
<tr>
<td>Ireland</td>
<td>1 year</td>
<td>Yes</td>
</tr>
<tr>
<td>Italy</td>
<td>Not available</td>
<td>Yes</td>
</tr>
<tr>
<td>Japan</td>
<td>1 year</td>
<td>Yes</td>
</tr>
<tr>
<td>Korea</td>
<td>1 year</td>
<td>Yes</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Not available</td>
<td>Yes</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Not available</td>
<td>Yes</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1 year</td>
<td>Yes</td>
</tr>
<tr>
<td>New Zealand</td>
<td>Not available</td>
<td>Yes</td>
</tr>
<tr>
<td>Singapore</td>
<td>1 year</td>
<td>Yes</td>
</tr>
<tr>
<td>Taiwan</td>
<td>Not available</td>
<td>Yes</td>
</tr>
<tr>
<td>Thailand</td>
<td>Not available</td>
<td>Yes</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1 year</td>
<td>Yes</td>
</tr>
<tr>
<td>United States</td>
<td>2 years</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**Note:**

¹ Generally, there are two major mechanisms for group loss relief, namely (i) group consolidation regime and (ii) group loss transfer regime. A group consolidation regime treats the group companies as one single company, whereby the taxable income and loss of member entities are considered together to determine the tax position of the group. Very often, a separate set of legal and administrative measures have to be in place to facilitate tax filings on a group basis. As regards the group loss transfer regime, each corporate entity within a group would still be treated as an individual entity for tax purposes. The entity with utilisable tax losses can opt to transfer its losses to offset against the taxable profits of another group entity. Compared with the group consolidation regime, which may require complex legislative amendments, a minor modification to the existing tax law by setting out the criteria for qualifying as “group entities” (by percentage of direct or indirect ownership) would suffice to implement the group loss transfer regime.

In the survey conducted by the Institute, 63% of the respondents supported the carry back of tax losses and 57% supported the introduction of group relief for tax losses.
**Recommendation 5:**

To maintain Hong Kong’s simple taxation system and having regard to the international norm and practice, we recommend that (i) carry back of tax losses be allowed for 2 years and (ii) group loss relief be introduced in the form of the transfer of tax losses between group companies.

For the purposes of the transfer of tax losses between group companies, we recommend that, similar to the current association threshold required to be eligible for stamp duty group relief under section 45 of the Stamp Duty Ordinance, the companies involved must be 90% or more associated with each other. We consider this high threshold level would justify such corporate groups being regarded as economic entities for tax purposes.
3.1.6 The case stated procedures (Issue 6)

The issue is whether the current practice of requiring the BoR to state a case for the opinion of the High Court should be replaced by a system whereby a taxpayer or the CIR may directly appeal against a decision of the BoR to the High Court on a question of law.

Discussion

Under the current practice, the taxpayer or the CIR may, if dissatisfied with a decision of the BoR, require the BoR to state a case for the opinion of the Court of First Instance on a question of law. This practice was adopted from the UK, where it has been in operation for over 100 years. It is an antiquated and inefficient practice and causes considerable delay in bringing cases to court. Very often, it takes a considerable amount of time for the BoR to draft a case and set out its findings, the reasons for its decision and the question of law. As a result, it usually takes many months for the BoR to state a case and for the case to be put to the court.

Apart from doing away with the time-consuming and costly process for stating a case, another advantage of the proposed direct appeal mechanism is that the court would have more freedom in hearing an appeal as it would no longer be confined by the case stated by the BoR.

In the survey conducted by the Institute, 71% of the respondents strongly agreed or agreed that the current tax objection and appeal procedures in Hong Kong should be reviewed to make them more equitable and better serve taxpayers’ needs and expectations.

Recommendation 6:

We recommend that the current practice of requiring the BoR to state a case be abolished and replaced by a procedure whereby a taxpayer or the CIR may directly appeal to the Court of First Instance on a question of law.
3.1.7 Other tax administration issues (Issue 7)

The study also identified a number of other issues relating to the administration of the tax system that have caused unfairness to taxpayers.

Discussion

Issue of tax assessments

Under the current provisions of the IRO, an assessor is granted the general power to issue an assessment or additional assessment to a taxpayer if it appears to the assessor that the taxpayer is liable to tax.

In cases involving the issuing of (i) an estimated assessment in the absence of a tax return and computation filed by a taxpayer or (ii) an assessment that differs from the tax return and computation filed by a taxpayer, the assessor does not generally provide detailed information to the taxpayer as to the reason for issuing the assessment and/or the basis of computing the assessable profits stated in the assessment.

The situation is particularly acute in field audit or investigation cases where the assessors often raise estimated assessments at or around the end of the statutory time bar period of the years of assessment concerned. In some instances, the assessments are estimated without reasonable basis or are simply wide guesses, as evidenced by the great discrepancies between the revised assessable profits in the eventual settlement and the estimated assessable profits in the assessments originally issued.

The above has caused significant unfairness to taxpayers as they do not know how to contest the assessments which are not explained to them.

A preliminary report “Towards Greater Fairness in Taxation - A Model Taxpayer Charter” was published in May 2013. The Model Taxpayer Charter seeks to lay out taxpayers’ rights and responsibilities in, broadly speaking, 20 different areas. Article 7 of the Model Taxpayer Charter deals with the assessment process and states, among other things, that (i) an assessment shall show the computation of the tax and the basis on which it is levied in sufficient details to enable the taxpayer to reproduce the computation in order to verify its accuracy and (ii) where the tax calculation of the tax authority differs from that of the taxpayer, the tax authority must provide sufficient details, as well as the basis in law for the difference, so that the taxpayer can readily understand the computation by the tax authority and the reason for the difference.

In the survey conducted by the Institute, 85% of the respondents strongly agreed or agreed that the tax authority should explain the reason and basis for issuing an estimated tax assessment.

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5 The Model Taxpayer Charter was jointly developed by the Asia Oceania Tax Consultants’ Association, the Confédération Fiscale Européenne and the Society of Trust and Estate Practitioners and was based on a survey of taxpayer rights and responsibilities in 37 countries. It can be accessed via the following link: http://www.cfe-eutax.org/node/3134.
The interest and penalty regime

Below are some examples to illustrate the deficiencies in the current interest and penalty regime:

- The existing provisions of the IRO do not provide for the charging of interest on additional taxes that become payable upon settlement of a field audit or investigation case. Under the current practice, taxpayers in a field audit or investigation case are often regarded by the IRD as having committed the civil offence of filing an incorrect tax return without reasonable excuse under section 80 of the IRO and are therefore subject to penalties upon settlement of the case, even though the case may involve purely disputes over technical issues. In the absence of a statutory right to charge interest under the IRO, the penalty imposed in effect serves as a substitute for the interest that would have otherwise been charged. We consider this practice (i.e. imposing a penalty as a substitution for interest) inequitable and unsatisfactory to taxpayers since if only technical adjustments are involved in a case, the taxpayer should only be required to pay interest on the outstanding tax amount and should not be regarded as having committed an offence and thus subject to a penalty.

- The above issue is particularly problematic in the situation where a field audit or investigation case is not settled until after 6 years from the end of the year of assessment concerned. In such a situation, due to the 6-year time bar provision in section 80(3) of the IRO, penal action in the form of civil prosecution (or a charge compounding the civil offence) under section 80 cannot be taken by the IRD. The IRD will therefore need to take penal action in the form of (i) criminal prosecution (i.e. the taxpayer will be regarded as having committed the criminal offence of evading tax wilfully with intent) under section 82 or (ii) imposing additional tax under section 82A. Neither (i) nor (ii) is equitable to taxpayers as in (i), they will be regarded as having committed a criminal offence, and in (ii), there will often be a significant delay in the settlement of the case due to the prolonged process that needs to be completed to close the case when section 82A is invoked.

- If tax has been held over unconditionally by the IRD upon objection and when the case is subsequently settled, the taxpayer is found to be liable to pay the tax being previously held over, the taxpayer is liable to pay interest on the tax payable at the court judgment rate (which exceeds 8% per annum) instead of the prevailing market interest rate. On the other hand, there is no provision in the IRO that provides for the payment of interest by the IRD to taxpayers upon refund of tax overpaid when the taxpayer’s objection is allowed by the IRD or the taxpayer’s appeal to the BoR or the court is allowed.
**Purchase of a TRC on a group basis**

- Under the current provisions of the IRO, a TRC purchased by a company can only be used to settle the tax liability of that particular company and not the tax liability of the other companies within the same group as the company purchasing the TRC. This inflexibility has caused uncertainty and inequity to taxpayers. For example, in the case of a group tax audit, if the final outcome of the audit is that a group company whose tax has previously been held over (instead of the group company that has purchased a TRC) is subject to a tax adjustment and therefore needs to pay the tax in dispute, the current practice of the IRD is to repay the principal value of the TRC to the group company that has purchased the TRC with interest at a very minimal rate (i.e. around 0.04%) and to request the group company with tax adjustment to pay the tax in dispute together with interest at the judgment debt rate (i.e. around 8%). In the United Kingdom, a company may use its tax deposits to settle the tax liabilities of its holding company, subsidiaries or fellow subsidiaries.

**Recommendation 7:**

On the basis of the above, we recommend that a comprehensive review be carried out and necessary changes made to the current (i) tax assessment process; interest and penalty regime; and (iii) administration of field audit and investigation cases. In particular, the following proposed measures should be considered with the aim of promoting greater fairness to taxpayers and aligning the local tax administration with international practices:

- Sufficient particulars of the reason for issuing an assessment and the basis of tax computation should be provided in the assessments issued to taxpayers
- Separate interest and penal provisions should be introduced into the IRO
- Taxpayers should only be required to pay interest at prevailing market rate if tax previously held over becomes payable
- Interest at prevailing market rate should be payable by the IRD to taxpayers on taxes overpaid upon settlement of an objection or appeal case
- Taxpayers should be allowed to purchase TRC on a group basis.

### 3.2 Enhancing tax competitiveness

The five issues related to enhancing tax competitiveness, together with our recommendations, are discussed below.

#### 3.2.1 Reduction in corporate tax rate (Issue 8)

The issue is whether Hong Kong should (i) reduce its headline corporation tax rate (currently 16.5%) for all corporations and (ii) introduce a lower corporate tax rate for SMEs.

##### 3.2.1.1 Reducing the corporate tax rate for all corporations

**Discussion**

Hong Kong’s corporate tax rate has remained unchanged at 16.5% since the year of assessment 2007/08. Some countries in the Asia region, however, have continued to lower their effective corporate tax rates in recent years by reducing the headline tax rate or introducing preferential tax rates for selected industries or in SEZs. The table below highlights the reductions in the corporate tax rate in some Asian countries in recent years.
## Study on the Competitiveness of the Hong Kong Tax System

### China
- 33% (2007)
  - Certain SEZs can enjoy a tax holiday for a few tax years and a reduced tax rate thereafter
  - Special rates apply to small-scale enterprises (20%) and enterprises with new high technology status (15%)

### Malaysia
- 27% (2007)
- 26% (2008)
- 25% (2009)
  - Companies with paid-up capital of not more than RM2.5 million – the first RM500,000 of income is charged at 20%

### Singapore
- 20% (2007)
- 18% (2008)
- 17% (2009)
  - 2007: 75% of the first SG$10,000 and 50% of the next SG$90,000 of income are exempt
  - 2008 and after: 75% of the first SG$10,000 and 50% of the next SG$290,000 of income are exempt

### Thailand
- 25% (2007)
- 23% (2008)
- 20% (2009)

This has led to considerable debate on whether Hong Kong’s competitive advantage of a low tax rate is being eroded and whether Hong Kong should follow suit and reduce its corporate tax rate.

According to information released by the HKSAR Government, in the year of assessment 2011/12, only 94,900 out of 864,000 (i.e. 11%) registered corporations paid profits tax, with around 64% of profits tax for the year being contributed by the top 800 taxpaying corporations. This reflects the fact that the majority (89%) of registered corporations in Hong Kong are already not paying any profits tax. It is also worth noting that the reduction in corporate tax rate in some of the above-mentioned countries (e.g. Singapore and Thailand) was accompanied by an increase in the indirect tax rate to compensate for the loss of government revenue as a result of reducing the corporate tax rate. As Hong Kong does not currently impose any major forms of indirect tax, it may not have the same flexibility in reducing the corporate tax rate as those countries.

In the survey conducted by the Institute, less than half (i.e. 49%) of the respondents supported a reduction in the corporate tax rate, 28% were neutral on whether Hong Kong should follow the other major economies in Asia and reduce its corporate tax rate, and 23% were against it.

### Diagram 12 – Survey results on reducing the corporate tax rate in Hong Kong

- Strongly agree: 4%
- Agree: 17%
- Neutral: 32%
- Disagree: 28%
- Strongly disagree: 19%

### Recommendation 8(a):

On the basis of the above, we recommend that the corporate tax rate be maintained at 16.5% in general.

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3.2.1.2 Introducing a lower corporate tax rate for SMEs

SMEs are the backbone of the Hong Kong economy. As of June 2013, there were about 300,000 SMEs in Hong Kong, accounting for over 98% of the total business units and about 47% of total employment (excluding civil service) and providing job opportunities for over 1.2 million people\(^7\). As the SMEs in Hong Kong play a vital role in contributing to the development of the local economy and thus to the livelihood of the Hong Kong people, we believe the HKSAR Government should lend more support to them to help ease their financial burden and maintain their competitiveness.

In the survey conducted by the Institute, 70% of the respondents strongly agreed or agreed that Hong Kong should introduce a lower corporate tax rate for SMEs. Moreover, on the question of what reduced tax rate for SMEs should be introduced, most respondents (i.e. 36%) thought that the rate should be set at 10% and 29% thought it should be set at 12%.

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\(^7\) Source: Website of the Support and Consultation Centre for SMEs (updated as of 6 November 2013): http://www.success.tid.gov.hk/english/lin_sup_org/gov_dep/service_detail_6863.html
Recommendation 8(b):

We recommend that a two-tiered profits tax rate structure be introduced, with a reduced rate of 10% for companies that meet all of the following conditions: (i) annual turnover below HK$20 million; (ii) net assessable profits below HK$2 million; and (iii) not part of a group.

3.2.2 Tax incentives for specific industries (Issue 9)

The issue is whether Hong Kong should introduce tax incentives to promote the development of certain specific industries.

Although Hong Kong’s statutory corporate tax rate (currently at 16.5%) is among the lowest in Asia, many countries in the Asia region are lowering their statutory corporate tax rate (e.g. Korea, Malaysia, Thailand and Vietnam) and/or providing tax incentives that substantially reduce the effective tax rates for selected industries/sectors (e.g. China and Singapore). The EDC was established by the Chief Executive in January 2013. The EDC’s terms of reference are “to provide visionary direction and advice to the HKSAR Government on the overall strategy and policy to broaden Hong Kong’s economic base and to enhance Hong Kong’s economic growth and development; and in particular, to explore and identify growth sectors or clusters of sectors which present opportunities for Hong Kong’s further economic growth, and recommend possible policy and other support for these industries”. Four working groups have since been formed under the EDC to study specific industries in an in-depth manner and explore measures for their development.

In the survey conducted by the Institute, the majority (84%) of the respondents strongly agreed or agreed that Hong Kong should introduce tax incentives to promote the development of certain specific industries.

As such, we believe it is now the appropriate time to introduce tax incentives for the specific industries identified as having potential for growth in order to promote the development of such industries. The study identified three industries as areas for growth where special tax incentives are warranted: (i) the maritime industry, (ii) the financial services industry and (iii) the green industry.
3.2.2.1 The maritime industry

Discussion

The Central People’s Government has indicated its support for Hong Kong to reinforce and enhance its status as an international shipping centre in the National 12th Five-Year Plan. In the 2013 Policy Address announced in January 2013, the Chief Executive also mentioned that the HKSAR Government will develop the international maritime services in Hong Kong and reinforce and enhance Hong Kong’s role as a regional hub for passenger and cargo traffic. To achieve this, the development of affiliated maritime services, such as ship management, shipping agency and ship finance, in Hong Kong is equally important. Furthermore, in the 2013/14 Hong Kong Budget delivered in February 2013, the Financial Secretary identified the modern logistics services as one of the areas for economic development. In this regard, developing the maritime industry in Hong Kong will have an important role to play in promoting Hong Kong as a logistics hub. The EDC has also set up a working group on transportation which covers both maritime and air transport.

On the basis of the above, we believe that the maritime industry is one of the key industries where tax incentives should be provided to support its development.

The tax incentives available for shipping businesses under Hong Kong’s current profits tax regime are mainly restricted to income derived from the operation or leasing of ships. Such tax incentives include the following:

(i) Hong Kong-registered vessels uploading goods or passengers in Hong Kong and heading to international waters are exempt from Hong Kong profits tax on the relevant shipping income.

(ii) Ship charter hire income will generally be exempt from Hong Kong profits tax except in limited circumstances (e.g. the ships are navigating solely within Hong Kong waters).

(iii) For a taxpayer residing in any jurisdiction outside Hong Kong but carrying on a shipping business in Hong Kong, its shipping income will be tax exempt in Hong Kong if there is reciprocal tax treatment in that jurisdiction for a Hong Kong resident taxpayer.

In contrast, Singapore offers tax incentives to ship operators/charterers as well as to numerous shipping-related businesses under the Maritime Sector Incentive Scheme. Such tax incentives include the following:

<table>
<thead>
<tr>
<th>Tax incentive for ship operators/charterers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Tax exemption for qualifying income derived from the operation/chartering of Singapore-flagged ships and foreign-flagged ships in international waters</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax incentive for shipping-related businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>• 10% concessionary tax rate for international freight and logistics operators</td>
</tr>
<tr>
<td>• 10% concessionary tax rate on qualifying management fees derived by approved ship investment managers</td>
</tr>
<tr>
<td>• 10% concessionary tax rate on qualifying management fees derived by approved container management companies</td>
</tr>
<tr>
<td>• 5% or 10% concessionary tax rate on qualifying income from container leasing derived by approved container investment enterprises</td>
</tr>
</tbody>
</table>

We therefore believe that tax incentives for shipping-related businesses should be introduced in Hong Kong to support the overall development of the shipping industry and the government’s policy of reinforcing Hong Kong’s status as an international shipping centre and logistics hub.
Recommendation 9(a):

We recommend that a concessionary tax rate for income derived from shipping-related support services (such as ship management, ship agency, container leasing, container management, etc.) be introduced so as to encourage providers of such services to base their operations in Hong Kong.

3.2.2.2 The financial services industry

Discussion

Given Hong Kong’s position as an international financial centre, the financial services industry has always been one of the driving forces of Hong Kong’s economic development. In the 2013/14 Hong Kong Budget, the Financial Secretary described the financial services industry as a high value-added industry that accounts for 6% of the total workforce and 16% of the GDP in Hong Kong.

The study conducted by the Institute identified the following three areas within the financial services industry where opportunities for growth exist: (i) aircraft leasing, (ii) the fund industry and (iii) the local bond market. The results of the survey conducted by the Institute indicated that within the financial services industry, the local bond market was the sector/business that most respondents (33%) considered in need of tax incentives, followed by the private equity funds (30%) and then the aircraft leasing business (16%).

(i) Aircraft leasing

In its press release in July 2013, the EDC urged the HKSAR Government to “seriously study the possibility of developing Hong Kong as an international aircraft leasing centre”. As aircraft leasing is closely connected with the international transportation and logistics business, developing the aircraft leasing business in Hong Kong is in line with the HKSAR Government’s goal of promoting Hong Kong as an international transportation and logistics hub.
The table below provides a comparison of the current key tax treatments of aircraft operating lease income/expenses between Hong Kong, Ireland and Singapore.

<table>
<thead>
<tr>
<th></th>
<th>Hong Kong</th>
<th>Ireland</th>
<th>Singapore</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Taxability of lease rental</strong></td>
<td>Taxed at standard rate of 16.5%</td>
<td>Taxed at standard rate of 12.5%</td>
<td>Taxed at concessionary rate of 5% or 10% under the Aircraft Leasing Scheme</td>
</tr>
<tr>
<td><strong>2. Deductibility of related interest expenses</strong></td>
<td>Generally deductible subject to certain anti-avoidance provisions</td>
<td>Generally deductible</td>
<td>Generally deductible</td>
</tr>
<tr>
<td><strong>3. Tax depreciation</strong></td>
<td>• Initial allowance at 60% of the purchase cost in the year of acquisition and annual allowance at 30% of the reducing value in subsequent years • However, tax depreciation is denied under section 39E(1)(c)(i) of the IRO if the lessee is not a HK-based aircraft operator</td>
<td>Over 8 years</td>
<td>Over 5 years</td>
</tr>
<tr>
<td><strong>4. Withholding tax on operating lease rental derived from China</strong></td>
<td>7% - under the Hong Kong/China tax treaty</td>
<td>6% - under the Ireland/China tax treaty</td>
<td>6% - under the Singapore/China tax treaty</td>
</tr>
<tr>
<td><strong>5. Treatment of capital gains</strong></td>
<td>Not taxable</td>
<td>Taxable at 33%</td>
<td>Not taxable</td>
</tr>
<tr>
<td><strong>6. Treatment of capital loss</strong></td>
<td>Not deductible</td>
<td>Deductible against capital gains</td>
<td>Not deductible</td>
</tr>
</tbody>
</table>

As can be seen from the above table, compared to Ireland and Singapore, Hong Kong is relatively non-competitive in terms of tax rates on aircraft leasing income and tax depreciation allowance for capital expenditure on the purchase of aircraft.

**Recommendation 9(b)(i):**

We therefore recommend that (i) a concessionary tax rate be introduced for aircraft operating lease income and (ii) section 39E(1)(c)(i) of the IRO be amended such that depreciation allowance would not be denied for aircraft leased to non-Hong Kong based aircraft operators if the related leasing income is taxable in Hong Kong.
(ii) The fund industry

One of the goals set in the National 12th Five-Year Plan is to support Hong Kong to develop into an offshore RMB business centre and an international asset management centre. As the global economy balance shifts more towards the East, Asia is experiencing some of the fastest wealth growth in the world. Hong Kong should seize this opportunity to further develop its fund and asset management business.

Although profits tax exemption is currently available to offshore funds, funds authorised by the SFC and funds authorised by the regulatory authority of certain jurisdictions upon fulfilment of certain conditions specified in domestic tax law, the current regime only provides a limited scope of profits tax exemption to funds and suffers from a number of drawbacks. The table below illustrates some of the drawbacks of the current profits tax exemption regime for funds.

<table>
<thead>
<tr>
<th>Condition for exemption giving rise to concerns</th>
<th>Drawbacks</th>
</tr>
</thead>
</table>
| 1. Offshore funds exemption                      | • This limits the scope of the offshore funds exemption to non-resident funds only.  
  • Although the criteria for determining “Hong Kong residency” under the domestic offshore funds exemption regime and the provisions under the Hong Kong treaties are different, it may be difficult in practice for a fund (assuming it is constituted outside Hong Kong) to argue that it is a non-resident of Hong Kong for offshore funds exemption purposes and, on the other hand, a Hong Kong resident for treaty purposes.  
  • This effectively forces the fund to choose between enjoying the domestic profits tax exemption or the benefits under Hong Kong’s tax treaties, but not both.  
  • In contrast, Singapore has introduced the “Singapore Resident Fund Scheme” to encourage fund managers to base their fund vehicles in Singapore by giving Singapore-based funds the same tax exemptions given under the offshore fund regime when certain conditions are satisfied. This makes it possible for a Singapore-based fund to access both tax exemption in Singapore and benefits under Singapore’s extensive tax treaty network. |
| 2. Exemption under section 26A(1A)(a) of the IRO | • The exemption only applies to a mutual fund, unit trust or similar collective investment scheme that is either  
(i) authorised under section 104 of the SFO; or  
• Under section 26A(1A)(a)(i), Hong Kong domiciled funds that are not authorised by the SFC (e.g. a Hong Kong domiciled non-retail/private equity fund) will not qualify for the exemption. |
<table>
<thead>
<tr>
<th>Condition for exemption giving rise to concerns</th>
<th>Drawbacks</th>
</tr>
</thead>
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<tr>
<td>(ii) established outside Hong Kong, “bona fide widely held” (i.e. there are at least 50 investors in the fund with no fewer than 21 investors entitled to 75% or more of the fund’s income or property) and complies with the requirements of a supervisory authority within an acceptable regulatory regime.</td>
<td></td>
</tr>
</tbody>
</table>

The Financial Secretary has already proposed, in the 2013/14 Hong Kong Budget, to (i) extend the profits tax exemption for offshore funds to include certain transactions in private companies (so that private equity funds could enjoy the same tax exemption as offshore funds) and (ii) amend the current legal and regulatory frameworks in Hong Kong so as to allow an investment fund to be established in Hong Kong in the form of an OEIC. In November 2013, the FSDC published a paper setting out its proposed specific changes to Hong Kong’s tax legislation to expand the current profits tax exemption for offshore funds to private equity funds for the consideration of the HKSAR Government.

**Recommendation 9(b)(ii):**

To further promote the fund industry in Hong Kong, we recommend that (i) the current requirement for a fund to be a non-Hong Kong resident in order to enjoy the profits tax exemption be removed so that a fund domiciled and managed in Hong Kong may enjoy profits tax exemption and the benefits under Hong Kong’s tax treaties at the same time and (ii) the profits tax exemption for funds under section 26A(1A)(a)(i) be further extended to cover Hong Kong domiciled funds that are not authorised by the SFC, subject to appropriate anti-avoidance provisions to prevent abuse by Hong Kong resident investors.

(iii) The local bond market

Under Hong Kong’s current tax law, interest income derived from Hong Kong by a corporation carrying on a trade, profession or business in Hong Kong is deemed to be taxable, with tax exemption/reduction available in certain circumstances. Below are the tax exemptions/reductions currently available:

- **a)** Interest income is exempt from profits tax if it is derived by a corporation (other than a financial institution) from a deposit placed with an authorised institution in Hong Kong.

- **b)** Tax exemption or a concessionary tax rate is available for interest income derived from certain qualifying debt instruments.

- **c)** Interest income is not taxable if it is regarded as non-Hong Kong sourced. For non-financial institutions, the “provision of credit test” will generally be applied to determine the source of the interest income unless the corporation is carrying on a money lending or bond trading business, in which case the “operation test” will be applied based on the current assessing practice. Special rules apply to interest derived by financial institutions.

As such, unless either condition (a) or (b) above for tax exemption is satisfied, a corporation in Hong Kong investing in bonds has to prove to the satisfaction of the IRD that the interest income is non-Hong Kong sourced in order to exclude the income from profits tax.
Lodging an offshore claim with the IRD can be a resource consuming process and can create considerable uncertainty for taxpayers. As a result, corporations in Hong Kong may be discouraged from investing in bonds issued in Hong Kong (the interest income of which is *prima facie* with a Hong Kong source) and may instead invest in bonds issued overseas. This will in turn dampen the development of the local bond market.

**Recommendation 9(b)(iii):**

We recommend that a blanket profits tax exemption be granted to interest income derived by corporations which are not financial institutions from bonds issued in Hong Kong, regardless of its source and whether it qualifies for the tax exemption/reduction currently available, in order to encourage more bond issuers to come to Hong Kong. Related professional service sectors in Hong Kong, such as banking, legal and accounting services, should also be able to benefit from the development of the local bond market.

3.2.2.3 The green industry

**Discussion**

Waste management has become a pressing issue in Hong Kong as all of the existing landfill sites in Hong Kong are expected to be full in a few years. The HKSAR Government has been exploring ways to tackle the waste crisis in Hong Kong such as the extension of the three existing landfills, reducing waste at source and promoting the development of the recycling industry.

We support the HKSAR Government's initiative of promoting the sustainable development of the recycling industry in Hong Kong. In addition to the support measures that the government is currently considering, such as setting up a recycling fund, improving the network of community collection points, promoting technological research and workforce training in relation to the recycling industry, we believe the provision of tax incentives will also help to support the development of the green industry in Hong Kong.

The results of the survey conducted by the Institute indicated that the majority (83%) of the respondents thought that promoting the development of the green industry (e.g. waste management industry / recycling industry) would help to ease the waste problem currently facing Hong Kong.

**Diagram 17 – Survey results on developing the green industry to ease the waste problem in Hong Kong**

- Strongly agree: 48%
- Agree: 35%
- Neutral: 5%
- Disagree: 11%
- Strongly disagree: 1%
Recommendation 9(c):

We recommend that (i) tax holidays be granted in respect of income derived from waste management / recycling / resources recovery businesses, (ii) super tax deduction be allowed for plant and machinery employed in such businesses and/or (iii) cash allowance be granted for qualifying investment in such businesses.

3.2.3 Promoting Hong Kong as an intellectual property trading hub (Issue 10)

In the 2013/14 Hong Kong Budget, the Financial Secretary stated that Hong Kong has a sound regime for the protection of IPRs and is well equipped to develop into a regional intellectual property trading hub. Furthermore, the Financial Secretary also indicated that the Secretary for Commerce and Economic Development will lead a working group to study the overall strategy for promoting Hong Kong as a hub for intellectual property trading.

In this regard, the issue is whether Hong Kong's current tax legislation is attractive enough to promote Hong Kong as a hub for one of the major types of intellectual property trading activities, namely the licensing and sublicensing of IPRs.

3.2.3.1 Costs incurred for owning IPRs

Discussion

For a company owning and holding IPRs, a major cost item is the acquisition costs of the relevant IPRs. The relevant IPRs are the fixed assets of such a holding company. As such, the costs incurred in acquiring the relevant IPRs would be regarded as capital expenditure.

Under the existing provisions of the IRO, such capital expenditure, including the amortisation of the same charged to the income statement of a company, is not tax deductible as normal revenue expenses. This is the case regardless of the fact that the relevant IPRs are used to generate profits which are chargeable to tax in Hong Kong.

Currently, the IRO contains certain specific provisions which grant tax relief for certain types of capital expenditure. In respect of IPRs, section 16E of the IRO grants a 100% tax write-off in respect of costs incurred in the acquisition of patents and know-how. However, the recently enacted legislation contained in section 16EA of the IRO only grants a tax deduction spread over 5 years for costs incurred for the purchase of registered trademarks, registered designs and copyrights.

Furthermore, under section 16EC(4)(b), where the owner of the relevant IPRs grants its contract manufacturers located outside Hong Kong the right to use the relevant IPRs royalty-free for the purposes of manufacturing goods ordered by the owner, the tax relief otherwise available under sections 16EA and 16E would be denied.

The justifications for enacting section 16EC(4)(b) are the same as those used by the HKSAR Government for not amending section 39E. In this regard, please refer to our discussion on the section 39E issue (Section 3.1.4 of the study) as to why we consider that these justifications are flawed.

Aside from the unreasonably restrictive provision of section 16EC(4)(b) discussed above, the costs incurred for the acquisition of other types of IPRs, including unregistered trademarks, unregistered designs, franchise rights, concessions or licenses and indefeasible rights of use (commonly incurred by the telecommunication industry), would also not be eligible for any tax relief under the IRO.
The deficiencies of the legislative framework for IPRs discussed above are reflected in the fact that an overwhelming percentage (82%) of the respondents in the survey conducted by the Institute agreed that Hong Kong should offer a more favourable tax regime for intellectual property licensing and sublicensing activities in Hong Kong.

The respondents in the survey indicated their preference for the granting of tax relief to costs incurred for the acquisitions of other types of IPRs in the following order of priority: (1) franchises and licences (48%), (2) unregistered trademarks and designs (21%), (3) indefeasible rights of use (20%), (4) customer lists (9%) and (5) others (2%).

**Recommendation 10(a):**

We recommend that (i) the scope of section 16EA be expanded so as to grant tax relief for other types of IPRs, including those preferred by the respondents in the survey; and (ii) the unreasonably restrictive provision of section 16EC(4)(b) of the IRO be removed.
3.2.3.2 Licensing income of IPR owners

Discussion

Currently, where an IPR owner receives royalties for its granting of the use or right to use the relevant IPR outside Hong Kong, its Hong Kong tax liabilities in respect of the royalties received would depend on whether such an IPR is self-developed or acquired from another person by the owner.

Where the IPR is acquired from another person by the owner, such royalty income received by the owner would be regarded as non-taxable offshore income in Hong Kong and the costs for the acquisition of the IPR would not be tax deductible.

However, where the IPR is self-developed by an owner that is carrying on business in Hong Kong, such royalty income received would be regarded as taxable onshore income in Hong Kong.

We consider that the legal basis for differentiating such royalty income as onshore or offshore by reference to whether the IPR is acquired from another person or self-developed by the owner is doubtful.

Recommendation 10(b):

In order to enhance tax certainty and promote Hong Kong as a licensing hub for IPRs, we consider that the IRD should adopt a source rule for royalties received by an IPR owner by reference to the place where the relevant IPR is used or exploited by the licensee.

3.2.3.3 Sublicensing income of IPRs

Discussion

As regards sublicensing income (i.e. the licensor itself does not own the relevant IPRs and is itself a licensee), the IRD would generally regard such sublicensing income as taxable onshore income in Hong Kong where the contracts for the licensing and sublicensing are effected in Hong Kong.

On the basis of the decision in the TVBI case8 decided by the Privy Council in 1992, we consider that the IRD’s assessing practice in respect of sublicensing income discussed above is reasonable.

However, the provision of section 15(1)(ba) of the IRO would inhibit Hong Kong from becoming a regional hub for sublicensing activities.

Section 15(1)(ba) of the IRO provides that a non-resident recipient is liable to withholding tax in Hong Kong in respect of certain royalty payments made by a Hong Kong payer. Such withholding is applicable even where the right to use the relevant IPRs can only be exercised exclusively outside Hong Kong.

Section 15(1)(ba) was perceived by many tax practitioners as a breach of Hong Kong’s territorial source rule when it was enacted in 2004 and has remained so since. This is because the legislation intended to charge withholding tax in Hong Kong on a non-resident recipient of royalty in respect of its granting of the rights to use the relevant IPRs wholly outside Hong Kong.

For a manufacturing and trading scenario such as in the Emerson case9, the royalty payment would generally not be subject to any withholding tax in the place where the relevant IPRs are actually used in the

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8 HK-TVB International Limited v. CIR [1992] 2 AC 397

9 Emerson case
manufacturing process outside Hong Kong or in the overseas markets where the manufactured goods are sold. This is because it is the Hong Kong taxpayer (as the trader who subcontracted out the manufacturing work) that would make the royalty payments, not any other entities located in the place of manufacturing or sales outside Hong Kong, thus avoiding double taxation.

However, in the case where the Hong Kong taxpayer is a sublicensing company, double or even multiple layers of taxation on the royalty income stream in more than one jurisdiction could arise. For example, a Hong Kong sublicensing company which has obtained the right to use the relevant IPRs from a US licensor in return for a royalty payment can sublicense the use of such IPRs to an end user in the PRC. In this case, the royalty payment from the PRC end user to the Hong Kong sublicensing company will suffer withholding tax in the PRC.

Furthermore, under the source principles established in the TVBI case, the net royalty income of the Hong Kong sublicensing company (i.e. the spread between the royalties it receives from the PRC end user and the royalties it pays to the US licensor) could potentially also be liable to tax in Hong Kong under section 14 of the IRO.

Where the royalty payment to the US licensor would be tax deductible to the Hong Kong sublicensing company (i.e., in the case where the royalty income received from the PRC end user by the Hong Kong sublicensing company is chargeable to tax in Hong Kong), the US licensor would also be liable to a withholding tax in Hong Kong under section 15(1)(ba) in respect of the payment. This is the case despite the fact that the rights granted by the US licensor in respect of the relevant IPRs are and can only be used outside Hong Kong in the PRC.

Effectively, the royalty stream in respect of the relevant IPRs by the end user in the above example could suffer double taxation in terms of withholding tax (i.e. in the PRC and Hong Kong). This is in addition to the sublicensing company being possibly taxed in Hong Kong on its net profit from the sublicensing.

This effective double taxation in terms of withholding tax on royalties is not conducive to Hong Kong becoming a centre of sublicensing operations.

**Recommendation 10(c):**

To promote Hong Kong as an IPR sublicensing hub, we recommend that

(i) section 15(1)(ba) be amended such that a non-resident recipient should be excluded from the charge to withholding tax in Hong Kong provided that (a) the Hong Kong payer is a sublicensing company and overseas withholding tax is paid or payable on the royalties received by the Hong Kong payer; (b) the relevant IPRs are as a matter of fact used outside Hong Kong; and (c) the royalties paid to the non-resident are in respect of the same rights covered by the sublicensing income of the Hong Kong payer; and

(ii) as an added incentive for promoting Hong Kong as a centre for innovation and sublicensing operations, royalty income for IPRs used exclusively outside Hong Kong should only be taxed at a concessionary tax rate of say 50% of the normal profits tax rate in Hong Kong.

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9 CIR v. Emerson Radio Corporation [1999] 5 HKTC 122; the section 15(1)(ba) legislation was enacted on the basis of the decision in this case.
3.2.3.4 Tax credit of overseas withholding taxes on royalties in Hong Kong

Discussion

Hong Kong taxpayers who grant the use or the right to the use of the relevant IPRs outside Hong Kong under a sublicensing arrangement will normally suffer overseas withholding tax in respect of the royalty income. This is because such income will likely be regarded as being sourced in the overseas countries concerned.

However, such royalty income of a Hong Kong sublicensing company could also be liable to tax in Hong Kong under section 14 of the IRO following the source rule for royalties established in the TVBI case. This has the effect that the royalty income earned by the Hong Kong sublicensing company could be taxed twice.

At present, a Hong Kong sublicensing company can only claim a tax deduction under section 16(1) of the IRO in Hong Kong, not a full tax credit, in respect of the overseas withholding taxes paid on royalties where Hong Kong does not have a tax treaty with the overseas jurisdictions concerned. However, Hong Kong’s current tax treaty network is not wide enough to cover many jurisdictions.

Unlike a tax credit under a tax treaty, a claim for a deduction under section 16(1) of the IRO for the overseas withholding taxes suffered does not provide a full tax relief. This also inhibits Hong Kong from becoming a regional sublicensing hub.

In this regard, we note that in its tax legislation, Singapore grants unilateral tax relief to certain offshore royalty income in cases where the income is derived from countries which have not concluded tax treaties with Singapore.

**Recommendation 10(d):**

To promote Hong Kong as an IPR sublicensing hub, we recommend that unilateral tax credit be allowed to Hong Kong taxpayers under the IRO in respect of their overseas withholding taxes suffered on royalties where no relevant tax treaties are in place to grant the relevant tax credit.

3.2.4 Encouraging R&D activities (Issue 11)

In the 2013/14 Hong Kong Budget, the Financial Secretary indicated that if Hong Kong can transform technology research outcomes into products with market potential, coupled with industrial production, its technological development can make an even greater contribution to its economy.

In this regard, the issue is whether Hong Kong’s current tax legislation is attractive enough to facilitate Hong Kong attaining the Financial Secretary’s vision.

Discussion

R&D expenditure, normally incurred with a view to developing new products and improving existing production methods, is generally regarded as being capital in nature. As such, R&D expenditure is disallowed under section 17(1)(c) of the IRO. Nonetheless, section 16B(1) of the IRO specifically provides for a tax deduction for certain R&D expenditure; it reads as follows:

“Notwithstanding anything in section 17, in ascertaining the profits from any trade, profession or business in respect of which a person is chargeable to tax… there shall …be deducted the following payments made, and expenditure incurred, by such person … namely-
(a) Payment to – (i) an approved research institute for research and development related to that trade, profession or business… or (ii) an approved research institute, the object of which is the undertaking of research and development related to the class of trade, profession or business to which that trade, profession or business belongs; and

(b) Expenditure on research and development related to that trade, profession or business, including capital expenditure except to the extent that it is expenditure on land and building or on alterations, additions or extensions to buildings."

As a matter of practice, most of the R&D expenditure incurred by taxpayers would be claimed for a tax deduction under 16B(1)(b) above.

However, as a result of the IRD narrowly interpreting the section, the scope of section 16B(1)(b) is not as wide as it appears to be. The IRD's interpretation is that where the R&D activities are subcontracted out by taxpayers, expenditure incurred on such subcontracted out R&D expenditure would not qualify for a tax deduction under section 16B(1)(b). This is the case regardless of the fact that such taxpayers would own the proprietary interest of any outcome of such subcontracted out R&D activities and could therefore commercially exploit the same to produce their profits which are chargeable to tax in Hong Kong.

Furthermore, while the provision of section 16B(1)(b) is generous in terms of allowing a deduction for certain R&D-related capital expenditure (e.g. expenditure on the provision of plant or machinery), section 16B(1)(b) does not grant any super deduction or a tax credit of the relevant R&D expenditure.

Many of the tax regimes of Hong Kong's regional competitors grant super deductions or a tax credit in respect of qualifying R&D expenditure. The table below summarises the R&D tax incentives of selected jurisdictions.

<table>
<thead>
<tr>
<th></th>
<th>Hong Kong</th>
<th>Australia</th>
<th>Japan</th>
<th>Korea</th>
<th>Mainland China</th>
<th>Singapore</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Accelerated depreciation of R&amp;D plant &amp; machinery</strong></td>
<td>√</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Super deduction (i.e. &gt; 100% deduction) for R&amp;D expenses</strong></td>
<td></td>
<td></td>
<td>√</td>
<td>(110%)</td>
<td>(150%)</td>
<td>(150% - 400%)¹</td>
</tr>
<tr>
<td><strong>R&amp;D tax credits</strong></td>
<td></td>
<td>√</td>
<td>(40% - 45%)</td>
<td></td>
<td>(20% - 30%)</td>
<td></td>
</tr>
<tr>
<td><strong>Reduced tax rate</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>√</td>
</tr>
</tbody>
</table>

(15%, instead of the 25% statutory rate)

**Note:**

1. An eligible business may opt to convert up to SG$100,000 of its qualifying R&D expenditure for each year of assessment into cash at the rate of 60%. This option is available for the years of assessment 2013-2015.

In the survey conducted by the Institute, the respondents indicated their preference for additional tax incentives in the following order of priority: (i) tax credit for R&D expenditure (28%); (ii) reduction in profits tax rate (24%); (iii) tax holidays for companies conducting R&D activities for others as a service provider (23%); and (iv) super deductions (150-200%) of R&D expenses (23%).
Recommendation 11:

We recommend that the HKSAR Government consider (i) granting at least 20% tax credit for R&D expenditure; (ii) reducing the profits tax rate for companies whose R&D expenditure for a year exceeds certain thresholds; (iii) allowing a 150% super tax deduction for R&D expenditure; (iv) providing tax holidays for companies conducting R&D activities for others as a service provider; and (v) instructing the IRD to interpret section 16B(1)(b) such that subcontracted out R&D expenditure also qualifies for a tax deduction provided that other general conditions for deduction are also met.

3.2.5 Stamp duty on the transfer of non-listed Hong Kong shares (Issue 12)

The issue is whether the transfer of shares of non-listed Hong Kong companies should be exempt from ad valorem stamp duty in order to attract more companies to invest in Hong Kong.

Discussion

Under the SDO, the transfer of “Hong Kong stock” (including listed and unlisted Hong Kong shares) is subject to stamp duty. The duty rate on stock transactions is 0.2% of the value of the shares transferred per transaction. With regard to the transfer of shares of a non-listed company, as the fair market value of such shares is not readily available, the following problems may arise:

(i) the officers of the Stamp Office may not have the expertise to determine the fair market value of the shares;

(ii) very often, there may be a delay in the stamping process if the non-listed company concerned has assets such as properties and/or other investments; and

(iii) such a delay may cause a deferral of registration with the company’s members register, thus affecting the daily operation of the company.

In addition, the amount of stamp duty collected from the transfer of non-listed shares is relatively small and may not be justified taking into account the related costs of collection; for example, for the year of assessment 2012/13, the stamp duties on contract notes for the sale and purchase of Hong Kong stock collected by the
Stamp Office\textsuperscript{10} only amounted to around HK$1.7 billion, whereas those collected through the Stock Exchange of Hong Kong Limited amounted to around HK$18 billion.

In the survey conducted by the Institute, 41\% of the respondents agreed or strongly agreed that the transfer of non-listed shares should be exempt from stamp duty, whereas 28\% were neutral about this.

\begin{center}
\textbf{Diagram 21 – Survey results on exempting transfer of non-listed Hong Kong shares from stamp duty}
\end{center}

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{diagram21}
\end{figure}

\begin{itemize}
\item [\textcolor{blue}{\textbullet}] Strongly agree
\item [\textcolor{red}{\textbullet}] Agree
\item [\textcolor{green}{\textbullet}] Neutral
\item [\textcolor{purple}{\textbullet}] Disagree
\item [\textcolor{orange}{\textbullet}] Strongly disagree
\end{itemize}

Recommendation 12:

To create a simpler, more efficient and less costly tax environment for investors to perform share transactions in Hong Kong, we recommend that a fixed amount of stamp duty of HK$5 be charged on both the instrument of transfer and the bought and sold note for the transfer of shares of non-listed companies.

3.3 Future Direction of Tax Reform

With regard to the future direction of reforming the Hong Kong tax system, the study focused on ways of building a sustainable tax system in the long term that is capable of generating sufficient and stable government revenue to meet the growth in public expenditure in the future.

3.3.1 Broadening the tax base in Hong Kong (Issue 13)

The issue is whether the current tax base in Hong Kong is too narrow and if it is, what options are available for broadening it in the long run.

Discussion

A narrow tax base has long been a notable defect of Hong Kong’s tax system. Back in 2006, the HKSAR Government launched a public consultation on the options for broadening the tax base in Hong Kong and a GST was named as a viable option for Hong Kong. Due to the controversy caused and the various concerns of the community over the introduction of a GST in Hong Kong, the HKSAR Government eventually decided not to proceed with the proposed tax reform. The issue of the narrow tax base has since remained unaddressed.

\textsuperscript{10} This amount of stamp duties mainly consists of duties collected on the transfer of non-listed stocks and stocks (both listed and non-listed) traded over the counter.
As mentioned in section 3.2.1.1 above, in the year of assessment 2011/12, only 94,900 out of 864,000 (i.e. 11%) registered corporations paid profits tax, with around 64% of the profits tax for the year being contributed by the top 800 taxpaying corporations. The salaries tax base in Hong Kong is similarly narrow. In the year of assessment 2011/12, only about 1.6 million out of a working population of 3.6 million (i.e. 45%) paid salaries tax, with 200,000 taxpayers (i.e. 12% of the taxpaying population) contributing 80% of the revenue from salaries tax for the year.

In the consultation document for the 2014 Policy Address and the 2014/15 Budget published in October 2013, the HKSAR Government pointed out that Hong Kong’s tax base is narrow and government revenue is sensitive to economic fluctuations resulting from broader economic changes beyond its control. The document further stated that the volatility of government revenue poses challenges to the management of public finance. According to the consultation document, profits tax, salaries tax, stamp duty and land premium accounted for 65% of the 2012/13 total government revenue. Income from all of these sources of revenue tends to fluctuate with economic conditions and therefore can cause financial instability during an economic downturn.

Our survey results also indicated that the majority (i.e. 71%) of the respondents strongly agreed or agreed that the tax base in Hong Kong is too narrow and needs to be broadened in the long run. In addition, most (i.e. 38%) of the respondents considered being “too reliant on sources of revenue that fluctuate with economic conditions” (e.g. income from land sales, profits tax and stamp duty) as one of the factors that most likely contributes to the volatility of government revenue, followed by a too narrow tax net (28%) and a lack of a broad-based tax on general consumption (21%) as the other factors.

Diagram 22 – Survey results on whether the tax base of Hong Kong is too narrow and needs to be broadened

- Strongly agree: 18%
- Agree: 45%
- Neutral: 7%
- Disagree: 4%
- Strongly disagree: 26%
The problem of fiscal volatility is of particular concern given Hong Kong’s aging population. In 2012, the number of elderly people aged 65 and over was 980,000, representing 14% of Hong Kong’s population. The current elderly dependency ratio is five working age persons to one dependent elderly person. According to the latest projection, by 2041, the number of elderly people will increase significantly to 2.56 million, representing 30% of Hong Kong’s population, and the elderly dependency ratio will reduce to less than two working age persons to one dependent elderly person.

The aging population will have profound implications for the long-term sustainability of public finance in the following ways: (i) the shrinking working population will slow economic growth and reduce the number of salaried taxpayers, which will in turn result in decelerated growth in government revenue from profits tax and salaries tax; and (ii) the increase in the proportion of elderly population will result in a surge of government expenditure on healthcare and welfare.

The Basic Law requires Hong Kong to keep expenditure within the limit of revenue and to avoid fiscal deficits. In order to cope with the soaring public expenditure brought about by the aging population in the long run, Hong Kong has to find new sources of government revenue that are stable and sustainable. Given the international trend of lowering income tax rates and increasing the reliance on indirect taxes as a means of raising stable government revenue, the Institute believes that the HKSAR Government should consider introducing new type(s) of indirect taxes in Hong Kong.

In the survey conducted by the Institute, the respondents indicated their preference for new types of indirect tax that Hong Kong may consider for broadening the tax base in the following order of priority: (1) sales tax on luxury goods (37%); (2) green taxes (e.g. road traffic tax, tax on waste disposal) (33%); (3) GST (17%); (4) tax on investment income (e.g. dividends and capital gains) (10%); and (5) others (3%). In addition, around 69% of the respondents strongly agreed or agreed that introducing a green tax, such as road traffic tax or a surcharge on waste disposal, could help to improve the living environment and address the waste problem in Hong Kong.
Recommendation 13:

In order to address the problem of fiscal volatility and to cope with the soaring public expenditure as a result of the aging population in the long run, we recommend that the HKSAR Government consider the possibility of introducing new type(s) of indirect tax to broaden the tax base in Hong Kong in the long run, such as (i) sales tax on luxury goods, (ii) green taxes, (iii) GST.

![Survey results on the preferred types of new tax for broadening the tax base of Hong Kong](image)