

Hong Kong Institute of Certified Public Accountants

Budget Proposals 2008-2009

Summary of proposals

I. THREATS

A. *Maintaining a low and simple tax regime: clarity, certainty and consistency*

1. The Hong Kong Institute of CPAs ("Institute") takes the opportunity of the commencement of the term of office of the new Financial Secretary ("FS") and new administration to reiterate several important tax issues and proposals that have not so far been taken up. The Institute also puts forward some new ideas to help strengthen the underlying economy and improve the quality of life in Hong Kong.
2. Firstly, we believe that it is essential for priority to be given to maintaining clarity, certainty and consistency in Hong Kong's tax system, otherwise there is a real danger that Hong Kong's reputation for having a low and simple tax regime could be adversely affected. In order to enhance clarity, certainty and consistency, some fundamental issues need to be addressed in statute, e.g., through rules under the Inland Revenue Ordinance ("IRO"), instead of by practice notes issued by the Inland Revenue Department ("IRD"). The recent Court of Appeal judgment case of *ING Baring Securities (Hong Kong) Limited v. CIR* has shown that the IRD's interpretation may not always be supported in law. Relevant matters include:
 - The taxation of unrealised gains and losses, which has become a more significant issue following the court of final appeal decision in *CIR v Secan Ltd & Anor* ("*Secan*"), as interpreted by the IRD;
 - the tests for determining source of profits in relation to, e.g. trading income and manufacturing profits (under section 14, IRO); and
 - the tests for determining source of employment income (under section 8, IRO).
3. The implementation of the "Assess First, Audit Later" ("AFAL") system for assessing of tax returns, introduced in 2001 has, in practice, led to increased uncertainty for many taxpayers as it has become more likely that a taxpayer's tax affairs will not be concluded for any particular year of assessment until the completion of the statutory time limit of six years. Taxpayers are entitled to timely resolution of their tax affairs for each year and thus a reasonable and certain time limit should be specified in the IRO for undertaking the "audit" of a tax return. We suggest that if the IRD has not begun enquiries within twelve months of the filing date, a tax return should normally be regarded as final. This is similar to the commitment made to taxpayers by the Inland Revenue in the United Kingdom ("UK").
4. To provide more certainty to businesses, the "time bar" period for re-opening tax affairs under section 60, IRO, should be shortened from six years to three or four years, which would be in line with a number of other jurisdictions.

5. Legislative changes should be made to provide that a statement of loss issued by the IRD should be treated as an assessment, so that it is binding upon the IRD and the taxpayer can object to it if he or she does not agree with it.

B. The need to keep abreast of changing business developments and practices and to remain competitive in the region

6. Hong Kong needs to keep pace with and react to changing business developments and practices in order to remain competitive in the region. The Institute believes that, in this context, some of the tax issues that need to be addressed include:
 - The concept of “substance over form” should be recognised in relation to, e.g., businesses trading in Hong Kong with manufacturing processing agreements in the Mainland;
 - the apportionment of profits, where profits are partially sourced in Hong Kong and partially overseas, should be given statutory backing;
 - the need for a comprehensive transfer pricing regime should be explored as section 20, IRO and the relevant provisions of the Mainland DTA are quite generic and cannot satisfactorily deal with the increasingly common issue of transfer pricing;
 - group/loss relief should be introduced; and
 - “loss carry-back” should be allowed, i.e., losses incurred in the current year of assessment should be permitted to be offset against the assessable profits of one previous year.

C. Improving the quality of life

7. More needs to be done to create a sustainable environment and improve the quality of life in Hong Kong. The Institute’s tax proposals include the following:
 - Improving the environment: Additional environmental protection measures should be considered as part of a more co-ordinated environmental policy, which should also take on board climate change. For example, energy conservation and sustainability in the design of new commercial and industrial buildings should be given tax concessions and electronic road pricing should be introduced to reduce traffic congestion.
 - Preserving culture and heritage: We suggest considering the establishment of a dedicated body, similar to the UK National Trust, and allowing private buildings to be donated to this body to be treated as donations in kind. Cash donated to the body should be tax deductible. Donors to charities that wish to do so, should also be able to transfer the benefit of the relevant tax deductions to those charities.
 - Promoting the Olympic ideal: To help promote the physical and mental benefits of sport to the community in the Beijing Olympics year, in which Hong Kong will participate directly, in 2008/09, donations to the Hong Kong Athletes Fund for elite sportsmen, or other approved sports

development funds, should be distinguished from other charitable donations and should be tax deductible without any ceiling against income or profits.

- Creating employment opportunities: Provide incentives to relocate back office functions to satellite towns to create employment and improve the local economy and local community development.

D. Addressing Hong Kong's narrow tax base

8. Although the economy is now in much better shape than it was before, the continuing narrowness and inherent volatility of the tax base reduces Hong Kong's ability to tackle the economic challenges ahead, as well as the flexibility to compete in other areas of the tax system. We refer the FS to the Institute's March 2007 submission in response to the consultation on broadening the tax base. Whilst the Institute concluded that no single option would be better than a goods and services tax in meeting the various objectives, the submission also suggested that other possible options should be further explored either singly or in combination, including: payroll and social security taxes; a single stage retail sales tax; a surcharge on utility supplies and green taxes.

II. OPPORTUNITIES

E. Enhancing Hong Kong's status a business and financial centre and supporting key sectors

9. In view of the improvement in the economy, the Institute supports the proposal in the Chief Executive's 2007/08 Policy Address to reduce the corporate profits tax rate and the standard rate of salaries tax by one per cent to 16.5% and 15% respectively.
10. Given the global trend towards lowering the rate of direct taxes, the government should conduct a study with a view to implementing further reductions in Hong Kong's profits tax rate in future, having regard to factors such as (i) the fiscal position; (ii) international trends; (iii) the effective tax rates in competing jurisdictions, particularly for industries that are vital for Hong Kong's economic well-being (e.g., service industries). The study should also consider whether there is a justification for continuing to maintain the differential between the corporate profits tax rate and the rate for unincorporated businesses.
11. In view of the substantial surpluses currently being generated, the tax burden on middle-income earners, who pay at the higher marginal rates of taxation, can be reduced. We propose that marginal rates should all be decreased by one percent to 1%, 6%, 11% and 16% and that the salaries tax bands should be widened from HK\$35,000 to HK\$40,000.
12. We do not propose any change in personal allowances in 2008/09. We suggest that there be a further look at personal allowances with a view to identifying an appropriate base year for future adjustments, which should take account of actual (e.g., inflationary) changes in the economy and avoid further narrowing of the tax base.

13. To support the development of value-added services, Hong Kong's tax regime should provide for the following:
 - Deductions for the cost of acquisition of trademarks and copyrights generally, not only patents and know-how;
 - deductions for the interest expenses incurred (for the period before the relevant property is used to produce assessable profits) in financing the acquisition of trademarks and copyrights generally, not only patents and know-how;
 - tax credits for any foreign tax paid on the royalty income concerned.
14. To support the logistics sector which has been identified as one of the strategic industries in Hong Kong's economy, we propose:
 - Exemption from or reduction in rates for storage facilities used directly for the logistics business, e.g. warehouses, wharfs, etc;
 - 50% reduction in the rate of profits tax on income derived from the international freight forwarding business, initially for a three-year period; and
 - improvements in the rail infrastructure between Hong Kong and the Mainland, to reduce the time and costs of transporting cargo to terminals in Hong Kong.
15. To enhance Hong Kong's competitiveness as a location for regional offices, service centres and group companies, the following measures should be considered:
 - Full profits tax exemption should be given to regional headquarters/offices in Hong Kong in respect of management and consultancy income derived by the Hong Kong entity from associated entities overseas;
 - interest income received by regional offices from loans made in Hong Kong to their overseas associates should be exempted from taxation;
 - a unilateral tax credit should be given for the amount of foreign withholding tax paid (in jurisdictions with no double taxation agreement ("DTA") with Hong Kong) on income sourced in Hong Kong, of up to a maximum of 50% of the amount of Hong Kong profits tax payable on such income.
16. A survey of business community should be concluded to better understand Hong Kong's competitiveness in terms of the cost of doing business.

F. Promoting health and education

17. It is essential to determine how to maintain a financially sustainable public health care system over the long term. As part of this the following should be explored:
 - Providing for a tax deduction/incentives for individuals to invest in

medical insurance or voluntarily contribute monies into a dedicated MPF-type fund for future medical expenses. Amounts paid into a dedicated fund should be deductible up to a fixed amount, but be taxable if taken out for non-medical uses.

- Extending the “user pays” principle to some non-essential medical services, such as non-emergency ambulance services.
18. The current deduction limit of HK\$60,000 for self-education expenses should be increased to HK\$80,000 to assist taxpayers to attend approved courses, given the increasing costs of many educational programmes. Claims for self-education allowances should be able to be carried forward for up to three years, when it is more likely the recipient will be working and able to take advantage of the deduction.
 19. Assistance by way of, e.g., more extensive loans or subsidy arrangements should be considered for students’ tuition fees.
 20. In addition, to help develop and improve their skill sets, knowledge and employability, a deduction of up to HK\$12,000 in aggregate should be available for any membership subscriptions of approved professional bodies, and not only for one membership, as is currently allowed.

G. Government services

21. To enhance the efficient use of resources and the delivery of public services, the government should continue reviewing its existing services and monitoring market conditions to identify services that could be privatised, and to determine the most appropriate time for doing so.

H. Additional technical proposals

22. Spouses should be able to elect individually for personal assessment and not have to be jointly assessed.
23. The following property-related measures should be introduced:
 - Define trading gains in property, more specifically, by reference to a holding period of less than two years, with an exception for the family home.
 - Increase the ceiling for the flat rate of HK\$100 stamp duty on real property to properties costing up to HK\$3 million from the current limit of HK\$2 million, given the continuing property price inflation. Subsequently, adjust the ceiling in line with the property price index.
 - Individual property owners should be encouraged to enhance the environment, safety and value of older building stock by allowing the option of deducting either actual renovation expenses, or the existing flat rate of 20% of the rent received. The former type of deduction could be subject to a maximum amount over a certain period, to avoid abuses.