



To: News/Business Editor
(FOR IMMEDIATE RELEASE)

**The Hong Kong Institute of Certified Public Accountants Submits its
Package of Proposals for the 2005/2006 Budget**

(Hong Kong, 3 December 2004) — The Hong Kong Institute of Certified Public Accountants today submitted its proposals package for the 2005/2006 Budget to Financial Secretary Mr. Henry Tang.

Noting that Hong Kong's tax system has helped it attract investment and stimulate business, the Institute says its proposals are aimed at protecting those strengths while broadening the tax base.

"Apart from low tax rates, clarity and certainty are strengths of the system, but the Institute believes there are signs that these strengths are eroding," says Mr. Paul Chan, Vice President and Chairman of the Institute's Taxation Committee. "If these strengths are compromised, Hong Kong could lose some of its competitiveness in the region - our rivals are seizing the opportunity to lower taxes and offer incentives and concessions."

A concern about Hong Kong's tax system, according to the Institute, is that in recent years flaws have come to light in relation to its ability to react to economic changes.

On the revenue side, the Institute says the narrowness of the tax base and reliance on direct taxes on profits and income, the bulk of which is paid by a very small proportion of taxpayers, needs to be addressed.

Goods and Services Tax

The Institute's believes the international trend to move away from direct forms of taxation towards consumption taxes, in particular, a goods and service tax (GST), would be good for Hong Kong, and that the government should move ahead with a public consultation on a GST for Hong Kong. In its submission to the Financial Secretary, the Institute recommends design features for a GST, including:

- simplicity;
- single low rate of less than 5 percent;
- compensatory allowances for lower income groups rather than a proliferation of exemptions and zero-rated items;
- reasonably high registration threshold so many small businesses would not have to register;
- reduction in direct taxes at the same time; and
- a commitment from the government to keep rates stable for several years.

Given that a GST could take several years to implement, the Institute's submission suggests other short-term revenue options, if more revenue is required in the interim, including moderate increases in tenements rates, a further review of some personal allowances and the introduction of the previously proposed Boundary Facilities Improvement Tax.

In its submission, the Hong Kong Institute of CPAs states that it does not support a capital gains tax or worldwide taxation because these measures would complicate the system and discourage investment without raising significant revenue. The Institute has also made submission to the Government for abolishing the estate duty.

Tax Amnesty

Instead, the Institute's recommendations included a "tax amnesty" that would allow the government to collect more tax now while encouraging compliance in the future.

"Amnesty would give assurance to those who want to correct past errors in their tax returns without fear of prosecution or punitive levels of penalties," says Mr. David Southwood, convenor of the HKICPA Taxation Committee's Budget Proposals Sub-committee. "While this is a novel concept for Hong Kong, it has been carried out successfully in various jurisdictions around the world."

Tax Incentives

To help maintain Hong Kong's lead as a regional financial centre and operations hub, the Institute's proposals include limited tax incentives for regional offices that provide management and consultancy services to related companies, and some concessions for the financial services sector.

For the manufacturing sector, the Institute suggests that the government consider granting a 50 percent profits tax reduction for a specified period, such as five years. Other tax incentives would encourage employment, such as incentives for employers to recruit workers who have been unemployed for a certain period. To help workers who are made redundant, the Institute suggests increasing the ceiling on any redundancy/severance payments that are treated as non-taxable by the Inland Revenue Department (IRD).

Other budget measures suggested by the Institute include:

- "green taxes," and tax incentives to promote environmental protection;
- greater flexibility in concessions allowed for charitable donations;
- incentives for corporate sponsorship of arts and culture; and
- concessions in relation to repayments of student loans from the government and self-education expenses.

Concerns

The Institute voiced its concerns about recent government actions that are introducing uncertainty for businesses and investors:

- taxation of unrealised profits (e.g., in revaluations of property holdings);
- handling of offshore profits and non-Hong Kong-employment claims; and
- the "assess first, audit later" IRD approach that means corporate taxpayers are more unlikely to have their tax affairs fully resolved before the expiry of the six-year statutory period for re-opening cases.

The Institute says the government should consider amending the Inland Revenue Ordinance for greater certainty and clarity. In addition, the submission recommends reducing the time period for re-opening tax cases from six years to three or four years, which is more in line with a number of major overseas jurisdictions.

On public expenditure, the Hong Kong Institute of CPAs' proposals range from looking for savings by contracting out services and expanding the "matching" scheme, through which universities are raising significant private donations, to other sectors. More privatisations and bond issues are also ways of encouraging efficiencies and generating revenue and/or controlling cash flow. The Institute noted, however, that given Hong Kong's aging population, it is important that a means be found to fund healthcare services.

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Editor's Notes

About Hong Kong Institute of Certified Public Accountants

The Hong Kong Institute of CPAs is Hong Kong's only statutory licensing body for accountants with more than 22,000 members and close to 10,000 registered students. Members of the Institute are entitled to the description *Certified Public Accountant* and to the designatory letters *CPA*.

The Hong Kong Institute of CPAs evolved from the Hong Kong Society of Accountants, which was established on 1 January 1973.

The Institute operates under the Professional Accountants Ordinance, working in the public interest. The Institute has wide-ranging responsibilities, including assuring the quality of entry into the profession through its postgraduate CPA Qualification Programme and promulgating financial reporting, auditing and ethical standards in Hong Kong. The Institute has responsibility for regulating and promoting efficient accounting practices in Hong Kong to safeguard its leadership as an international financial centre.

For more information, please contact:

Stella To
Deputy Director, Media Relations & Marketing
Hong Kong Institute of Certified Public Accountants
Email: stella@hkcipa.org.hk
Phone: 2287 7209
Mobile: 9027 7323

Summary of Major Proposals
in the HKICPA Budget Submission 2005/06

Fundamentals

- 1) A decision should be made and announced on introducing a goods and services tax (GST). A consultation paper should be released as soon as possible so that a consensus can be reached at an early stage on the appropriate design of a GST system in Hong Kong.
- 2) Pending the introduction of GST, if it is necessary to raise additional revenue, the options of a further review of certain personal allowances, a moderate increase in rates on tenements and the introduction of the previously-proposed Boundary Facilities Improvement Tax should be considered.
- 3) To address the acute uncertainties that have arisen following the Court of Final Appeal decision in *CIR v Secan Ltd and Ranon Ltd.*, consideration should be given to amending the Inland Revenue Ordinance (IRO) to establish that there is no necessary connection between accounting and tax treatment in relation to corporate profits.
- 4) A one-time tax amnesty should be introduced covering all open years of assessment (i.e., the six years prior to the year in which it is introduced) to improve tax compliance in the future and provide a one-off increase in revenues with very little cost to the government in terms of additional facilities.

Opportunities

- 5) Various measures should be introduced to enhance Hong Kong's competitiveness as a location for regional offices and group companies, such as the following concessions:
 - Full profits tax exemption to regional headquarters/offices in Hong Kong in respect of management consultancy income derived by the Hong Kong entity from associated entities overseas.
 - Exemption of interest income received by regional offices from loans made in Hong Kong to their overseas associates.
 - Group relief.
 - Loss incurred in the current year of assessment should be permitted to be offset against the assessable profits of one previous year.
- 6) Given the international trend towards lowering the rate of direct taxes, the profits tax rates in Hong Kong should be reduced at the earliest opportunity. In particular, the differential between the corporate profits tax rate and the rate for unincorporated businesses should be removed at the time of introduction of a GST, or in 2008/09, when the budget is forecast to go into surplus again, whichever occurs first.
- 7) To improve the competitive environment for the local manufacturing sector, and provide employment opportunities, a 50% profits tax reduction should be granted to local manufacturers of goods, for a limited period of, say, five years.

- 8) Freeing up land in the Border Closed Area separating Shenzhen and Hong Kong has the potential to generate significant economic benefits to Hong Kong. We would suggest that, as a start, the government should clearly state its position in relation to the future of this area.
- 9) A unilateral tax credit should be given for the amount of foreign withholding tax paid (in jurisdictions with no double taxation agreement with Hong Kong) on income sourced in Hong Kong, of up to a maximum of 50% of the amount of Hong Kong profits tax payable on such income.
- 10) Consistent with the Institute's recent submission on the subject, we advocate abolishing estate duty in one go, but if the government opts for a phased approach, exemptions on bank accounts and listed securities should be given, and a clear timetable provided for final abolition.
- 11) A capital gains tax should not be introduced in Hong Kong as it will be unlikely to result in an overall gain to Hong Kong and will discourage investment.
- 12) Worldwide taxation should not be introduced in Hong Kong, as it would necessitate a complex system of tax credits together with double taxation agreements. It would also be inconsistent with the source principle of taxation.

Community

- 13) The duty on alcoholic beverages in Hong Kong provides a stable source of revenue and we doubt whether abolishing the duty on alcoholic beverages would encourage wine tourism in Hong Kong, particularly given the competition from wine-producing countries in the region, or stimulate Hong Kong's development as a regional hub for wine products. Under the circumstances, we do not see the need for any change at present.
- 14) A detailed review of the level of duties and fees levied by the government should be undertaken and, as far as possible, the "user pays" principle should be adopted, as long as the government is willing to be accountable for the services that it provides and to examine whether and how services could be delivered more efficiently.
- 15) Fiscal measures, including environmental taxes and tax incentives, should be considered as a way of promoting and improving environmental protection.
- 16) Employees should not be taxed on any redundancy/severance payments from their employers of up to twice the statutory limits.
- 17) In relation to (16) above, where an employee's salary has been reduced because of business conditions and the employer subsequently pays a long-service/severance payment based on the previous higher salary, the difference between the payment based on the final salary and the actual payment made by the employer should also be deductible by the employer.

- 18) An extra deduction of 50% on the salary costs of employing unemployed persons (who have been actively seeking working for one year or more) should be granted to employers in the year of assessment 2005/06.
- 19) Government ground rent, like rates, should be deductible against property tax to better reflect the actual expenses borne by landlords.
- 20) Students should be allowed to claim a deduction for the interest they pay on their student loans from the government for a period of, say, five years, after they begin work, with the students being able to elect in which five years they wish to claim the expense.
- 21) Self-education expenses should be able to be carried forward for up to three years so that they may be claimed when the taxpayer is generating income subject to salaries tax.
- 22) To further encourage charitable donations, the following measures should be introduced:
 - The present ceiling for allowable deductions should be increased from 25% to 50% of assessable profits/income, with a view to removing the ceiling altogether as a long term objective.
 - Any donations that cannot be claimed against tax in the relevant year should be able to be carried forward.
 - The term “approved charitable donation” should be defined for the purposes of the IRO to include donations in kind, provided the goods are valued by a qualified third party.
- 23) To improve the arts and cultural environment in Hong Kong, and encourage more private sector support, consideration should be given to allowing corporate sponsors of “approved” events and activities to claim deductions of 150% of actual expenditure.

Understanding

- 24) Clarity, certainty and consistency application of tax laws and tax administration have been fundamental to Hong Kong’s reputation as a place to do business. We therefore propose that:
 - Consideration should be given to following the approach adopted by other jurisdictions by publishing the IRD assessors’ manual.
 - Given the reliance of Hong Kong’s tax system on the principle of source of profits, legislation should be introduced to clarify the position regarding offshore profits, particularly in the case of manufacturing and trading profits.
 - The government should encourage voluntary disclosure of errors and omissions in tax filings by imposing penalties based primarily on financial restitution, and not imposing punitive penalties and/or prosecution on those making full voluntary disclosure.
 - The IRO should be amended to include tests to determine the major source of income that are subject to profits tax.
 - The IRO should be amended to clarify the tests or rules for determining whether an individual has a Hong Kong-source employment.

- The legal basis of the “assess first audit later (AFAL)” approach now adopted by the IRD needs to be clarified. The AFAL has led to increased uncertainty amongst taxpayers, because their tax affairs may not be concluded for any particular year of assessment until the expiry of the statutory time limit of six years.
- To provide greater certainty to businesses and to counteract the negative effect of the AFAL, the time for re-opening tax affairs under the IRO should be shortened from six years to three or four years, which would be in line with a number of other jurisdictions.

Saving

- 25) Since the government is continuing to face a shortfall of operating revenue over operating expenditure, it should critically review the various areas of public expenditure.
- 26) Consideration should be given to out-sourcing where appropriate, and also to expanding the matching scheme, which has been successful in engaging more private sector support for universities, in relation to other community activities funded by the government.
- 27) As health expenditure is expected to continue to grow in the future, it is critically important to determine how to maintain a financially sustainable public health care system over the longer term.
- 28) To help to develop Hong Kong into a regional centre of excellence for tertiary education, and better utilise the fixed cost facilities in the tertiary education system in Hong Kong, consideration should be given to offering tertiary education programmes to overseas students, either in or outside Hong Kong, having regard to, amongst other things, the full costs of providing those services.
- 29) To enhance the efficient use of resources and the delivery of public services, further studies should be carried out to identify suitable public services for privatisation, which may include postal services and water supplies.
- 30) With a view to cutting capital expenditure, the government should encourage more private participation in major capital projects.

2 December 2004