The Dream Ticket: Competitiveness and Stability
– Strengthening Hong Kong’s Competitive Edge and Enhancing Stability

Budget Proposals 2007-08
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Budget Proposals 2007/08

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OVERVIEW

1.1 Economic Outlook

Hong Kong’s economy strengthened with GDP increasing by 6.8% in real terms in the third quarter of 2006 compared with a year earlier. This followed a 5.5% increase in the second quarter of 2006. On the strength of the latest economic data, in November, the government revised upward the forecast GDP growth for 2006 as a whole to 6.5% compared with the range of 4%-5% quoted in the 2006/07 Budget Speech. This is close to the forecast contained earlier in Pacific Economic Co-operation Council’s State of the Region report, which anticipated growth of 6.3% in real terms.

Following a long period of deflation, the Composite Consumer Price Index (“Composite CPI”), has shown a slight year-on-year increase since September 2005. For the 12 months ended October 2006, the Composite CPI was on average 1.9% higher than in the preceding 12-month period, while for the third quarter, the index rose by 2.2% from a year earlier. The forecast for the Composite CPI in 2006 as a whole remains at 2%.

The unemployment rate fell to 4.5% in the period August-October 2006, down from 4.7% in July-September 2006, and the lowest figure since the second quarter of 2001. This translates to around 168,900 people out of work. The under-employment rate rose from 2.3% in July-September 2006 to 2.4% in the three months to October 2006. Total employment rose to a new high of 3,500,300 in August-October 2006 out of a total labour force of 3,669,200. (All August-October figures are provisional.)

The financial markets, in particular the stock market, have been fairly buoyant in 2006, particularly in relation to initial public offerings (“IPOs”). Recent offerings included the largest ever IPO, with the successful listing of the Industrial and Commercial Bank of China, which raised over US$19 billion. On 15 November 2006, the Hang Seng Index closed at over 19,000 for the first time. Total market capitalisation exceeded HK$12 trillion for the first time on the same day and the monthly turnover in November exceeded HK$1 trillion for the first time ever. Total turnover in the first three quarters of the year reached HK$5.65 trillion, more than annual turnover of HK$4.44 trillion achieved the year before.

Given its external orientation, Hong Kong’s open economy is constantly vulnerable to factors beyond its control, including sentiment in the economies of the US, the Mainland and Europe, and the impact of global events and factors, such as oil prices, etc. The US economy grew faster than expected at an annualised rate of 2.2% in the third quarter, although this was still the weakest quarter so far this year, compared with 2.6% in the second quarter. The Mainland economy,
meanwhile, continues to demonstrate fundamental strength, achieving growth of 10.4% in the July – September 2006 period, compared with 11.3% in the previous quarter. In the first three quarters of 2006 growth overall was around 10.7%, according to official figures, which may reflect to some extent the effect of the tightening policies adopted by the Central Government.

1.2 Fiscal Position

The overall fiscal outturn in 2006/07 is now likely to be significantly better than the HK$5.6b surplus estimated in the 2006 Budget, with the improved state of the economy and consequently the increasing amount of revenue to be collected.

Fiscal reserves stood at HK$288.7 billion on 31 October 2006, compared with HK$264.5 billion as at 31 October 2005. Prior to the recent upward revision in the GDP forecast, the government forecast that the reserves would stand at HK$306.3 billion by end-March 2007, representing 15 months’ of government spending. It is likely that this figure will now be higher.

As at 30 November 2006, the foreign currency reserves held by the Exchange Fund stood at US$132.7 billion compared with US$122.4 billion at 30 November 2005. Hong Kong remains the world’s seventh largest holder of foreign currency reserves, after Mainland China, Japan, Russia, Taiwan, Korea and India.

1.3 Structural Deficit

In February 2002, the Task Force on Review of Public Finances identified changes that had occurred on the revenue and expenditure side of the budget and concluded that Hong Kong was facing a structural fiscal problem. On the expenditure side, the cumulative growth of government expenditure in nominal terms started to outstrip growth in the economy from 1993-94 and the gap widened from 1997-98 onwards. This, coupled with the aging of the Hong Kong population, which meant that there would be increasing demand for social security payments, prompted the Secretary for the Treasury to state: “the directions indicate that the continuation of current revenue and expenditure policy is not an option”. The Task Force recommended that the first priority was to control the growth of government expenditure. On the revenue side the Task Force recommended that the government should consider the recommendations of the Advisory Committee on New Broad-based Taxes.

Since the Task Force released its recommendations, there has been a significant improvement in the economy, which, in 2005/06 resulted in a surplus of HK$14 billion in the consolidated account, compared with a 2005 budget forecast of a deficit of HK$10.5 billion. Also in 2005/06, for the first time since 1997/98, both the operating account and the consolidated (overall recurrent and capital) accounts were in surplus. On the basis of forecast growth of 4%, the government anticipates achieving surpluses in both accounts for the period to 2010/11.

Nevertheless, larger than projected land premiums and issuance of bonds by the government have been significant contributors to this turn around, which points to continuing reliance on potentially volatile sources of income. There remains
question, therefore, as to whether Hong Kong’s taxation system is able to generate sufficient revenues from stable sources in order to pay for a broad range of community services and major capital projects. At the same time, proper control over government expenditure must be maintained to ensure that revenues raised are utilised as efficiently and effectively as possible.

1.4 Summary of Proposals

A summary of the specific proposals contained in this submission is provided below.

Fundamentals - Clarity, consistency and certainty in the tax system

1. It is essential that priority be given to maintaining the elements of clarity, certainty and consistency in Hong Kong’s tax system. From our experience, the following areas can no longer be dealt with by Departmental Interpretation and Practice Notes (“DIPNs”) issued by the Inland Revenue Department (“IRD”) if clarity, certainty and consistency are to be maintained. To restore these key features of our tax system, areas of the Inland Revenue Ordinance (“IRO”) should be reviewed and amendments be introduced, in relation to:

- the source of employment income under section 8 of the IRO;
- the source of profits rules regarding, e.g. trading income and manufacturing profits under section 14, IRO; and
- counteracting the adverse effects of the decision CIR v Secan Ltd & Anor (“Secan”), as interpreted by the IRD, which could result in the taxation of unrealised profits in some circumstances.

On other particular issues, the IRD should issue DIPNs after consultation with the Joint Liaison Committee on Taxation. Assessors should follow the approach contained in the DIPNs so that taxpayers can safely rely on the published practice as an accurate reflection of the Department’s actual practice on the same matters.

2. The Institute supports the government’s decision to consult the public on broadening the tax base and a goods and services tax (“GST”) and still considers that GST should remain an option for broadening the tax base. However, other possible options that should be considered include reviewing personal allowances; introducing a land and sea departure tax and making more use of existing broad-based sources of revenue, such as rates on tenements. The Institute will consider the different options in a separate submission on the government’s consultation document, “Broadening the Tax Base Ensuring Our Future Prosperity – What’s the Best Option for Hong Kong?”
3. The implementation of the “Assess First, Audit Later (“AFAL”)” approach by the IRD has, in practice, led to increased uncertainty amongst taxpayers because their tax affairs may not be concluded for any particular year of assessment until the completion of the statutory time limit of six years. This needs to be addressed. Taxpayers should be entitled to timely resolution of their tax affairs for each year and thus a reasonable and certain time limit for undertaking the "audit" should be prescribed in the IRO.

4. To provide more certainty to businesses, the time for re-opening tax affairs under section 60 of the 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 Department and the taxpayer can object to it if he or she does not agree to it.

6. Spouses should be able to elect individually for personal assessment and not have to be jointly assessed.

7. The areas of uncertainty referred to in points 3 - 6 above should be resolved by amending the IRO.

Opportunities – Strengthening Hong Kong’s competitiveness

8. We reiterate certain proposals made in the Institute’s previous budget submissions to introduce measures to enhance Hong Kong’s competitiveness as a location for regional offices, service centres and group companies. These include the following:

- 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;
- group relief should be introduced; and
- losses incurred in the current year of assessment should be permitted to be offset against the assessable profits of one previous year.

9. An 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.
10. To support the development of a knowledge-based economy and a focus on value-added services, Hong Kong’s tax law should allow for:

- deductions for the cost of acquisition of trademarks and copyrights generally, not only patents;
- 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;
- tax credits for any foreign tax paid on the royalty income concerned;
- depreciation allowances for intellectual property.

11. In view of the improvement in the economy, the corporate profits tax rate should be reduced by one percent to 16.5% and the rate for unincorporated business should also be reduced by one percent to 15%.

12. 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 wellbeing, 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.

13. To reduce the tax burden on middle-income earners, who pay at the higher marginal rates of taxation, the salaries tax bandwidth should be increased from HK$30,000 to HK$35,000, i.e. back to the threshold applicable in 2002/03. There should be a mechanism to ensure that the salaries tax bandwidth is adjusted for inflation. The progressive rates should also revert to their 2002/03 levels of 2%, 7%, 12% and 17%.

14. In view of the improving fiscal situation, the standard rate of salaries tax should be reduced by one percent to its 2002/03 level of 15%, in line with our proposal for unincorporated businesses. We do not propose any change in personal allowances in 2007/08, neither upwards, as this would take more people out of the tax net and further narrow the tax base, nor downwards, because there is no immediate need for more revenue. In any case, the issue of the narrowness of the tax base needs to be considered with a view to finding long-term solutions and not on a year-to-year basis.

15. The study referred to in paragraph 12 above, should also include salaries tax rates and personal allowances within its scope.
Community – Building a stronger community and fostering stability

16. 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. At the same time, the government needs to be accountable for the services that it provides and should examine how services can be delivered more efficiently.

17. The Institute supports the idea of a proposed "product eco-responsibility law", which the government has indicated will be put forward to provide a legislative framework for regulations implementing various recycling measures.

18. In past submissions, the Institute has advocated that more be done to improve the environment. We hope to see more tax initiatives, aimed at promoting and improving environmental awareness and protection including the reduction of cross-border air pollution. For example, energy conservation and sustainability in the design of new commercial and industrial buildings should be incentivised with tax concessions.

19. Government rent, like rates, should be deductible against property tax, to better reflect the actual expenses borne by landlords.

20. Individual property owners should be encouraged to enhance the environment, safety and value of older building stock by the provision of a building renovation allowance for the actual amounts spent on external renovation of old buildings, once every, e.g., 10-15 years, subject to a ceiling of, say, HK$100,000 per time. If the property is rented out, the deduction should be available under property tax on the net figure after deduction of the 20% allowance for wear and tear. If the property is owner occupied, it should be available under salaries tax or personal assessment.

21. Assistance by way of, e.g. more extensive loan or subsidy arrangements should be considered for students’ tuition fees.

22. The current deduction limit of HK$40,000 for self-education expenses should be increased to HK$60,000 to encourage salaries taxpayers to attend approved courses, given the increasing costs of many educational programmes.

23. To ensure Hong Kong’s financial markets remain competitive, the stamp duty on transactions in the stock of companies listed on the Hong Kong Stock Exchange should be reduced to 0.1%.

24. First-time purchasers of property for owner occupation should be given a stamp duty exemption, where the property consideration does not exceed HK$3 million.
25. In view of the increase in interest rates and property prices, the ceiling amount of home loan interest for which a salaries tax deduction can be claimed should be increased to HK$120,000. In general, the allowance should be reviewed periodically to take account of changes in the prevailing rate of interest and property prices.

26. To provide a more certain tax environment and further assist the service sector, we recommend that the deduction from salaries tax for professional membership subscriptions should be provided in law, instead of administratively. In addition, to help taxpayers keep abreast of the latest international developments, and enhance their 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.

Delivery of community services

27. As health expenditure is expected to continue to grow in the future, it is essential to determine how to maintain a financially sustainable public health care system over the long term. Therefore:

(a) The government should consider providing for a tax deduction / incentives for individuals investing in medical insurance or voluntarily setting aside monies in a fund for future medical expenses. The amount should be deductible upon contribution into a fund set up and independently administered for such purposes and taxed if taken out for non-medical uses. The maximum deduction could be capped at a fixed amount;

(b) consideration could also be given to adopting the “user pays” principle, to a greater extent, for non-essential medical services, such as non-emergency ambulance services.

28. 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.

DETAILED PROPOSALS

B.1 FUNDAMENTALS

1.1 The Need for Certainty – Tax Administration

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

In future, it is vital that we continue to give priority to maintaining the elements of clarity, certainty and consistency in our tax system, as Hong Kong faces increasing competitive pressures from other international cities in the region.

Unfortunately, in recent years, a significant degree of uncertainty has been introduced into the administration of the tax system as a result of various factors, including court decisions and IRD practices that stray from the published position. As a result, taxpayers and their representatives are increasingly unable to plan with certainty in relation to some fundamental areas, such as the source of employment income and the source of profits for profits tax purposes.

**Taxation of unrealised profits and losses**

Some uncertainties and inconsistencies have arisen following the decision of the Court of Final Appeal in *CIR v Secan Ltd & Anor* [2001] 1 HKRC 90-107 ("Secan"), which has had an impact on the policy of the IRD and the interpretation of the Inland Revenue Ordinance (Cap.112)("IRO").

In answer to concerns addressed to the government that on this matter, the IRD has expressed the view that the Secan case has not introduced any new principle, while quoting Secan as authority that unrealised profits can be taxed if they are recognised in the taxpayer’s financial statements. This runs counter to the well-established taxation principle that income or profit should not be taxed before it is "realised". Clearly, therefore, there is uncertainty in this area. The IRD has been quoted as taking the following position:

> "The accounting profession has seen fit, for certain items, to recognise a profit or loss before the item is sold. Such a profit or loss is recognised in the enterprise’s financial statements as the profit or loss of the period concerned. Such financial statements are meant to present a true and fair view of the enterprise’s profit or loss and financial position. The profit or loss so recognised should also form the basis for computing taxable profit or loss. Profits and losses are treated in the same way. Losses so computed can be used to set-off against other assessable profits of the enterprise, or be carried forward indefinitely."

We think the above statement does not duly consider the causes leading to recent changes in accounting principles and the consequences thereof.

In the last decade the accounting bodies in some overseas jurisdictions found it necessary to amend accounting principles in the light of the collapse of some major corporations in their domestic markets. Many of such amended accounting principles were incorporated into International Financial Reporting Standards ("IFRS") and adopted by the Hong Kong accounting profession, not because we have experienced similar collapses, but in order to preserve Hong
Kong as an international financial centre. By and large, the spirit of these accounting principles has been to reflect as far as possible the existing and contingent values of the assets and liabilities of an enterprise in its balance sheet, with the necessary adjustments included in the profit and loss account. In reflecting and measuring such values, some economic concepts have been used which are not consistent with tax law concepts.

For instance, the value of an asset may be revalued upwards because of changes in the economic environment in which the enterprise operates, even if the enterprise has carried out no sales at all during the accounting period. The increase in the value would then be included in the profit and loss account as profit. Under well-established tax principles, such profit is not taxable. However, in view of the statement quoted above, the IRD is suggesting that it may be taxable.

If the statement quoted above is meant to apply to all accounting treatments, it could lead to another interesting situation. Under new accounting principles, shares issued to employees as part of their salaries are treated as an expense in the profit and loss account. Pursuant to the above statement, this expense should be deductible in computing the company’s assessable profit; but the IRD denies taxpayers a deduction on the ground that such expenses are capital in nature.

Subordinating tax law to accounting principles may result in severe consequences. Accounting principles are developed by accounting bodies, which, though they are concerned with issues of public interest, are not immediately answerable to the general public. These principles are aimed at facilitating the provision by companies of general-purpose financial statements, which may be useful for the purposes of investment on an international basis. They do not, however, take into account issues of taxation, which in any case may differ from jurisdiction to jurisdiction and reflect the fiscal policy of a particular jurisdiction.

If Hong Kong tax is to be charged based on financial statements in the manner described in the above-quoted statement, to the extent that any IFRS (which are made, and ultimately subject to interpretation and amendment, by international bodies) are adopted in Hong Kong, the government is in effect deferring to such bodies its power of making and interpreting its law, as well as the power of determining how to charge tax, even though, as indicated above, the possible tax implications are not a factor that is taken into consideration when new IFRS are drawn up. This is a concern even though IFRS may be introduced in Hong Kong as Hong Kong Financial Reporting Standards (“HKFRS”). Although HKFRS are, in principle, subject to interpretation in Hong Kong, in practice the interpretation is likely to depend heavily on any interpretation that may have been given at the international level. Independent powers to make laws and determine the basis of charging tax are among the most important aspects of sovereignty. Hong Kong should not compromise on such powers.
The IRD’s approach to the Secan case ignores the basic principle, discussed above, that income should not be taxed until realised, and also does not recognise the fact that other jurisdictions where IFRSs have been adopted may have other measures in place that can help to mitigate the problems outlined above, such as provision for tax loss carry-back; this means that an unrealised profit that is taxed in a particular year may be offset by a loss carried back in subsequent years, if that profit is in fact never realised. We do not have such loss carry-back provisions in our tax system. (See also section 2.2.1 below on group relief, which is another measure that can help in this context).

The above concerns have been conveyed to the IRD by a number of business and professional bodies, including the Institute but, so far, no specific action has been proposed by way of response. Certainly DIPNs issued by an executive arm of the government, i.e. the IRD, cannot be a substitute for legislation to achieve clarity and certainty. Our legal system is founded on a clear segregation of powers between the relevant organs responsible for legislation, administration, and justice, represented by the Legislative Council, the Administration and the Judiciary, respectively.

The level of certainty in Hong Kong’s tax system needs to be enhanced in order to protect Hong Kong’s standing as an international financial centre, and, this includes making clear laws and also ensuring that the actual practices of the IRD, as reflected by individual assessors, are consistent with the IRD’s published practice in DIPNs.

**Source of profit and income**

It has been suggested that the areas of uncertainty regarding source of profit can be dealt with through DIPNs issued by the IRD. However, it is a fundamental concept of taxation law that those who administer tax laws should not also set the tax policy. The present situation where significant parts of the existing IRO give rise to uncertainties, which are supposedly dealt with by DIPNs, is not satisfactory. The IRD states that DIPNs do not purport to provide a binding interpretation for taxpayers or the IRD and, in fact, practitioners note that there has been an increasing and worrying trend in recent years for assessors to diverge from the published practice.

If DIPNs are to be meaningful and useful, taxpayers should be entitled to rely on them to provide a clear statement of the IRD’s practice, which should be consistent with the IRO, so that if the taxpayer adheres to the position in the DIPN, the taxpayer will have certainty as to the tax treatment afforded to him by the IRD. Unfortunately this is no longer always the case in relation to the fundamental area of the source of income and profit.

It may be pertinent that the current version of the explanatory note on the covering page of DIPNs no longer states unequivocally that the notes inside reflect departmental interpretation and practice, unlike the previous version. The explanatory note previously read as follows:


“These notes contain a summary of the Departmental Interpretation and Practice [our emphasis] and are issued for the information and guidance of taxpayers. They have no binding force and do not affect a person’s right of objection and appeal to the Commissioner, the Board or the Courts.”

It now reads:

“These notes are issued for the information and guidance of taxpayers and their authorised representatives. They have no binding force and do not affect a person’s right of objection and appeal to the Commissioner, the Board of Review or the Courts.”

In the case of DIPN 10 The Charge to Salaries Tax, for example, most taxpayers and their representatives accept that the existing DIPN 10 reflects the correct interpretation of the legislation and has in the past provided a fairly high degree of certainty. However, increasingly, officers of the IRD have not been following this practice note, suggesting, instead, that each case has its own facts, and applying uncertain and, at times, seemingly unrealistic tests – leading to an increasing lack of clarity in this area. This is particularly problematic where the practice that is apparently being adopted now is not consistent with that adopted previously in relation to the same case and, as a result, matters agreed previously are now being called into question.

Similar problems have arisen with regard to DIPN 21, Locality of Profits on the circumstances in which profits are chargeable to profits tax. The Institute has made comprehensive comments in relation to revisions to DIPNs 10 and 21.

Certainty by legislation

If the published practice cannot be relied upon to provide the necessary level of certainty in Hong Kong’s tax administration, this points to the need to legislate for greater clarity in key areas of our tax laws. It is clear that legislation to address perceived difficulties resulting from court decisions or other uncertainties can be introduced quite quickly, where it is considered necessary or desirable. When, for example, the decision on royalties in the case of Emerson Radio Corporation v CIR [1999] (1 HKRC 90-095) was handed down in favour of the taxpayer, amendments to the IRO were brought forward relatively quickly.

Against the above background, we consider it important for the restoration of certainty in our tax legislation that certain specific areas of the IRO be reviewed and amended as appropriate. These include:

(i) The determination of the source of employment income in section 8, IRO.

(ii) The clarification of the source of profits rules regarding, e.g., trading income and manufacturing profits in section 14, IRO.
iii) Legislation to correct the adverse effects of the Secan decision and the adoption of IFRSs, which have resulted in the taxation of unrealised profit, as explained above.

The Institute provided further details of these technical matters in a separate letter to the Financial Secretary (“FS”) dated 19 January 2006. We urge the FS to set up an ad hoc working group to review these and other problematic areas of the IRO, on a one-off project basis.

As an alternative to ad hoc committee, we believe the Joint Liaison Committee on Taxation (“JLCT”) could be given a specific mandate to undertake this review, identify areas of concern and propose draft legislation. However, if either the JLCT, or a separate, ad hoc working group, are tasked with identifying the legislative changes required, this must be supported by a firm commitment by the government to introduce the required changes to the IRO in a timely manner.

1.2 Hong Kong’s Narrow Tax Base

In July 2006, the government issued a consultation document on tax reform, entitled, “Broadening the Tax Base Ensuring Our Future Prosperity – What’s the Best Option for Hong Kong?” and launched a nine-month public consultation exercise.

As the Institute’s previous budget submission would suggest, we support the initiative to consult the public on this important subject. We note the announcement by the FS on 5 December 2006 that a goods and services tax (“GST”) will not be advocated as the only option for the remainder of the period of consultation on broadening the tax base. Nevertheless, we consider that a GST should remain one of the options for broadening the tax base.

Broad-based Tax Measures

In the 5 December 2006 announcement, the FS also invited the public to express views on other options, including those reviewed by the Advisory Committee on New Broad-based Taxes during its 2001/02 consultation.

The Institute has in the past recommended consideration of other possible measures to make greater use of existing broad-based taxes or help to broaden Hong Kong’s narrow tax base, including, increasing rates on tenements, reviewing personal allowances and introducing a land and sea departure tax.

Of these three options, consideration has been given in previous budgets to the reduction of personal allowances and the Boundary Facilities Improvement Tax, but only personal allowances have been reduced.

The Institute considers it would be appropriate for the FS to establish a basis for future adjustments of personal allowances (as suggested below) and to consider again the merits of introducing the Boundary Facilities Improvement Tax.
(a) Personal Allowances

The Advisory Committee concluded that, by international standards, personal allowances given to salaries taxpayers and other concessionary deductions were high in Hong Kong. In the past, increases in personal allowances when the economy was stronger also contributed to a narrowing of the salaries tax base. We note that, over the past few years, reductions in the basic personal allowance and the married person's allowance have been introduced to try to partly redress this situation. We suggest that a further review of personal allowances should be considered, which should include identifying an appropriate base year, so as to ensure that any future adjustments in the relevant allowances are in line with the changes in the economy, e.g. inflation, and that there is no further narrowing of the tax base.

(b) Boundary Facilities Improvement Tax

The Advisory Committee considered that a land and sea departure tax (subsequently referred to as the Boundary Facilities Improvement Tax) would provide a steady source of revenue for the public purse. In our view, such a tax would be equitable and there is a solid case for introducing it, provided it could operate in an administratively simple way and would not lead to delays at border crossings. We propose that the option of introducing this form of tax should be re-examined by the government.

(c) Rates on tenements

Rates currently represent a broad-based form of taxation and, as the collection mechanism already exists, there would be no significant administrative cost in raising more revenue through this means.

(d) Other options

Other reasonable options of existing or new broad-based taxes should also be considered and could be seen as part of a package of measures to help diversify the sources and stabilise the flow of revenue over the medium and long term.

The Institute will present further views on this question in its submission on the government’s consultation document on broadening the tax base.

1.3 Assess First Audit Later

In recent years the IRD has adopted a policy of tax collection, which is commonly known as “Assess First Audit Later (“AFAL”). Under this approach, an IRD assessor will either issue an assessment or a statement of loss based on the assessable profit or allowable loss contained in the taxpayer’s tax return, without undertaking any review of the tax return. The IRD then reserves the right to review this position for any time up to six years from the end of the basis period.
We consider that the legal basis of the AFAL approach is unclear and, even if there is a valid legal basis for the AFAL, the practice is unsatisfactory as a means of administering the tax system, as it creates fundamental uncertainty in that a taxpayer cannot be sure that his tax liabilities have been finalised at any given prior to six years after the end of a particular basis period. Such an approach is contrary to the concept of certainty. Even if there is a valid legal basis for the policy of AFAL, taxpayers should be entitled to timely resolution of their tax affairs for each year and thus a reasonable time limit for undertaking the "audit" should be included in the IRO (e.g., one year after the issuing of the assessment). We addressed this concern in more detail in a letter to the FS dated 19 January 2006.

1.4 Proposal for shortening Hong Kong’s time-bar provisions

Certainty and predictability are important factors for business and time is often of the essence. Hong Kong’s current provisions for re-opening tax affairs create considerable uncertainty for businesses trying to finalise their tax affairs. This is also a major factor in exacerbating the uncertainty for taxpayers arising from the AFAL approach adopted by the IRD. We consider that shortening the period for re-opening tax affairs under Hong Kong’s statutory provisions would provide additional encouragement to businesses that are currently operating, or are considering operating, in Hong Kong.

Section 60 of the IRO currently allows IRD assessors to raise additional assessments within six years from the end of the year of assessment, which can be further extended to 10 years in cases of fraud. In contrast, the corresponding timeframes in various other jurisdictions for the re-opening of tax affairs tend to be relatively shorter. Some examples are set out in the Appendix.

Given the number of developed and developing jurisdictions that currently offer more favourable (i.e., shorter) timeframes for re-opening tax affairs, we feel that Hong Kong should similarly reduce the period for re-opening assessments from six to three or four years. This should be subject to an extension to 10 years in cases of fraud, as is currently the situation.

1.5 To provide for statutory right to appeal against a statement of losses

Currently a statement of loss issued by the IRD is legally not an assessment. It is not binding upon the Department and the taxpayer cannot object to it. Legally it has no status. This creates uncertainty for taxpayers, as they cannot be sure whether the loss in question is available for setting off against their profits for future years. We recommend that legislative changes be made so that a loss is treated as an assessment, is binding upon the Department and the taxpayer can object to it if he is not agreeable to it. This will not create additional workload to the IRD or loss of government revenue.

1.6 Elections for personal assessment

Currently spouses must jointly elect personal assessment. For profits tax, property tax and salaries tax, spouses may be separately assessed and taxed.
We see no reason why spouses must jointly elect personal assessment and be jointly assessed.

1.7 Technical amendments to the IRO

We believe that the above areas of uncertainty should be resolved by technical amendments to the IRO. Simply leaving these matters to be dealt with by DIPNs is not a satisfactory solution and, as experience has shown, can contribute to the level of uncertainty.

B.2 OPPORTUNITIES

2.1 Hong Kong as a Regional Base

2.1.1 Tax exemption for management fees received from overseas associates

There has been a trend of globalisation whereby jobs have moved to locations with very low labour and land costs. The costs of land and labour in Hong Kong are significantly higher than those in many neighbouring locations and, therefore, low-skilled jobs have moved from Hong Kong to other areas. Hong Kong remains competitive, however, in relation to, for example, the provision of regional service centres, by virtue of its infrastructure and human resources, including good legal and financial systems, and its well-trained professionals.

As a result of globalisation, most multinational corporations need to set up regional service centres to manage their production and finance in designated regions. Such regional service centres usually create job opportunities for accountants, lawyers, computer professionals and bankers, as well as demand for office space and residential properties in the city where such centres are set up. Hong Kong has a sizeable population of such professionals and a well-developed physical infrastructure.

In this highly competitive environment cost efficiencies are important. Overall tax costs and benefits are certainly an important factor when selecting the location of a regional service centre.

We therefore reiterate our proposal for a full exemption from profits tax to be granted to regional headquarters/offices in Hong Kong in respect of management and consultancy income derived by the Hong Kong entity from associated entities overseas. This would encourage the establishment of regional headquarters in Hong Kong and create jobs for professionals and others.

It is recognised that anti-avoidance provisions would be required to prevent abuse of this relief and this could be provided for by ensuring that the term “associated entities overseas” was suitably defined, for example, by reference to the common beneficial ownership of at least 50% in each of the companies that charges/pays the management or consultancy fees.
2.1.2 Tax exemption for interest received on loans made to overseas associates

As submitted in the preceding point, a regional service centre usually handles the financial management of other associated companies in the region. Hong Kong is well equipped to provide such services by virtue of its first-rate banking system and well-trained professionals. Yet financial margins are usually thin and counted in terms of decimal places. Hence tax costs and benefits here again will be highly relevant in the selection of suitable regional service centres.

Currently section 15(1)(f) of the IRO deems the interest derived by a corporation on loans made to its overseas associates to be subject to profits tax at 17.5% if the provision of credit is made in Hong Kong. While, in practice, group companies may arrange for the provision of inter-company credit to be made outside of Hong Kong, we believe that if the interest received by regional offices from loans made in Hong Kong to their overseas associates were to be exempted from profits tax, this would provide a further incentive for international businesses to establish their treasury function in Hong Kong. This in turn would benefit the development of the financial services sector in Hong Kong.

As in the case of the proposal at item 2.1.1, above, similar anti-avoidance provisions may also need to be considered here.

We note the government’s response of 22 February 2006 to this proposal in the context of the Institute’s 2006/07 budget submission, that taxation is only one of the factors considered by corporations in deciding the location for their regional headquarters and that, given the already relatively low tax rate, source-based and simple tax regime, it is not proposed to offer the tax concession suggested. Nevertheless, we recommend that the government conduct a study and survey to ascertain the priority of this factor when multinational corporations are selecting a location for a regional service centre.

2.2 Utilisation of Tax Losses

2.2.1 Group Relief

The offset of losses by companies within the same group, commonly known as "group relief", is common in many developed tax jurisdictions and we have, in a number of previous submissions, advocated that some form of group relief should be introduced in Hong Kong.

The Institute has previously proposed the introduction of group loss relief provisions in, e.g. its Budget Proposals 2006/07. In its response, the government suggested that group loss would come at a heavy cost to government revenue, and is prone to abuse and would also entail complex legislation.

Group relief systems have been successfully implemented in a number of developed tax jurisdictions in Asia, including Singapore, Australia, Japan, Malaysia, as well as in the United States, the United Kingdom and some European countries. We are not aware of any evidence of widespread abuse in these jurisdictions. It is noted that, for example, the UK and Singapore have a common
ownership requirement of 75%. It is considered that the Institute’s proposal for common ownership of 90%, coupled with the safeguards against possible abuse available under, e.g., sections 61 and 61A of the IRO, should be sufficient to prevent abuses.

Given the IRD’s interpretation of the decision in Secan (see section B1.1, above), which means that unrealised profits (e.g., a nominal profits on a hedging arrangement) may be subject to profits tax, even though they have not been received until a later period, or not received at all, the need for group relief has become more apparent. As indicated in section B1.1, above, we believe that the taxation of unrealised gains runs counter to accepted principles of taxation law in Hong Kong and, if legislation to minimise the more unfavourable implications of the decision in Secan is not introduced, there will be inequity in the tax system. The adoption of group relief in Hong Kong would at least enable unrealised gains, in principle, to be offset by losses incurred by other group companies.

2.2.2 Loss carry-back

The IRO currently allows losses incurred in one fiscal year to be offset against profits for subsequent years without limits on the amount and number of years. However the law does not allow the loss incurred in one year to be offset against profits for any prior year. This potentially creates an inequitable tax result: A company cannot obtain any refund of tax that it has paid on profits made in earlier years where it makes losses in subsequent years and, in the extreme case, a business could end up paying tax although it made an overall loss during its lifetime.

Even though the business may offset the loss in subsequent years, the economic value of the loss to the business is diminished, bearing in mind that a business usually needs more cash in a year in which it makes a loss than in a year when it is profitable.

Given again the interpretation of Secan, an unrealised gain in investments, for example, which is required to be reflected in the profit and loss account, could be taxable, even though ultimately no gain is realised at all. While, in principle, unrealised losses may also be set off against other profits or carried forward, where a business does not have other profits, and fails to make a profit in subsequent years before ceasing business altogether, it will not be able to set off the unrealised losses, even though it may previously have been taxed on its unrealised gains. This is inequitable.

We do not agree with the government’s previous response to the proposal for loss-carry-back arrangements, that introducing such provisions would come at a heavy cost to government revenue. To control the cost to government revenue the amount that could be carried back could be capped and period of carry back could be limited to one year only.

Loss carry-back has been adopted by many countries with advanced taxation systems. Amongst the most notable of these are Germany, Japan, the United States and the Netherlands.
2.3 Promotion Hong Kong as Two-way Platform for Doing Business with the Mainland and Other Markets

2.3.1 Tax Relief on Withholding Tax

The current tax law contains provisions for Hong Kong taxpayers to offset Hong Kong profits tax against overseas withholding taxes paid in those countries with which Hong Kong has concluded arrangements for the relief of double taxation. However, Hong Kong has so far only concluded three double taxation agreements (“DTAs”) with the Mainland, Belgium and Thailand and, therefore, tax credits can only be claimed for withholding taxes paid in the Mainland, Belgium and Thailand. Only limited relief is available for Hong Kong taxpayers on withholding taxes paid in those countries that do not have a DTA with Hong Kong. In such cases, a deduction is available to the Hong Kong taxpayer when the overseas tax is an expense, which must be borne regardless of whether a profit is derived (e.g., withholding taxes). With our current tax rate standing at 17.5%, this in effect leaves 82.5% of the withholding tax paid not relieved. Hence, such relief does not fully alleviate the taxpayer from double taxation where the income on which the withholding tax was levied is also subject to tax in Hong Kong (e.g., interest, royalties, and service/management/technical fees).

In the light of the government’s commitment to create a network of DTAs with various countries, and as part of our proposal to enhance Hong Kong as a regional services centre and knowledge-based economy, we propose that the current problem of double taxation of income that is deemed to be sourced in Hong Kong, and which also suffers withholding tax in another (non-DTA) jurisdiction, be addressed by introducing a unilateral tax credit in Hong Kong for the amount of foreign withholding tax paid up to a maximum of 50% of the Hong Kong profits tax payable.

2.3.2 Trading in Hong Kong and Processing Agreements in the Mainland

Many manufacturers in Hong Kong have relocated their manufacturing base to the Mainland over the last two decades. For these manufacturers, Hong Kong may serve as a sales and/or finance centre.

Typically, these Hong Kong manufacturers may have entered into a processing or assembly arrangement with a Mainland entity. Under a processing and assembly agreement, the Mainland factory owner agrees to provide processing and/or assembly services to the Hong Kong manufacturer at the factory premises in the Mainland in exchange for a processing fee. The factory owner typically undertakes to provide the factory premises, utilities and labour. The Hong Kong manufacturer, on the other hand, typically agrees to supply everything else necessary to the production of the finished goods, such as raw materials, designs, plant and machinery, training, production and management skills. Normally, the purchase of raw materials, as well as the development of design and technical know-how are carried out in Hong Kong. Finished products are normally exported to the Hong Kong manufacturer who sells them, with negotiations and sales transactions principally conducted in Hong Kong. All processing fees and
manufacturing expenses will be absorbed in calculating the income from the subsequent sales.

According to DIPN 21, where the Hong Kong manufacturer retains the management and control of the offshore processing operations, a 50/50 apportionment basis applies to income earned by the Hong Kong manufacturer on the sale of goods. This concession offers a simple approach to resolving the question of whether manufacturing operations in the Mainland should or should not be considered to be more immediately responsible for the generation of sales income. The IRD limits the application of this concession to certain specific legal forms of processing arrangements. In practice, however, for reasons other than tax considerations, the actual form of the arrangement between the Hong Kong company and the Mainland manufacturer may sometimes vary from the arrangement described above.

We believe that not only is there a need for the IRD to be more flexible in relation to the issue of processing agreements in the Mainland but, furthermore, that the difference in treatment between so-called “contract processing” and “import processing” is not supported by the case law (CIR v Hang Seng Bank Ltd. (1972) 1 HKTC 583). The IRD should consider whether in substance, in respect of the Hong Kong entity, a particular arrangement can essentially be regarded as processing agreement or offshore manufacturing arrangement. If this is the substance of the set-up then we would suggest that the Hong Kong entity involved should be eligible for a 50/50 apportionment of profits tax. This would also take into account the changing practice in the Mainland where in practice it has been getting increasingly difficult to set up processing agreements in the form envisaged by DIPN 21.

With a rapidly improving business environment, including banking facilities and telecommunications, in the Mainland, the need for manufacturers to maintain a sales and/or finance office in Hong Kong is diminishing. Coupled with increasing competition from neighbouring jurisdictions by way of favourable tax legislation, Hong Kong is facing a real threat of losing its status as a centre for the sales/finance office function. If these functions cease to be undertaken in Hong Kong, this is also likely to have a negative impact on the local logistics industry.

2.4 Promoting Intellectual Property Development

Consistent with Hong Kong’s development as a knowledge-based economy and with the increasing focus on value-added services, the Institute proposes that the tax concessions in relation to intellectual property under the IRO be extended. The concessions under sections 16E and 16B should be reviewed to establish a tax framework that would make Hong Kong more attractive as a centre of intellectual property development. This should include providing for:

- deductions for the cost of acquisition of trademarks and copyrights generally, not only patents;
• deductions for the interest expenses incurred (for the period before the 
relevant property is used to produce assessable profits) in financing the 
aquisition of trademarks and copyrights generally, not only patents;

• tax credits for any foreign tax paid royalty income;

• depreciation allowances for intellectual property.

Suitable anti-avoidance provisions may also need to be considered.

2.5 Profits Tax Rates

In 2005/06, the consolidated budget surplus was revised upwards from an 
estimated HK$5.6 billion at the time of the 2006 Budget Speech to a final figure of 
almost HK$14 billion. This, and the projections for continuing growth, justify a 
reduction in the rate of profits tax back to, or closer to, those prevailing in 2002/03, 
before the rates were increased on the back of a series of fiscal deficits. We 
propose, therefore, that the corporate profits tax rate be reduced by one percent 
from 17.5% to 16.5%, and the rate for unincorporated businesses also be cut by a 
similar amount from 16% to 15%.

Furthermore, the Institute notes the international trend towards lowering the rate 
of corporate taxes as reflected in the government’s consultation document, 
“Broadening the Tax Base Ensuring Our Future Prosperity – What’s the Best 
Option for Hong Kong?” A table, extracted from the consultation document, 
reflecting the changes in various jurisdictions, is reproduced at Appendix 2.

Against this background, we believe that it is necessary to research the longer-
term trends. To this end, we suggest that the government conduct a study, 
which should include international comparisons, with a view to reducing profits tax 
rates over a period, and securing Hong Kong’s competitive position. Due 
consideration will need to be given to the following, amongst other factors:

• The fiscal position.

• The international trend.

• The effective tax rates, not merely the published rates, in competing 
jurisdictions, particularly for industries that are vital to Hong Kong’s 
economy, e.g. service industries.

The study should also consider whether there is any continuing justification to 
retain the differential between the profits tax rate for corporations and that for 
unincorporated businesses.

2.6 Salaries Tax Rates

In view of the substantial surplus for 2005/06 and increases in price levels, it is 
proposed to reduce the tax burden on middle-income earners by increasing the 
salaries tax bandwidth for the marginal rates from HK$30,000 to HK$35,000 and
reducing the top two marginal rates from 19% and 13% to 17% and 12%, respectively. This will bring the bandwidths and marginal rates back to their 2002/03 levels. The standard rate of salaries tax should at the same time be reduced by one percent from the present 16% to 15%, also the 2002/03 level.

The study proposed above in relation to profits tax should also cover salaries tax and personal allowances as well and the long-term aim should likewise be to reduce the burden of personal direct taxation. Hong Kong’s system of taxation must remain competitive in all respects with other major financial and business centres around the world and we cannot afford be caught unawares or overtaken by other jurisdictions, which may be more intent on change and advancement.

B.3   COMMUNITY

3.1 User Pays Taxes – Charges and Levies

We propose that a detailed review of the level of duties and fees levied by the government should be undertaken and that, as far as possible, the “user pays” principle should be adopted. It is reasonable, in principle, that fees and charges should be reviewed regularly and brought into line with changes in the price index, and that the public should have a greater appreciation of the real costs of providing the relevant services. However, the quid pro quo should be a high degree of transparency and accountability on the part of the government in relation to its costs, and a willingness to examine possible means of delivering services more efficiently and economically.

3.2 Environmental Taxes

The 2006/07 Budget Speech acknowledged the need to enhance public awareness of environmental protection and that the adoption of fiscal measures and the “polluter pays” principle may help to achieve that objective. The Chief Executive also emphasised in the Policy Address that priority should be given to fighting pollution. The Institute fully supports priority be accorded to this area and has been advocating greater awareness and more co-ordinated action on a domestic and cross-border basis for some years.

We support the announcement regarding the government’s municipal solid waste management strategy, with its proposals for the introduction of charges on solid waste through legislation to be introduced in 2007.

While those proposals, once implemented, may serve as an effective encouragement to help minimise certain types of waste, the Institute believes that consideration should be given to applying the “polluter pays” principle more generally, and to the introducing some of following additional forms of environmental protection measures as part of a co-ordinated environmental policy:

- Emission taxes.
- Taxes on polluting inputs.
- Credits for emission reduction.
• Permits to emit a specified amount of a pollutant.
• Targeted public sector procurement policies.

More specific measures could embrace, for example:

• A comprehensive review of fuel duties.
• Electronic road pricing.
• Air and water pollutant taxes.
• Taxes in respect of the disposal of plastics, glass, batteries and vehicles.
• Taxes on polystyrene foam and plastic bags or other non-biodegradable matter.
• A refund system to encourage recycling.
• Carbon and energy taxes (on electricity, coal, gasoline, etc.) and other resource consumption taxes.
• Refund mechanisms to reward the control of pollutants and efficient use of energy.
• Imposing a green tax on motor vehicle ownership and non-biodegradable products.

In addition, tax incentives, such as accelerated depreciation allowances, or deductions in excess of 100%, could be offered as incentives. Possible measures include:

• concessions for investment in, and spending on, environmental protection equipment, machinery or systems;
• grants (such as low/no interest loans) to small and medium-sized enterprises (SMEs) which have insufficient capital to acquire environmental protection equipment, machinery or systems;
• incentives for energy conservation measures, e.g:

  ➢ New industrial and commercial complexes adopting approved environmentally sustainable designs could be given additional commercial building or industrial building allowances, for example:

<table>
<thead>
<tr>
<th></th>
<th>Initial Allowance</th>
<th>Annual Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Existing</td>
<td>Proposed</td>
</tr>
<tr>
<td>Industrial Building</td>
<td>20%</td>
<td>25%</td>
</tr>
<tr>
<td>Commercial Building</td>
<td>NIL</td>
<td>25%</td>
</tr>
</tbody>
</table>
Expenditure on the installation of energy efficient systems for old buildings such as double-glazing and solar energy, could be given a 150% deduction in the year of expenditure. Any potential disincentives to such spending should also be reviewed and addressed as far as possible.

**Cross-border pollution**

More radical measures, and a change in mindset, may be required, as the air pollution in Hong Kong and the Pearl River Delta, generally, has reached an intolerable level. This is already affecting the business environment, with fewer key staff being willing to transfer here with their families and others leaving or considering whether or not to stay. It would be a mistake, with potentially major consequences, to think that efforts directed towards environmental improvement come at a too high a cost to economic development. Looking beyond the short-term, the two must go hand in hand and both are essential elements of sustainable growth, which ought be our legacy to future generations.

There is clearly pressing need to work closely with the Mainland authorities to take practical steps to alleviate the situation. If fiscal measures in Hong Kong can be of any assistance in these efforts, they should be considered, in order to facilitate the long-term sustainable development of the region and to protect public health on both sides of the border.

### 3.3 Property Tax

#### 3.3.1 Deduction for government rent

Property tax is currently levied on the owner of land and/or buildings situated in Hong Kong (“the landlord”), at the rate of 16%, for the 2006/07 year of assessment, on the “net assessable value” of the property. “Net assessable value” is defined as the consideration payable to the landlord in respect of the right of use of the land and/or buildings, less any rates paid by the landlord and an additional allowance equal to 20% for deemed repairs and outgoings.

While the IRO provides for a specific deduction for rates paid by the landlord against the net assessable amount subject to property tax, no specific deduction is granted for the government rent levied on landlords by the government. We propose that section 5(1A) of the IRO be amended to allow a specific deduction for government rent in the calculation of the net assessable value subject to property tax. This will help to provide reasonable deductions for actual expenses incurred by landlords for property tax purposes.

#### 3.3.2 Building renovation allowance

Quite a number of residential buildings in Hong Kong are aging and require renovation and refurbishment. For private landlords, the flat-rate deduction of 20% from the rent received for wear and tear may be adequate to cover minor renovations, but is not sufficient to cover major refurbishment or rehabilitation work that may need to be carried out periodically on older buildings. We would suggest, therefore, that a separate building renovation allowance be introduced in
respect of actual amounts spent on external renovation of old buildings, once every, e.g., 10-15 years, subject to a ceiling of, say, HK$100,000 per time. This would serve a public interest purpose by encouraging individual property owners to enhance the value and safety of buildings.

3.4 Self-education Expenses

3.4.1 Carry forward of expenses incurred

Currently, the deduction for self-education expenses is available in respect of amounts actually paid in the year of assessment, irrespective of the period to which it relates. However, it should be noted that, in practice, self-education expenses are often paid in a year of assessment where the salaries tax payer may not have any significant taxable income against which to offset the relevant expenses, particularly if the course involved is a full-time course, or if the person involved is unemployed at the time. It is proposed, therefore, that such expenses should be able to be carried forward for up to three years, so that they may be claimed at a later date when the taxpayer concerned may be receiving sufficient income to be subject to salaries tax.

3.4.2 Higher education assistance to students

A review of the system is needed in relation to students’ tuition fees. While it is noted that parents can claim child allowances for children who are still studying, up to the age of 25 years old, these cover only living expenses.

Education costs in Hong Kong are comparatively high in the region and we understand that a lower proportion of students go on to tertiary education in Hong Kong than in a number of other jurisdictions in this region (e.g., Singapore and Malaysia). Consideration should be given to providing more assistance for students’ tuition fees and other education costs. While loans are already available for low-income families, more extensive student loan arrangements are available elsewhere, e.g., in Australia and the United Kingdom. Students are required to repay the loans only when they start to earn a sufficiently high employment income. It is also noted that, for example, the Macau Government has started a substantial subsidy programme for student tuition. The system should be reviewed in Hong Kong to facilitate loans to students for tuition and other education costs. Repayment of these loans could, for example, be required once a working graduate’s income reaches a certain level, and tax deductible if the graduate repays voluntarily at income levels below that threshold.

3.4.3 Increase in relief

In line with the increasing costs of educational courses, we would reiterate our proposal that the current limit of HK$40,000 for self-education expenses be increased to HK$60,000, to encourage salaries tax payers to attend approved courses, including relevant undergraduate, postgraduate, professional training and language courses. In response to the Institute’s Budget Proposals 2006/07, the government indicated that, with the average claim at $13,000, it does not see the need to enhance the deduction ceiling for self-education expenses in 2006/07.
We believe that some clarification is needed of the basis for this figure of $13,000, as averages can be misleading. While many professionals, for example, may claim only HK$10,000 or less for continuing professional development-type courses, students can quite easily run up costs of HK$100,000 or more, but are able to claim only HK$40,000 in relief. It would be useful to know how many claims exceed HK$40,000. Furthermore, if the average of HK$13,000 is representative of the majority of claims, then increasing the amount will help needy students without any meaningful loss to government revenue.

3.5 Stamp Duty

3.5.1 Stock transactions

Progressive reductions in the stamp duty on transactions in company stocks were introduced in the late 1990s through to 2001. In order to ensure that Hong Kong’s stock market remains competitive, this process should continue. Furthermore, we believe that reducing the stamp duty will not necessarily result in significantly less revenue from this source, as the number of transactions executed in Hong Kong, rather than overseas, would be likely to increase. We recommend that the duty should be reduced to 0.1%.

3.5.2 Immovable Property

Given the increasing price of property in Hong Kong since 2003, and the difficulty faced by young first-time buyers to get on foot on the ladder, we propose a stamp duty exemption for first-time purchasers for owner-occupation, where the property consideration does not exceed HK$3 million. The proposed exemption should not apply where either the consideration for or the market value of, the property exceeds HK$3 million. We believe that this measure will help young and middle-income families gain entry into the private property market.

3.6 Mortgage Interest

We are pleased to see that the mortgage interest deduction period has been extended to 10 years, in line with a proposal in the Institute’s 2006-07 budget submission. As a longer-term measure, consideration should be given to removing the restriction on the period for which a salaries tax deduction can be claimed for home loan interest.

In view of the increase in interest rates and property prices in recent years, the ceiling amount of interest for which a salaries tax deduction can be claimed should be increased to HK$120,000. Although, we do not propose increasing the ceiling further at this time, as this would benefit primarily the better off, in general, the allowance should be reviewed periodically to take account of changes in the prevailing rate of interest and property prices.

3.7 Deductions for professional membership subscriptions

To provide a more certain tax environment and to further assist the service sector, we recommend that the deduction for professional membership subscriptions
should be provided for under the IRO, and not merely as a matter of administrative discretion or concession. This deduction should be allowed for all professional membership subscriptions, and not only as is currently allowed, subject to a ceiling of HK$12,000 in aggregate per annum, if obtaining and maintaining the relevant memberships helps a taxpayer keep abreast of and enhance his knowledge and his employability. This change will also provide the following benefits:

(i) It will help enlarge the membership of many professional associations, which will, in turn, help invigorate those associations for the benefit of Hong Kong industries.

(ii) As many professional associations are international in scope, participation in the activities of professional associations helps improve the international exposure of Hong Kong professionals, and is one type of self-education for them.

(iii) As most professionals are middle-income earners, the proposed deduction can also help relieve the middle class tax burden.

B.4 DELIVERY OF COMMUNITY SERVICES

4.1 Public Health Care

Against a background of an aging population, advances in medical technology and rising community expectations, health expenditure is expected to continue to grow in the near future, a trend in line with other advanced economies. It is, therefore, critically important to determine how to maintain a financially sustainable public health care system over the long term. One option would be to adopt the “user pays” principle for health care services above the basic level, e.g., for ambulance services other than in emergency cases.

The government should consider providing for a tax deduction / incentives for individuals investing in medical insurance, or voluntarily setting monies aside in a fund for future medical expenses. The amount should be deductible upon contribution into a fund set up and independently administered for this purpose and taxed if taken out for non-medical use. This would also help the investment management industry in Hong Kong, in a similar way to the mandatory provident fund scheme ("MPF").

The maximum deduction could be capped at a fixed amount and any amounts that were subsequently taken out for purposes other than medical could be subject to tax.

It is suggested the government should set up a task force to determine what form the incentives should take in order to be attractive enough to encourage more people to move away from relying on public medical healthcare towards private healthcare. Issues such as whether the incentives should be extended to individuals who finance the medical insurance/funds for their non-working
dependent family members; how the incentives could be recouped if monies were taken out from the investment funds for other reasons, etc. would need to be discussed. There should also be a public consultation exercise.

Other factors, e.g., whether the fund should be separately administered in a similar way to the existing MPF, but as a non-mandatory fund, would need to be considered carefully.

4.2 Privatisation of Government Services

In accordance with the principle of “big market, small government”, it is the objective of the government to encourage free competition and create business opportunities for the economy. In general, the government should not compete with the private sector in providing services to the public and, wherever possible, the government should consider privatising services and allowing them to operate on a commercial basis.

The beauty of privatisation of government services is to let the market drive the relevant services and enable them to operate in a cost-effective, customer-oriented and more flexible manner. The performance of the services could also be measured more accurately in terms of costs and benefits.

The government should continue reviewing its existing services and monitoring the market conditions to decide which services could be privatised, and the most appropriate time for doing so.

Hong Kong Institute of Certified Public Accountants
December 2006
### Appendix 1

<table>
<thead>
<tr>
<th>Countries</th>
<th>Timeframe for re-opening tax affairs</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>Three years from due date of tax return, or the date of filing, whichever is the later. (Unlimited timeframe where no return filed, or a false or fraudulent return is filed with the intent to evade tax.)</td>
</tr>
<tr>
<td>Canada</td>
<td>Four years from date of original notice of assessment, except in certain circumstances when the period can be extended to seven years (e.g., where the taxpayer has exercised their statutory right to carry back an amount (e.g., tax losses or foreign tax credits) to a prior year return). In cases of fraud or misrepresentation due to neglect, carelessness, or wilful default, a taxpayer’s tax affairs can be re-opened at any time.</td>
</tr>
<tr>
<td>New Zealand</td>
<td>Four years after the end of the year in which the tax return is filed. (Unlimited timeframe for omitted income, fraudulent or willfully misleading returns.)</td>
</tr>
<tr>
<td>Australia</td>
<td>Four years after the end of the year of assessment. (Unlimited timeframe where there is an avoidance of tax due to fraud or evasion.)</td>
</tr>
<tr>
<td>Mainland China</td>
<td>Three years from the end of the year of assessment (for revising the amount of tax assessed where an error has been made by the tax authority). Five years from the end of the year of assessment (for revising a return where a “computational type” error has been made by the taxpayer). Unlimited timeframe for returns involving tax evasion or fraud, or where no return has been lodged.</td>
</tr>
<tr>
<td>Taiwan</td>
<td>Five years after the return has been accepted as final. (Seven years after the due date for filing a return where a return has not been filed or taxation has been evaded due to fraud.)</td>
</tr>
<tr>
<td>Thailand</td>
<td>Five years after the date of filing of a return. (Ten years after the due date for filing a return where a return has not been filed.)</td>
</tr>
<tr>
<td>Philippines</td>
<td>Three years after the date of filing of a return. (Ten years in cases of false and fraudulent returns or failure to file a return.)</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Five years and ten months after the end of the tax year (for the tax authorities to make an assessment in the absence of a self-assessment), or 22 months after the end of the tax year (for amending a self-assessment). In cases of fraud or negligence, the timeframe for re-opening tax affairs is extended to 20 years and 10 months.</td>
</tr>
<tr>
<td>South Africa</td>
<td>Three years after the date of the assessment. (Unlimited timeframe for cases of fraud, misrepresentation, or non-disclosure of material facts.)</td>
</tr>
</tbody>
</table>
### Appendix 2

#### Comparing corporate tax rates between Hong Kong and other economies

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>2000 Company Profits Tax Rate</th>
<th>2005 Company Profits Tax Rate</th>
<th>Change in percentage points</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD</td>
<td>33.6%</td>
<td>29.8% (2004)</td>
<td>-3.8</td>
</tr>
<tr>
<td>European Union</td>
<td>about 35%</td>
<td>about 25%</td>
<td>about -10</td>
</tr>
<tr>
<td>South Korea*</td>
<td>30.8%</td>
<td>27.5%</td>
<td>-3.3</td>
</tr>
<tr>
<td>Austria</td>
<td>34%</td>
<td>25%</td>
<td>-9</td>
</tr>
<tr>
<td>Singapore*</td>
<td>26%</td>
<td>20%</td>
<td>-6</td>
</tr>
<tr>
<td>Iceland</td>
<td>30%</td>
<td>19%</td>
<td>-11</td>
</tr>
<tr>
<td><strong>Hong Kong</strong></td>
<td><strong>16%</strong></td>
<td><strong>17.5%</strong></td>
<td><strong>+1.5</strong></td>
</tr>
<tr>
<td>Hungary</td>
<td>18%</td>
<td>16%</td>
<td>-2</td>
</tr>
<tr>
<td>Lithuania</td>
<td>24%</td>
<td>15%</td>
<td>-9</td>
</tr>
<tr>
<td>Ireland</td>
<td>24%</td>
<td>12.5%</td>
<td>-11.5</td>
</tr>
<tr>
<td>Macau*</td>
<td>15.75%</td>
<td>12%</td>
<td>-3.75</td>
</tr>
<tr>
<td>Cyprus</td>
<td>15%</td>
<td>10%</td>
<td>-5</td>
</tr>
</tbody>
</table>

(Extracted from “Broadening the Tax Base Ensuring Our Future Prosperity – What’s the Best Option for Hong Kong?” Consultation Document, The Government of the Hong Kong Special Administrative Region, July 2006.)

* These jurisdictions also offer tax incentives or holidays that can reduce the effective tax rate.

1 Jurisdictions that compete for high value-added services have been selected for comparison. OECD and EU averages are included as a reference point for developed economies.