CHAPTER 5 A PROPOSED GST FRAMEWORK FOR HONG KONG

77. In proposing a suitable GST framework for Hong Kong, we are guided by the following principles:

simple and certain	it should be compatible with our existing low-rate taxation system;
fair and equitable	it should tax the Government, business and individuals in similar ways;
economically neutral	it should not cause market distortion nor affect market decisions on resource allocation;
efficient and effective	it should minimise the administrative costs for the Government and compliance costs for business; and
revenue generating	it should be able to generate a steady and growing stream of income to meet public expenditure requirements.

What are the proposed GST features?

78. A brief summary of our proposal is in Table 4.

Table 4 Proposed features for GST in Hong Kong

	Proposal	**Rationale**
General Features		
(a) Type of GST	Credit-invoice based on destination principle	Credit-invoice destination approach is the modern international benchmark. GST would be levied on domestic consumption, including imports, but not on exports. Export competitiveness would be maintained.

	Proposal	Rationale
General Features		
(b) GST rate	Low and single-rate	A low, single rate is considered appropriate for Hong Kong. This would also be consistent with the requirements of the Basic Law.
(c) Registration threshold	Annual turnover of $5 million and above	A high registration threshold would exclude most small and medium-sized enterprises from the tax net.
(d) Tax base	Broad-based, with few exemptions	A simple, efficient and robust tax system, with comparatively low costs of compliance for businesses.
(e) Food, Health and Education	No special treatment	In order to minimise complexity and maintain a broad-based tax.
(f) Treatment of e-business	No special treatment	GST would apply to e-business or electronic transactions in a similar manner to those transactions performed in the physical world. E-business is just another mode of transacting business.
Special Features		
(g) Treatment of Exports	Zero rated	Following the destination principle and in line with international practice, export goods and international supplies would be zero rated. This would maintain Hong Kong's competitiveness and status as an international trading and logistics hub.
(h) Tourist Refund Scheme (TRS)	Refund of GST to be provided to tourists	To retain Hong Kong's appeal to tourists as a shopping paradise, we would introduce a TRS for tourists leaving at all departure points.
(i) Treatment of Financial Services	Mostly zero rated	In the interest of maintaining Hong Kong's competitiveness as a leading financial centre, we propose that most financial services be zero rated.
(j) Treatment of Immovable Property	Non-residential: taxable Residential: exempt	In line with international practice, we propose to tax non-residential property and exempt residential property (both sales and rentals).

	Proposal	Rationale
Special Features		
(k) Deferral Schemes for Imports	Deferred GST Payment Scheme (DGPS) and Qualifying Exporters Scheme (QES)	For purposes of trade facilitation and cashflow management, we propose that a DGPS and a QES be put in place to mitigate upfront GST costs on traders at the time of importation. In addition, temporary storage areas and bonded warehouses would be licensed and authorised for unloading and storage of imported goods pending GST payment.
(l) Treatment of Charities and Not-for-profit Organisations	Taxable if registered	We propose that all approved tax-exempt charities should have the ability to register for GST and reclaim input tax, even if they were not undertaking a commercial activity. Not-for-profit organisations would, however, only be allowed to register if they were undertaking a commercial activity.
(m) Treatment of Government	Only commercial and non-regulatory activities are taxable	The Government would be regarded as a "taxable person" to enable it to reclaim input tax on its purchases. Moreover, to ensure that the Government could compete with the private sector on a level playing field, the Government's commercial and non-regulatory activities would be subject to tax.
(n) Transitional rules	To be developed	Transitional rules would be drawn up to minimise the impact of GST upon its implementation. These would be based on international practice.

79. The proposed features are set out in more detail in the following paragraphs.

General features

(a) What is the type of GST being proposed?

80. Hong Kong would adopt the credit-invoice, destination principle as its tax model. The operations of the GST tax credit mechanism have been explained in Chapter 4. A tax invoice system would be used as the basis for entitlement to reclaim GST incurred on purchases. Under the destination principle, exports would be relieved of tax and imports would be subject to tax. The credit-invoice, destination principle model for GST is the preferred international approach and would be required to maintain the competitiveness of our exports.

(b) What is the proposed GST rate?

81. While we have no predetermined view on the GST rate, we consider that it should be set at a low level and, if introduced, should not be changed for at least five years. Our modelling indicates that each percentage point of GST, with minimal exemptions and zero-rated items, would yield approximately $6 billion in revenue a year. This would mean that the GST rate of 5% assumed in the example given in Chapter 4 would be capable of generating $30 billion in gross revenue. We believe that a low-rate GST would be appropriate for Hong Kong and consistent with the Basic Law, which stipulates in Article 108 that:

> *"The Hong Kong Special Administrative Region shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation."*

82. Based on international practice and for administrative simplicity, we do not consider it desirable to have multiple GST rates. More than one GST rate would significantly increase compliance and administrative costs for business and the Government. Internationally, some economies have more than one GST rate, but those economies that have recently implemented a GST, i.e. Singapore and Australia, have adopted a single rate.

(c) Who would need to register?

83. The GST administration would require registration of a "taxable person" who conducts a "taxable activity", which generates a turnover in excess of the registration threshold. Please see Box 1 below for an explanation of the highlighted terms.

84. Currently, there are around 750 000 businesses on our Business Register, of which approximately only 230 000 are active. Of these, 65 000 businesses have an annual turnover of $5 million or above. We propose setting the registration threshold at this level. A $5 million registration threshold would be high by international standards, as illustrated in Table 5. Registration would be mandatory for those businesses with a turnover exceeding the $5 million threshold and would be optional for those with a turnover below the registration threshold.

Table 5 GST registration thresholds of other major economies

	Australia	**Canada**	**New Zealand**	**Singapore**	**United Kingdom**
GST Registration Threshold (HK$ equivalent*)	A$50,000 ($288,500)	C$30,000 ($204,600)	NZ$40,000 ($200,000)	SG$1 million ($4,820,000)	GBP61,000 ($847,290)

* The HK$ equivalent is derived from the average exchange rates of these currencies against the Hong Kong dollar from January to June 2006.

85. The purpose of setting a high registration threshold is to exclude most small and medium-sized businesses from the proposed GST system and therefore exclude them from GST compliance obligations. In this way, small and medium-sized businesses would not be required to levy or collect GST. With a smaller number of GST registrants, the administrative costs for the Government would also be lower.

86. The proposed exclusion of small and medium-sized businesses from mandatory registration acknowledges the fact that their accounting systems and manpower resources are generally not as sophisticated as larger businesses. However, the cost of not registering for GST would be that they could not reclaim any input tax which they might have paid on their purchases. Nevertheless, they might still voluntarily register if they so wished.

Box 1 Who charges GST?

Only a "taxable person" has an obligation to register and charge GST. The meaning of "taxable person" in Hong Kong would include all persons with a separate personality at law capable of carrying on a "taxable activity" that is commercial in nature. The definition would apply to a sole proprietorship, a body corporate with a separate legal entity, whether created under Hong Kong law or elsewhere, a partnership, an unincorporated body of persons, such as a club or association, that is a taxpayer for Profits Tax purposes. Charities and the Government would also be included as taxable persons. It should be noted, however, that few of their activities are commercial in nature, but those that are would be subject to GST. It would be necessary to include charities as taxable persons so that they could enter the GST system and recover GST on the inputs of their activities, thereby avoiding inflationary pressure on their expenditure.

The term "taxable activity" serves three functions in a GST framework:

- A taxable person is liable to register and charge GST when it conducts a taxable activity with an annual turnover above the registration threshold.

- A taxable person is permitted to register and recover input tax when it conducts a taxable activity.

- Taxable persons who do not conduct a taxable activity are not able to register for GST. The term "taxable activity" operates to ensure that some people cannot enter the tax net to claim credit for the tax paid on their inputs.

The core concept of taxable activity in Hong Kong would be carrying on a trade, profession or business. It is proposed that the Profits Tax definition of "trade, profession or business" would be the basis for the definition of taxable activity in the GST framework. This is a well-established definition in Hong Kong tax law and its adoption would reduce confusion for taxpayers and the tax authority.

A taxable person who conducts a "taxable activity" in Hong Kong would charge GST when it made a taxable supply in Hong Kong on the consideration received or receivable [14].

[14] GST is usually calculated on the price agreed by the parties to the taxable supply. However, where the relationship of the "taxable person" and the customer is not at arm's length, the transaction is treated as occurring at market value, and the GST is calculated on this amount in lieu of the consideration actually paid.

It should be noted that GST would not be imposed where there is no supply of goods or services, for example on money received by way of gift or donation, grants of financial assistance, appropriations and government subventions, taxes, fines or penalties. Money received in these circumstances would not be considered as received for making a supply.

(d) What would GST cover?

87. The core concepts that underpin the GST tax base and determine who would have to pay GST, and on what supplies they would have to charge it, are described in Box 1. In addition, GST would apply to all taxable imports. For a description of how GST would apply to imports, please refer to Box 2.

88. Consistent with the taxable activity concept discussed in Box 1, and in order to maximise the consumption expenditure that would be subject to GST, it is proposed that the scope of taxable supplies be drawn as widely as possible. This would both achieve equity and keep the tax rate at a low level.

89. Overseas experience suggests that the more exemptions and zero-rating treatments there are in the tax system, the more complicated and inefficient the system becomes. Exemptions increase government administrative costs and add substantial compliance costs to business. Furthermore, exemptions tend to distort markets and can lead to inefficient allocation of resources.

Box 2 GST and imports

GST would be charged on all taxable imports of goods. Goods brought into Hong Kong's territorial boundary for home consumption would be subject to GST. Goods passing in transit or on transshipment through Hong Kong would not be taxed.

Importers and transshippers would be required to lodge goods declarations with Customs before taking delivery of their imported goods. Subject to the deferral provisions available (see paragraphs 127 to 132 below), importers would need to pay GST upon lodgment of the goods declarations. On the other hand, exporters who were registered as taxable persons would be required to lodge goods declarations with Customs before they shipped out their goods. No goods declaration would be required for transit cargo that remained at all times on board an incoming vessel or aircraft.

Goods that would otherwise be exempt or zero rated would not be "taxable" imports, and therefore not chargeable to GST. Temporary imports and returned (unaltered) goods would not be subject to GST, nor would imported goods below a certain value. It is proposed that the GST-free threshold be set at $3,000 for goods brought in by individual incoming travellers[15] and $4,000 for imported cargo[16]. If the threshold allowance were to be exceeded, the full value of the imported goods would be subject to GST.

90. In the proposed GST framework, Hong Kong would adopt a broad-based tax system, levying GST on virtually all expenditure items, with very limited exemptions. Accordingly, only some financial services, residential property sales and rentals and exports (of goods and services) would not be subject to GST.

91. Most household purchases would be subject to GST, unless they were purchased from unregistered retailers. Examples of ordinary household expenditure that would be subject to GST include: groceries, telephone charges, water charges, electricity, public transport fares, medical services,

15 An incoming traveller means a visitor coming to Hong Kong or a Hong Kong resident returning to Hong Kong.

16 Having regard to (a) the average expenditure by Hong Kong residents travelling abroad (only 1% spent more than $3,000 on shopping during their travel abroad in 2005) and (b) the administrative cost in checking the imports and collection of GST, a threshold allowance of $3,000 is proposed for incoming travellers. For imported cargo, the threshold of $4,000 is proposed with reference to the current exemption threshold of $4,000 for import declarations on postal parcels.

education fees, newspapers, magazines, meals, clothing, electrical goods, snacks, books and home furnishings.

(e) What would be the treatment of daily necessities?

92. It is not proposed to include special exemptions for food, education or health. For further explanations of the treatment of these items, please refer to Boxes 3 and 4 below.

Box 3 Why basic household expenditure would not be excluded from GST – Food

Food is a basic human necessity. Often, it is argued that food is so important that it should not be taxed. Some overseas jurisdictions do not subject all food to taxation. In spite of these contentions, we do not propose to give any special treatment to food, as explained below.

As lower-income households normally spend a higher proportion of their expenditure on food than higher-income households, GST on food is often perceived as regressive. However, in money terms, higher-income groups usually spend more on food than lower-income families. Table 6 shows expenditure on consumption of food by different household income groups.

Table 6 Average consumption expenditure on food by different household income groups

Household income groups	Expenditure on food* ($ per month)	Expenditure on food as a % of household expenditure
Overall**	**4,860**	**25.8**
Lowest 20%	2,530	31.7
Second 20%	3,880	31.4
Third 20%	4,760	30.6
Fourth 20%	5,680	27.2
Highest 20%	7,490	19.8

Note: * Values at 2004/05 price level, rounded to the nearest $10.
** Excluding CSSA households.

Based on the above Table, were we to exempt food from GST, the greatest financial benefit would go to higher-income households.

Overseas experience shows that granting exemptions for specific categories or selective food items would narrow the tax base, impair economic neutrality, and increase compliance and administrative costs for business and the Government. Furthermore, no matter what definitions were applied to food, there would inevitably be disputes, controversies and criticisms. This is because there is no universally accepted definition of what constitutes "basic food" that may be zero rated and how it can be differentiated from non-basic items.

Even in those jurisdictions that do not tax basic food, food consumed in restaurants or taken away is subject to tax. In Hong Kong, food not consumed at home constitutes around 50% or more across all household income groups. Please see Table 7 for more details.

Table 7 Average spending on food not consumed at home by different household income groups

Household income groups	Expenditure on food* ($ per month)	Expenditure on food not consumed at home ($ per month)
Overall **	**4,860**	**3,080 (63.3%)**
Lowest 20%	2,530	1,230 (48.8%)
Second 20%	3,880	2,250 (58.1%)
Third 20%	4,760	2,990 (62.9%)
Fourth 20%	5,680	3,700 (65.3%)
Highest 20%	7,490	5,220 (69.7%)

Note: * Values at 2004/05 price level, rounded to the nearest $10.
** Excluding CSSA households.

In 2001, the IMF Mission[17] recommended that, should Hong Kong decide to introduce GST, the tax should contain as few exemptions, zero rating and special concessions as possible. It did not recommend zero rating any food items. This view was supported by the Advisory Committee on New Broad-based Taxes. In 2004, the IMF Mission re-visited this issue and reaffirmed the view that all food items should be taxed. The Government concurs with these views.

Notwithstanding the above, we are aware that subjecting food to GST would have a financial impact on lower-income groups, as this would increase their household expenditure. To relieve the impact, we propose that a series of tax relief and compensation measures be introduced alongside GST. These are explained in Chapter 6.

[17] At the request of the HKSAR Government, the IMF sent a Mission team to Hong Kong both in late 2000 and early 2004 to study Hong Kong's fiscal situation. The IMF prepared two reports to summarise their findings and recommendations. Executive Summaries of these reports are at Appendices A and B respectively of this consultation document. The full reports can be downloaded from the website www.taxreform.gov.hk.

Box 4 Why basic household expenditure would not be excluded from GST – Health Services and Education

Health services and education, like other goods and services, are items within the scope of a consumption tax and therefore provision of such services should be taxable. Accordingly, no tax concession is proposed for these services regardless of whether they are provided by the Government, charitable or private business organisations.

Schools and hospitals with a turnover above the $5 million registration threshold would be required to register and charge GST on their services. However, some clinics and schools would be below the threshold and hence would not need to charge GST on their services.

As with food, there are, however, arguments that these supplies have a bearing on people's livelihood and therefore deserve concessionary treatment. In Hong Kong, the Government subsidises medical services heavily (often by more than 90%) to ensure affordability for the less well-off. In education, the Government also shoulders a great responsibility, with the provision of nine years' free and universal basic education, highly-subsidised senior secondary education, vocational training and university education.

Notwithstanding the provision of publicly-subsidised education and medical services, members of the community may choose their own private sector providers. In Hong Kong, approximately 9% of hospital beds are in private hospitals and around 17% of patients are admitted to them. Similarly, apart from government-run and aided schools, direct subsidy schools, private schools and international schools provide a wide spectrum of choice.

In the interests of introducing a broad-based GST, we believe that there should be as few exemptions and special treatments as possible. Exempting or zero rating services provided by the Government while taxing supplies by the private sector would cause market distortion and affect resource allocation. If, however, we were to exempt or zero rate all education and medical services, we would benefit high-income more than low-income families, as private hospitals, clinics and schools are generally patronised more by high-income families. We therefore do not propose exempting or zero rating these services.

(f) Would GST be charged on e-business?

93. In recent years, Hong Kong has seen a growing use of electronic and Internet-based transactions. Based on 2005 data[18], 14.6% of persons aged 15 and above in Hong Kong have performed online transactions for personal matters. This figure represents a significant increase when compared to the figure for 2002 (8.6%)[19]. It is also noted that 15.4% of business establishments made purchases via electronic means in 2005 and this figure is 3.6 percentage points higher than that of 2004[20].

94. With online transactions increasing, there may be concern over how GST would impact this form of business. Overseas jurisdictions generally treat businesses conducted over the Internet no differently from those conducted via conventional means. Having regard to overseas practice, it is proposed that GST in Hong Kong be applied to e-business transactions in a similar manner to those performed in the physical world. In essence, its application would comprise the following:

(a) GST-registered businesses in Hong Kong making supplies of goods, services or digitised products (e.g., downloaded software, music or videos) ordered via the Internet and physically supplied to or performed for local customers would be subject to GST;

(b) GST-registered businesses in Hong Kong making supplies of goods, services or digitised products ordered via the Internet and physically supplied to customers outside Hong Kong would be zero rated under the export rules (see part (g) below);

(c) goods purchased via the Internet and imported into Hong Kong would be subject to GST, if the value of the goods were in excess of the exemption threshold for low-value cargo (proposed to be $4,000)[21];

(d) GST would not be payable on imported services or digitised products that were purchased from a non-Hong Kong supplier, if that supplier did not carry on a business in Hong Kong; and

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18 "Thematic Household Survey Report No. 23", Census and Statistics Department.
19 "Thematic Household Survey Report No. 10", Census and Statistics Department.
20 "2005 Annual Survey on Information Technology Usage and Presentation in the Business Sector", Census and Statistics Department.
21 According to "Thematic Household Survey Report No. 23", the median spending of persons aged 15 and over who had purchased products/services online during the 6 months before enumeration was $500, which is much lower than the proposed $4,000 exemption threshold for low-value cargo.

(e) all transactions of immovable property in Hong Kong (if taxable) would be subject to GST irrespective of where, or through what means, these transactions were performed.

Special features

(g) Would exports and international supplies be subject to GST?

95. Exports are universally zero rated across developed economies. This approach is consistent with the destination principle that GST in Hong Kong should only apply to goods and services which are consumed locally (including imports). By zero rating exports, the input tax paid on the production of exports is relieved from the price when sold overseas, hence GST would not undermine the cost competitiveness of Hong Kong's exports[22]. As imports are generally subject to GST, the failure to remove tax at the output level on exports would lead to double taxation, hence making a jurisdiction's exported products and services less competitive vis-à-vis the zero-rated exports of other jurisdictions.

96. With regard to the definition of "exports", reference has been made to overseas jurisdictions and it is proposed that exports in Hong Kong would include two main categories of items for zero rating, namely export goods and international supplies.

Box 5 Preliminary list of export goods

Export goods would comprise the following:

(a) goods for export;

(b) goods not entered for consumption in Hong Kong (and intended for export);

(c) aircraft and ships for export;

(d) goods to be consumed on international flights or voyages (including stores and spare parts);

(e) goods used for repair of other goods for re-export, ships and aircraft;

[22] The claiming of input credit from exported goods and services is applicable only to exporters who are taxable persons and registered with the tax authority for GST purposes.

(f) lease or hire of goods for use outside Hong Kong;

(g) containers used for export; and

(h) goods under the Tourist Refund Scheme.

Box 6 Preliminary list of international supplies

International supplies would comprise the following:

(a) services physically performed outside Hong Kong;

(b) supplies of services connected with immovable property or goods located outside Hong Kong;

(c) supplies performed in Hong Kong but performed for a non-resident outside Hong Kong at the time of supply;

(d) international transport [23] of passengers and goods (including transport within Hong Kong if done by the same supplier as part of the international transport), services in connection with the export of goods, logistics services including loading, unloading, packing and handling; insurance of goods in international transit; repair of ships and aircraft engaged in international transport;

(e) telecommunications directed to a foreign exchange and mail to be delivered outside Hong Kong; and

(f) licensing intangibles for use outside Hong Kong.

97. Boxes 5 and 6 contain preliminary lists regarding the scope of the definition of export goods and international supplies respectively. They will be refined to take account of feedback from the trade and relevant business chambers during the course of the public consultation. As a general principle, adopting a broad export definition would put us in an advantageous position insofar as promotion of export trade is concerned, as most connected activities would be zero rated. This would preserve our overall

[23] International transport includes transportation of passengers and goods between Hong Kong and the Mainland and places of other jurisdictions.

competitiveness as a leading logistics and trading hub in the Asia-Pacific region.

(h) Would tourists have to pay GST?

98. Given Hong Kong's status as a tourist centre and the importance of tourism to our economy, there would be a strong case for a Tourist Refund Scheme (TRS) to operate in Hong Kong. A TRS is a mechanism whereby GST paid on goods purchased by tourists is refunded when they depart with the goods.

99. In 2005, over 23 million visitors visited Hong Kong, spending more than $105 billion. With the popularity of the Individual Visit Scheme and the steady increase in visitors, the Hong Kong Tourism Board estimates that visitor arrivals will reach over 27 million in 2006, representing a growth of 16% over the figure for 2005 and 24% over that for 2004. Hence, a TRS would be critical to retain Hong Kong's appeal to tourists as a shopping paradise and to maintain its competitiveness with neighbouring economies should GST be introduced.

100. When determining the threshold for tourist refunds under a TRS, we have made reference to the levels currently adopted in the region. We have also taken account of the average visitor spend. According to surveys[24] conducted by the Hong Kong Tourism Board, the per capita spending of an overnight visitor in 2005 was $4,663 of which 53% was on shopping. Having considered the above, we propose that the threshold for tourist refunds be set at $1,500 for purchases in a shop[25].

101. In considering a TRS for Hong Kong, we are being guided by the following principles:

(a) it should afford equal treatment to all tourists irrespective of their exit point;

[24] Figures obtained from "Tourism Expenditure Associated to Inbound Tourism (January – December 2005)" published by the Hong Kong Tourism Board in March 2006.

[25] Multiple purchases from the same shop (including from different outlets of the same retailer) could be included for the purpose of assessing whether the value of the threshold had been met but purchases from different retailers could not be aggregated for this purpose.

(b) it must ensure an efficient inspection process capable of clearing a large number of refund claimants quickly; and

(c) no substantial space or facilities would be required beyond those of our existing or future control points.

102. The last point is especially important given the physical constraints at our land boundary control points, particularly at Lo Wu and Lok Ma Chau, and the huge number of visitors that use these exit points daily. The congestion is even worse during peak hours and festive seasons.

103. In view of the above, a conventional TRS, which requires endorsement of the application forms and inspection of the purchased goods by Customs at the departure points, may not be appropriate for Hong Kong, as it would take up too much space, lead to significant delays and adversely affect passenger traffic flows, which we cannot afford.

104. Based on our preliminary study, we consider that the "sealed bag" system currently adopted in Australia for sales of duty/tax-free goods by licensed duty free shops or registered retailers may, with suitable modifications, be appropriate for Hong Kong. Under this system, GST-paid goods would be put in a transparent sealed bag, which is designed to speed up checking and prevent substitution of the sealed goods. The checking process would be conducted at exit points and any refund could be collected either by post or at the exit points where appropriate facilities were available.

105. The principal benefit of this system is that it could enable inspection and checking to be carried out in an efficient manner, thus avoiding further congestion at our land boundary control points. It could also be implemented at all other exit points, such as the airport and ferry terminals. We might also be able to minimise administrative costs as we are proposing that the refund process under this scheme could be outsourced.

106. Nevertheless, there are issues that would still need to be addressed. For instance, special arrangements would be required to deal with bulky items. We are ready to work together with the trade to resolve these issues and would welcome your views, so that a viable TRS could be drawn up to sustain the growth and vibrancy of our tourism industry.

(i) Would the financial services industry be affected?

107. Financial services cover a wide range of activities including the provision of loans, the taking of deposits, trading in financial securities such as shares and debentures, as well as the provision of insurance services. Based on 2004 data, the financial sector accounted for about 12.2% of Hong Kong's GDP. Service providers include banks and other financial institutions such as brokers, fund management companies and insurance companies.

108. Financial services are widely acknowledged as a very difficult area to tax under GST. This is because GST is a consumption tax on final goods and services whereas returns on savings, or interest are to compensate for the time value of money and therefore should theoretically not be included in the GST base.

109. Aside from the theoretical arguments, there is also a practical problem in taxing many financial services, e.g. financial intermediation. The "value" of financial intermediation is frequently incorporated into the interest rate spread and cannot be easily ascertained transaction by transaction, which is the normal basis for applying GST. As a significant portion of the services provided by the financial sector is of an intermediation nature for which the prices charged are typically implicit — in the form of interest margins or margins of a similar kind — it is widely recognised that no output tax can be collected on implicit fees.

110. In the light of the practical difficulties, most jurisdictions exempt[26] most financial services from GST. Yet, there is a range of negative outcomes associated with exempting financial services:

(a) high compliance costs caused by the need to allocate purchases between taxable and exempt activities;

(b) disincentives to outsource services. This is because they would not be able to recover input tax on outsourced fees;

(c) tax cascades because the providers would not be able to reclaim any input tax and this would increase their costs in supplying financial services to other taxable businesses;

[26] The effect of exemption from GST is that there is no liability to account for the output tax when an exempt transaction is undertaken. Correspondingly, the person undertaking the exempt transaction has no entitlement to an input tax credit in respect of the goods and services used in the production of the exempt supply.

(d) higher costs associated with "stuck" non-creditable input tax;

(e) reduced competitiveness of the sector due to (a) to (d) above; and

(f) greater incentives for tax avoidance.

111. In designing the GST system for our financial sector, we have worked on the basis that it should be simple, easy to administer and would not undermine our competitiveness as a major international financial centre. This is particularly important given the highly-competitive and mobile nature of our financial sector and the falling corporate tax rate differentials between Hong Kong and our competitors. Hence, having regard to the lessons learnt from overseas jurisdictions and global trends, it is proposed that certain financial services to be defined as "financial supplies" be zero rated. Financial services that did not fall within the defined scope of "financial supplies" would be taxable.

112. The IMF Mission and the Advisory Committee on New Broad-based Taxes mentioned in their reports that consideration should be given to zero rating financial supplies in order to overcome the problems outlined in paragraph 110 above.

113. The proposed zero-rating arrangement would be applicable to all defined financial supplies in Hong Kong, irrespective of whether an implicit or explicit fee were charged. The reason why we propose such an arrangement is that the charging mode of many financial products varies and sometimes can be restructured between explicit and implicit fees. For example, a bank account, which is fundamentally a margin-based product, may incorporate an explicit fee as well, such as a monthly account-keeping fee. If we were to zero rate only implicit fee-based financial services, but not explicit fee-based ones, the latter could change their charging mode to avoid levying of GST. Our intention is to ensure simplicity and consistency of treatment between similar types of financial services.

114. This approach would make Hong Kong a pioneer insofar as no major financial centre in the world has yet moved to a full zero rating of its financial supplies, although the international trend is moving in that direction[27].

[27] Singapore allows up to 98% input tax recovery, Australia allows 75% input tax relief for certain outsourced financial-related services, and New Zealand has a zero rate for business-to-business supplies.

115. Meanwhile, the proposed scope of zero-rated financial supplies will be drawn up in consultation with the financial regulators and the financial industry to ensure that the scope is practicable, would provide equal treatment between like products and suppliers, and would not be subject to abuse. Our preliminary view is that the proposed scope should include the items covered in Box 7. In consultation with the trade, we will examine including any other related financial services (e.g. services provided by stock brokers and insurance brokers or "arranging" services[28]) for zero rating.

Box 7 What financial supplies would be zero rated

Bank accounts	Loans and mortgages	Securities (e.g. shares and bonds)
Bank deposits	Money exchange	Futures
Stored value cards	Certificates of deposit	Derivatives
Currency	Insurance[29]	Underwriting
MPF and CIS[30]	Financial guarantees	Precious metals
Bills of exchange	Trade finance	Refining of precious metals

(j) What would happen to the property market?

116. Immovable property (including land) is important to Hong Kong's economy. Based on 2004 data, the real estate sector accounted for 4.2% of GDP. Its importance to our economy demands our careful consideration of the GST treatment of this sector.

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[28] The definition of "arranging" services would need to be carefully defined to avoid unintended consequences or avenues for abuse.

[29] Detailed scope of insurance which would be subject to zero rating will be drawn up with the trade to ensure practicability and avoid abuse.

[30] MPF = Mandatory Provident Funds and CIS = Collective Investment Schemes.

117. It is proposed that the classification of property be consistent with the Stamp Duty Ordinance (Cap 117). Section 29A defines “residential property” as “immovable property other than non-residential property”. And “non-residential property” is defined as immovable property which, under the existing conditions of:

(a) a government lease or an agreement for a government lease;

(b) a deed of mutual covenant, within the meaning of section 2 of the Building Management Ordinance (Cap 344);

(c) an occupation permit issued under section 21 of the Buildings Ordinance (Cap 123); or

(d) any other instrument which the Collector of Stamp Revenue is satisfied effectively restricts the permitted user of the property

may not be used, at any time during the term of the government lease in respect of the property or during the term of the government lease that has been agreed to in respect of the property, wholly or partly for residential purposes.

118. In other words, any property that may be used (according to the legal documents) wholly or in part for residential purposes will be residential property by definition. Any other property must be non-residential property. This proposed “permitted use” approach is preferred to an “actual use” basis because it is already well established in Hong Kong, is easy to determine, and cannot be manipulated or changed by an owner without resort to the Government.

119. Having regard to (i) the practice of most economies in the region in taxing both the sale and the use of non-residential property, (ii) the recommendation of the IMF Mission, as well as (iii) the ability of businesses to recover the GST input tax, we consider that Hong Kong should follow the international norm. It is therefore proposed that the sale and rental of non-residential property should be taxable.

120. Residential property, on the other hand, is not so easily taxed under a GST system. Residential rents represent consumption and should theoretically be taxable under a broad-based consumption tax. However, consistent with international practice, and the inherent difficulty in determining the implicit value of owner-occupied housing, it is proposed that residential

rents be exempt from GST. This would also have the benefit of not requiring landlords of residential properties to register for GST.

121. With regard to the sale of residential property, it is proposed that all sales be exempt. This arrangement is in line with the more common international practice, including in Singapore. We did examine an alternative taxing approach for new or first sales of residential property as practised in some jurisdictions, but found that it would not be suitable for our property title and transfer arrangements. The merit of exemption is that it would be simple and certain. It would have the added advantage of avoiding the need for very complex special rules to cover the transitional period in the light of Hong Kong's unique property transfer system. This approach would also ensure that the introduction of GST would not have a major impact on home buyers.

122. The proposed treatments of residential and non-residential rental property would create a cross-over point for commercial residential premises; i.e. long-term accommodation in hotels, serviced apartments and boarding houses. To address this matter, we propose following the Hotel Accommodation Tax treatment that if the tenure of stay is equal to or more than 28 days, GST would not be charged on the accommodation.

123. Notwithstanding the differing treatments of the sale of residential or other types of property, all construction activities and building materials purchased from registered businesses would be subject to GST.

124. For ease of reference, the following table summarises the proposed treatment of immovable property.

Table 8 Summary of treatment of immovable property

Supply	**Non-residential Use**	**Residential Use**
Sale of property	Taxable	Exempt
Rental	Taxable	Exempt
Commercial residential < 28 days	Taxable	N/A
Commercial residential >= 28 days	Exempt	N/A

(k) Would the import/export trade and logistics sector be adversely affected?

125. In 2005, on an aggregate basis (i.e. taking imports, exports, inward and outward transshipments together), 230 million tonnes of cargo entered and left Hong Kong via river and sea mode, 39.5 million tonnes by truck and train and 3.4 million tonnes by air. Out of this total volume of goods, 41% of the cargo was for transshipment. In terms of value, 75% of the imports were subsequently re-exported.

126. Under the proposed GST system, all imported goods entering Hong Kong for home consumption would be subject to GST. Transshipments would not be subject to GST because they would not have entered for home consumption. If the importer was a GST registrant, he could reclaim the GST paid on imports in his next GST return (as for any other purchases). Despite his entitlement to reclaim GST paid on imports, he might still face a cashflow problem.

127. For trade facilitation purposes and to help address importers' cashflow issues, we propose to introduce special schemes under which importers could enjoy a deferral of the GST payment on imports (the Deferred GST Payment Scheme, "DGPS") or a suspension of the GST on importation (the Qualifying Exporters Scheme, "QES"[31]). Similar GST postponement schemes are in place in most jurisdictions with a GST. The models for the schemes proposed for Hong Kong are generous and in line with our objective of maintaining Hong Kong's competitiveness and being an efficient trading centre.

128. Drawing on overseas experience, the deferral payment arrangements proposed for Hong Kong would include the following features in order to achieve administrative efficiency, demonstrate fairness, and maintain sufficient revenue protection:

(a) all importers, not necessarily GST registrants, might apply for the DGPS. They would be subject to credit vetting by the Customs and Excise Department (C&ED) or IRD, as appropriate, and might be required to provide a security bond;

[31] The QES would be modelled on Singapore's Major Exporter Scheme (MES).

(b) approved importers could enjoy a deferred payment period of between three and seven weeks (details to be worked out with the trade);

(c) importers who were GST registrants would account for the deferred GST when submitting GST returns to IRD;

(d) importers who were non-GST registrants would pay the deferred GST to C&ED prior to the end of the deferment period; and

(e) importers exporting a major portion of their supply of goods and services and who were GST registrants might apply for the QES which would suspend the GST normally payable on importation[32]. They would be subject to credit vetting by IRD.

129. In addition to the above schemes, we propose that Hong Kong put in place approved temporary storage areas (ATSAs) and bonded warehouses (BWs) to provide further flexibility and relief to importers. Under the proposed arrangements, GST on imported goods would not become payable until goods were brought out of the ATSAs or BWs for local consumption.

130. With the introduction of GST, importers would need to lodge goods declarations and pay GST, where applicable, before taking delivery of their imported goods. The provision of ATSAs would be a facilitation measure to enable the off-loading of imported goods from the importing conveyances prior to the lodgement of goods declarations by the importers. At present, goods imported into Hong Kong are generally off-loaded from the importing conveyances and placed in temporary storage areas pending transshipment, re-export or collection by importers. To avoid changing existing trade practices and causing undue inconvenience to traders, it is proposed that the existing temporary storage areas located in cargo terminals at the airport, Kwai Chung Container Terminals, the River Trade Terminal, Public Cargo Working Areas and private wharves be authorised and licensed as ATSAs for temporary storage of imports subject to GST.

[32] To qualify for the QES, it is proposed that export sales should be at least 51% of the registered person's total turnover. The definition of exports would include not only export of goods, but also zero-rated international supplies. Imports made by QES participants would receive an indefinite suspension of the GST usually payable on importation. When the QES participant had sold the goods, normal GST rules would apply: i.e. subject to GST if for domestic sale or zero rated if exported.

131. Importers joining DGPS or QES normally would not need any bond facilities. However, those importers who were not GST-registered and who had not joined DGPS or were not eligible for QES might require bond facilities for temporary storage of their goods liable to GST pending re-export. Subject to satisfaction of requirements as to their physical security and, if necessary, the provision of a bond, existing warehouses might be authorised and licensed as BWs for longer-term storage of goods liable to GST. As most importers would be either GST-registered or eligible to join DGPS or QES, it is envisaged that the demand for such bond facilities would be low.

132. Details of the DGPS, QES, ATSAs and BWs would need to be finalised. The Government will refine the details of these schemes in light of public feedback, including from the trade and relevant commercial organisations.

(I) What would happen to charities and not-for-profit organisations?

133. Charitable institutions raise funds by donations, from investments and sometimes by selling goods and services (often for little charge). Some also receive grants from the Government. Receipts in the form of donations, gifts and government subventions would not be subject to GST. Where these organisations have trading activities, they could meet the standard taxable activity test, but many charities could not do so. If they were not registered, then they could not reclaim input tax paid on their purchases and their costs would rise as a result of GST.

134. Charities apply all types of “income” towards their charitable objectives. Therefore we need to provide charities with special arrangements. In order to ensure that these organisations would not have to bear the cost of GST on their inputs, it is proposed that all activities of charities that had been granted tax exemption under section 88 of the Inland Revenue Ordinance (Cap 112) would be treated as taxable activities.

135. In the interests of maintaining fair treatment and not introducing complex exemptions, it is not proposed to zero rate their sales of taxable supplies if they were registered. Therefore, charities that registered for GST would have to charge GST on their taxable supplies. However, they would be able to reclaim input tax for all of their activities: i.e. both activities that were funded from taxable supplies and activities that were funded from other sources. However, some small charities might decide not to register where their turnover did not require them to do so.

136. In respect of other not-for-profit organisations, many of which are set up primarily for the benefit of their members or to promote various causes, international GST practice varies.

137. The GST approach we propose for Hong Kong is to follow the treatment of clubs and associations in section 24 of the Inland Revenue Ordinance. For example, if a club derived more than half of its revenue from non-members, then its operations would amount to a taxable activity and it would be required to register, if above the mandatory registration threshold. Whereas for associations with more than half of their receipts by way of subscriptions coming from members who could deduct such subscriptions under Profits Tax, they would be treated as carrying on a business and required to register, if above the mandatory registration threshold.

(m) Would government activities have an advantage?

138. Under the proposed GST regime, the Government[33] would be treated as a "taxable person" and have to account for input and output tax. That means it would have to pay GST on its purchases and charge GST on the provision of taxable supplies. Through the GST tax credit mechanism, it would reclaim the input tax paid on its purchases.

139. However, not all government supplies would be taxable. Following common international practice, the Government would only levy output tax on those supplies that were commercial in nature or in competition with the private sector (e.g. medical charges and school fees) and not on those supplies that were mandatory and regulatory in nature (e.g. vehicle licence fees and business registration fees).

140. The Government currently levies around 5,000 fees and charges, which would be classified according to the basis of whether they were commercial or mandatory and/or regulatory in nature, so as to determine whether GST should apply. For the avoidance of doubt, all taxable government fees and charges would be explicitly stated and regulated under any future GST law.

[33] Government means government bureaux, departments and agencies and, if appropriate, might include those statutory bodies that are financially dependent on government appropriations or subventions.

141. Government appropriations and subventions, either to its departments and bodies or to non-government organisations, would not be regarded as commercial activities and therefore would not be subject to GST.

(n) How would GST changeover be managed?

142. It is international practice to have transitional rules in place well in advance of the introduction of a GST. The purpose of those rules is to provide business and the tax authority with guidance and certainty with respect to GST treatment of a wide range of supplies, particularly those associated with contracts spanning the pre and post implementation date.

143. Theoretically, GST should apply to all goods delivered, services rendered and property transferred after the commencement of a GST. This rule would apply regardless of whether the contract had been entered into, payment had been received, or an invoice had been rendered by the supplier. Hence, suppliers who expect to effect delivery after GST commencement, under a contract entered into force prior to GST implementation, would need to account for GST. Correspondingly, buyers of these goods and services would be entitled to reclaim any attributable input tax.

144. Where the supply in question is covered by an ongoing contract, this might, however, require valuation of the supply to determine which part of the supply was made prior to, and which post, GST commencement.

145. We propose that the following principles for transitional rules be adopted:

(a) for contracts covering supplies spanning GST introduction, only that proportion of the supply relating to post GST introduction would be subject to GST; and

(b) for prepaid and fixed-price contracts spanning the implementation date, and entered into prior to a specified date, zero rating would apply until there was a contractual price review opportunity.

Question

✧ What are your views on the proposed GST framework and design features as outlined in this Chapter?