香港稅務學會
THE TAXATION INSTITUTE OF HONG KONG
(Incorporated in Hong Kong as a company limited by guarantee)

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BY HAND AND BY E-MAIL

The Honourable Mr. Henry Tang
Financial Secretary
12th Floor, West Wing
Central Government Offices
Lower Albert Road
Central
Hong Kong

Dear Mr. Tang

2007/08 BUDGET PROPOSALS

We have seen the economy of Hong Kong back to a full swing in 2006/2007. The estimated GDP growth rate will be expected to exceed 6.5% and the Heng Seng index has already reached its height since the handover. Amidst these positive factors public finance will still need to be managed prudently since Hong Kong still has a very narrow tax base (as discussed in section A below) and the economy of Hong Kong is still subject to fluctuations in the global economy and other external factors. It is beyond doubt that the Government of the Hong Kong SAR (the "Government") will expect a surplus in both the Operating Account and Consolidated Accounts for a second consecutive year since the handover. However, for the reasons set out in the proposals the Institute does not suggest the Government to reduce the tax rates for profits tax and salaries tax to the pre-2002/2003 level, instead we believe that the surplus accumulated should be utilized prudently to improve the living standard of the underprivileged, to improve our infrastructure and environment and to build cultural facilities without too much reliance on the funding and participation from the commercial property sector.

As with our previous budget proposal we have made suggestions to improve our business operating environment. On the tax administration aspect, the Institute, as in the past, has recommended measures to maintain fairness, certainty, simplicity and transparency of the tax system in Hong Kong.

This year, the proposals of our Institute cover the following areas:

A Broadening the tax base

B Improvement of environment

C Fairness, certainty and transparency of tax system

D Incentives to enhance business operating environment

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E Tax incentives to individuals

F Creating a caring community

A Broadening the tax base

We have touched on this topic in our 2004/2005, 2005/2006 and 2006/2007 budget proposals. The fact that recommendation of a broad tax base has become a common feature in our recent budget proposals demonstrates the importance of this topic. In order to maintain a healthy fiscal system and to secure a stable source of revenue, the Institute believes broadening of our tax base is desirable.

The Government started public consultation on how we should reform our tax system in July 2006. An interim report was issued in December 2006 in which the Government shelved the further study of a Goods and Services Tax (GST) as an appropriate option to broaden the tax base due to the mixed public opinion. Although we believe GST has some technical merits as an option to broaden our tax base against other options (which were considered by the Advisory Committee on New Broad Based Taxes in 2000), we understand the Government's stance to shelve the GST proposals. The Government has, we believe, through the consultation process, successfully passed the message to the public that (i) our tax base is narrow; and (ii) there is a need (for various reasons set out in the consultation document) to reform our tax system.

We agree that the Government should continue to study on how to broaden our tax base and explore other methods to achieve this end.

We propose:-

The Government should continue to study on how to broaden our tax base despite its recent decision to stop further considering GST as an appropriate option to broaden the tax base.

B. Improvement of environment

Echoing and further developing on our theme in last year's budget proposals to improve our environment, we believe the Government should devise a comprehensive environmental policy - our youngsters, workforce and indeed all our citizens should deserve to live in a better and cleaner environment. We are confident that tax policies do have a role to play in the structuring of a comprehensive environmental policy.

In addition to the tax policies, we believe that administrative measures and concessions should be devised to encourage the establishment and sustainable operation of industries involved in the recycling of waste products or production of environmentally friendly goods. In particular, we propose a number of fiscal and tax measures.

B1 To implement the measures proposed in the 2005-2006 budget

To fully implement the proposals mentioned in the 2005-2006 budget speech to levy taxes on usage of plastic bags and the introduction of a product responsibility scheme for waste tyres.

B2 Fees on collection of solid waste

In order to enshrine the "polluter pays" principle, the Government should conduct a comprehensive study for the introduction of a charge system for collection of industrial and domestic solid waste.

B3 Increase in tobacco duty

In order to encourage our citizens to quit smoking and to enhance the effectiveness of "The Smoking (Public Health) (Amendment) Bill 2005" which came into effect on 1 January 2007, we propose that the Government should raise tobacco duty.

We propose:-

The Government to have a tax policy to enhance the environment of our city, including but not limited to the measures proposed in B1 to B3 above.

C Fairness, certainty and transparency of tax system

C1 According a 'statement of loss' the same legal status as an 'assessment'

The recent Court's decision in the *Common Empire* case has confirmed the validity of the practice of the Inland Revenue Department ("IRD") regarding the status of a 'statement of loss'. The practice is that the issuing of a 'statement of loss' by the IRD is only an extra-statutory administrative measure indicating to a taxpayer the amount of tax losses that the taxpayer may carry forward for offset against his future assessable profits. However, since no tax is payable by the taxpayer for the year covered by a 'statement of loss', the statement cannot in law be regarded as an 'assessment', even though the process of ascertaining tax losses is very much akin to that of ascertaining assessable profits.

As such, the IRD is not bound by the normal 6-year time limitation period to reopen a case applicable to an assessment. That means the IRD can revise a 'statement of loss' any time before the tax losses are fully utilized to offset against the taxpayer's subsequent assessable profits contained in an assessment, and before that assessment becomes final and conclusive.

In case the taxpayer does not generate profits for a number of years, the taxpayer would face an uncertainty for a very long period of time whether the IRD would come back one day to re-open his case, and reduce or annul a statement a loss previously issued, resulting in him paying tax that cannot be envisaged. This state of affair is undesirable and does not promote fairness and certainty of our tax system.

This proposal will also benefit the CIR in providing to him or her certainty on the estimation of tax collectable (or tax refundable) and in the management of his or her officers in clearing outstanding loss cases.

We propose:
That the legislation be changed so that a 'statement of loss' must be issued by the IRD within six years after the end of the year of assessment in question and the statement be accorded the same legal status as an 'assessment', subject to the same 6-year limitation period.

C2 Publication of Assessor's Manual by the Inland Revenue Department

It is understood that the Government adopts a policy of fairness, certainty and transparency in its administration in Hong Kong. We believe that in order to foster a favourable investment environment, tax law should be consistently interpreted and applied by the IRD. The issue of Departmental and Interpretation & Practice Notes ("DIPNs") alone may not be adequate in this respect as DIPNs in general do not deal with procedural matters or specific situations. The application of these guidelines and rules affects the day-to-day tax administration. In line with the practice of other tax authorities (including the United Kingdom), the IRD should publish the Assessor's Manual in order to increase its transparency and taxpayers' trust and confidence in their dealings with the IRD.

We propose:-

The IRD to publish the Assessor's Manual to the public.

C3 Consistency of the source rules

We found from our members' feedback that there are various practices and policies in our tax administration which lack consistency and certainty. We believe that such a situation will damage Hong Kong as a preferred place to attract investment, and thus undermine significantly Hong Kong's simple and effective tax system. Examples of the uncertainty in the tax administration include adopting the so-called totality-of-facts approach in assessing offshore profits (in particular trading profits) and re-opening of 50:50 exemption cases premised on an unclear "apportionment of profit" policy. Further details and examples are set out C3.1 to C3.3 below.

C3.1 Avoid changes in certain long established administrative practices and assessment policy

In recent years, we found that the IRD has become much aggressive in their assessing and auditing initiatives. Without any forewarning, some of the long established administrative practices and assessing policies are ignored and, in their place, new practices and polices implemented without any prior consultation with the tax and accounting professions. For example, our members have noted a number of previously agreed cases on 100% and 50%

offshore profit exemption cases as well as time-apportionment exemption cases in salaries tax sections, are being re-opened by the Field Audit or Assessing Units of the IRD.

These exemption cases were previously agreed or allowed by the IRD. The 50:50 offshore profit exemptions have been given to those concerns which have their manufacturing bases in the Mainland of China. What remains in Hong Kong are only the management offices to provide supportive services to the manufacturing operations in the Mainland of China, such as the purchase of raw materials, receipt of sale proceeds, opening of letters of credit and keeping of books of accounts. As the manufacturing operations are carried out in the Mainland of China, the portion of profits attributable to manufacturing activities is outside Hong Kong. It has been a practice by the IRD to grant 50% exemption on those profits deemed to arise outside of Hong Kong. It is much to our surprise that cases which have been settled for a few years have been re-opened by the IRD. Such new assessing policy to re-open settled cases goes back to six years and sometimes with heavy penalties. Such retroactive change of administrative practice and assessing policy has created much discomfort and discontent amongst the taxpayers.

We do not categorically object the tax administration to change their practice and policies from time to time, which may be required according to the change of circumstances. We would expect that the changes be done in a controlled and informed manner with fairness to the taxpayers. We also suggest the Government consider allowing some kind of grand-fathering measures if there are any changes in the administrative practices and assessing polices.

We propose:-

The IRD to have consultation with the tax and accounting professions prior to any significant change of administrative practices and assessing policies and to consider allowing some kind of grand-fathering measures prior to any changes in the same.

C3.2 Set up a task force to review the source rules to be used in Hong Kong with a view of restoring and enhancing the attractiveness of the territorial tax regime of Hong Kong

Source rules for profits tax

It has been claimed that one of the tax incentives of Hong Kong is its territorial source based tax regime. Under such a regime, companies carrying on business in Hong Kong are not subject to taxation in Hong Kong so long as the profits earned are not sourced in Hong Kong.

In the past, many international corporations were able to set up re-invoicing and logistics centres in Hong Kong and book some of the trading profits here without exposing the same to taxation in Hong Kong. This was done on the basis that the contracts of purchase and sale of these trading activities were essentially concluded outside Hong Kong by other overseas associates, and Hong Kong was no more than the booking centre of those profits.

It has, however, been felt that the IRD is increasingly seeking to tax the profits which were merely booked in Hong Kong under the so-called "totality-of-fact" approach. This is so even in many cases it could be said that the economic activities in Hong Kong (that is, booking, re-invoicing and logistics etc.) are grossly incommensurate with the large amount of profits booked in Hong Kong and that the activities in Hong Kong could hardly be said to generate the profits assessed. One indication of this situation may be reflected in the case shown in the CIR's Advanced Ruling case No. 11.

Specifically, the IRD has once argued in a High Court in the case of Indosuez W.I. Carr that the profits in question were Hong Kong sourced simply because it was a place where the transaction was booked and certain background functions were performed.

In response to such assessing practice, it has been known that some investors are comparing setting up companies in Hong Kong vis-à-vis other jurisdictions with more favourable tax regimes such as the British Virgin Islands.

We believe that these booking profits are conducive to the economic well being of Hong Kong. If the IRD continues to pursue the aggressive assessing policies in the way it has changed to adopt, Hong Kong takes the risk of losing the competitiveness and businesses to other tax jurisdictions. It is obvious that businesses do create jobs and employment opportunities for the people of Hong Kong, including those of the lower income group.

Source rule for salaries tax

Similarly, in relation to the assessment of salaries tax, the IRD has also been seen as increasingly aggressive, in some cases, to use the more uncertain "totality-of-fact" test rather than the more certain "three-factor" approach stated in its own practice notes to determine source of employment. This deviation from his or her own practice notes creates uncertainty and discomfort amongst taxpayers.

We propose:-

A task force to be formed with a brief of reviewing the source rules in Hong Kong for both salaries tax and profits tax with a view of devising ways of restoring and enhancing the attractiveness of the territorial tax regime of Hong Kong. The review will make use of the tax policy to serve the best interests of Hong Kong.

C3.3 Legislation needed to specifically exempt certain non-taxable profits

Hong Kong adopts a territorial concept of taxation. Only profits arising in or derived from a source in Hong Kong from a trade, profession or business carried on in Hong Kong is assessable to Hong Kong profits tax. The CIR has issued DIPN No. 21 which specifies, amongst other things, that the following activities performed in Hong Kong will not, of themselves, create taxable profits in Hong Kong, namely:

- issuing or accepting invoices (not order) to or from customer or supplier outside Hong Kong (whether related or not) on the basis of contracts of sale or purchase already effected by an associated company situated outside Hong Kong;
- arranging letters of credit;
- operating bank accounts and receiving payments; and
- maintaining accounting records.

We propose:-

To provide confidence to the taxpayers in our tax system for certainty and consistency, the exemption status of the above activities should be enacted by law in the Inland Revenue Ordinance ("IRO"). The legislation of exemption for these exempted activities in the statute law is necessary because the Board of Review does not recognise the binding effect of DIPN imposed upon it in hearing tax appeals from taxpayers' objection against the CIR's determination.

D Incentives to enhance business operating environment

D1 Legislative changes to S15(1)(ba) to remove the hindrance for Hong Kong becoming a sub-licensing operational base for the region and Mainland China in particular

Section 15(1)(ba) of the IRO provides that a non-resident recipient would be liable to withholding tax in Hong Kong in respect of certain royalty payments made by a Hong Kong payer – even though the rights to use of the intellectual property rights in question can only be exercised exclusively outside Hong Kong. The section was enacted in 2004 to effectively nullify the Court of Final Appeal's decision in the Emerson case, which involved a Hong Kong company using the intellectual property rights for its sub-contracted out manufacturing activities outside Hong Kong and its sales activities in the US.

The enactment of S15(1)(ba) in 2004 was then widely perceived as breaching the territorial source rule of Hong Kong - as the legislation intended to charge royalty withholding tax on a non-resident recipient in respect of his granting to a Hong Kong payer rights to use intellectual properties outside Hong Kong. Nonetheless, despite the controversy, the legislation was passed and S15(1)(ba) in its present form was enacted.

For a manufacturing and trading situation such as in the Emerson case, the royalty payment would generally not be subject to any withholding tax in the place the intellectual property rights are actually used, as it is the Hong Kong payer which would make the royalty payments, not any other entities located in the place of manufacturing or sale outside Hong Kong. As such, double taxation would not generally occur.

However, in case the Hong Kong payer is a sublicensing company, further licensing out the rights to another person outside Hong Kong, the royalty stream would normally suffer withholding tax in the place where the sub-licensee operates. And under the TVBI case source rule stated in D9 below, the sublicensing income of the Hong Kong company would probably also be liable

to tax in Hong Kong under S14 of the IRO. If so, the royalty payments made by the Hong Kong payer to the non-resident recipient would be chargeable to the royalty withholding tax in Hong Kong under S15(1)(ba) of the IRO, albeit the rights granted are and can only be used outside Hong Kong. As such, effectively the royalty stream in respect of the same intellectual property rights outside Hong Kong would suffer double taxation in terms of withholding tax – in the place where the sub-licensee actually uses the rights and also in Hong Kong.

This effective double taxation in terms of withholding tax on royalties is not conducive to Hong Kong becoming a centre for intermediate licensing operations in the region, in particular to those wishing to take advantage of the reduced PRC royalty withholding rates under the recently concluded comprehensive tax arrangement between Hong Kong and the Mainland of China. Nor do we believe that the resulting double taxation in the circumstances is the legislative intent of S15(1)(ba).

We propose:-

That the legislation be amended so that a non-resident recipient be excluded from the charge of withholding tax under S15(1)(ba) of the IRO in Hong Kong, so long as (i) the Hong Kong payer is a sub-licensing company and overseas withholding tax is paid or payable on the royalties received by the Hong Kong payer, (ii) the intellectual property rights are and can only be used outside Hong Kong and (iii) the licensing fees paid to the non-resident are in respect of the same rights covered by the sub-licensing income of the Hong Kong payer.

D2 Investment in human resources by allowing 150% deductions on training costs

With the policy of the Government in securing and maintaining a talented population and promoting Hong Kong as an International Financial and Services Centre in the 21st Century, we need a pool of educated, talented and motivated workforce to sustain the success of Hong Kong. This pool of talented people would be replenished from time to time. For tax purposes, the Government should allow certain incentives to the employers to invest in human resources.

We propose:-

To allow 150% deduction on training cost to employers for profits tax purpose so as to encourage human investment in our workforce for the good of Hong Kong in the future.

D3 Tax incentives to companies setting up headquarters in Hong Kong

Hong Kong, in these recent years, is losing its status as a location for headquarters in the Asian region. Some companies have been moving their headquarters to other Asian countries.

On the one hand, with the signing of the Closer Economic Partnership Arrangement (CEPA) between the Mainland of China and Hong Kong and the integration of the Pan-Pearl River Delta Economic Zone, more multi-national companies are attracted to set up headquarters in Hong Kong. On the other hand, we do not have any tax incentive to attract companies to set up headquarters in Hong Kong. Against the rising costs of maintaining headquarters in Hong Kong, we may grant tax concessions to these companies in the form of tax reduction, say, reduction of the tax rate to 10% from the present profits tax rate for corporations of 17.5%.

Certain criteria could of course be stipulated to be met by the companies for their qualification for the tax concession by reference to the amount of investment in Hong Kong, the number of highly qualified persons to be brought to Hong Kong and the number of local people that the company will employ in Hong Kong etc

We propose:-

To allow tax concessions to qualified corporations which maintain headquarters in Hong Kong.

D4 Tax loss relief for business

In response to requests for tax loss relief for businesses made by many professional bodies, including ourselves, the administration's response in the last year's budget speech was that group loss relief and carry-back would cost the Government billions of tax revenue foregone and could be easily abused.

However, we believe that if the tax loss relief is only granted to substantially wholly-owned group companies and necessary anti-avoidance provisions are built-in, the revenue cost of introducing such relief should be affordable, and would be a worthwhile investment in enhancing the attractiveness of our tax system to foreign investors.

We propose:-

That the Government should reconsider our previous proposals on the introduction of group loss relief and carry-back of tax losses in the light of our current fiscal position and, if necessary, the imposition of the conditions for granting such relief so as to prevent abuse.

D5 Deduction for initial purchase costs incurred on implements, utensils and articles

Inland Revenue Rules allows certain cost of purchase to be allowable on replacement basis and the items concerned for deduction include implements, utensils and articles. Under the rule, the initial purchase cost is not, and will never be, allowable and only the replacement cost is allowable. The common businesses affected by the rules are restaurants and hotels which incur a lot of expenditure on these items. This line of businesses has contributed a lot to the

economy in Hong Kong. In particular, they employ many workers in Hong Kong. The tax law should be amended to allow the initial purchase cost of those items to reflect the concern of the Government towards these businesses and indirectly, the employment of workers by these businesses.

We propose:-

To allow full deduction for the purchase cost of implements, utensils and articles because these are genuine business expenses of restaurants and hotels which contribute much to the prosperity of Hong Kong by employing many workers in Hong Kong.

D6 Amortisation of capital expenditure on franchise, concession or licence etc. in service industries

Certain capital expenditure for service industries is as important as plant and machinery for manufacturing industries.

Such capital expenditure includes, for example, acquisition costs of franchise, concession or licence. We do not see the rationale of merely granting depreciation allowances to plant and machinery but ignoring the capital expenditure involving franchise, concession or licence to which we believe an amortisation allowance should be given.

We propose:-

To allow amortisation of capital expenditure on franchise, concession or licence in service industries.

D7 Full deduction for business equipment

From 1 April 1998 onwards, expenditure incurred for the purchase of computer equipment and manufacturing plant and machinery are fully allowable under section 16G of the IRO in the year of purchase. To encourage service industries to upgrade their operating apparatus, cost of business equipment such as fax machines, copiers and telephone systems etc. should also be fully allowable.

We propose:-

To allow full deduction for the purchase cost of business equipment, irrespective of the nature of business.

D8 Review of depreciation allowances for cross-border leasing/manufacturing activities

The amendment of section 39E(1)(b) of the IRO in March 1992 was intended to stop the use of leveraged leasing structure of assets principally used outside Hong Kong to obtain tax benefits by way of depreciation allowances. The

amendment has the effect of deterring genuine international investors from setting up companies in Hong Kong to lease machinery and equipment to users in other territories.

Further, according to the IRD's recently made known interpretation and assessing practice, it appears that the provision would also apply to a Hong Kong taxpayer's plant and machinery used by its wholly-owned subsidiary company in the Mainland of China under an "import processing" arrangement. In such a case, no depreciation allowances would be granted under S39E on the ground that the provision of plant and machinery by the Hong Kong taxpayer to its PRC subsidiary technically constitutes a "lease" arrangement by definition and that the plant and machinery are used outside Hong Kong, As such, the IRD seems to have indicated that its concessionary practice of granting depreciation allowances to similar arrangements but under a different legal form, i.e. a PRC "contract processing" arrangement would not be extended to cover "import processing" arrangement. The IRD has also further indicated that since the plant and machinery are under a lease arrangement as explained above, the assets would not qualify as prescribed fixed assets within the terms of S16G of the IRO. Therefore, the Hong Kong taxpayer cannot also rely on that section to claim tax deduction for the costs of the plant and machinery.

The amendment has the unintended effect of making some genuine cross-border leasing operations in Hong Kong unviable, and of hindering certain commercial operational mode of Hong Kong taxpayers in their "import processing" manufacturing arrangements in the Mainland of China (at least as far as the provision of plant and machinery is concerned).

The law should be amended to make room for the granting of depreciation allowances or outright deduction for the cost of the plant and machinery to genuine cross-border leasing or manufacturing businesses when their profits are assessable to Hong Kong tax. This would make Hong Kong a more attractive place for setting up cross-border leasing or manufacturing businesses.

In fact we made the same submission last year but the IRD's recent indication and the apparent assessing practice that the concessionary practice of granting tax depreciation allowances to "contract processing" arrangements (despite the provision of S39E) would not generally be extended to cover "import processing" arrangements make our proposal demand more immediate attention.

We propose:-

To amend section 39E of the IRO and to adopt a more restrictive interpretation of the term "lease" in the case of a contract manufacturing arrangement between a Hong Kong taxpayer and its subsidiary in the Mainland of China so as to allow room for genuine cross-border leasing and manufacturing businesses to claim tax depreciation allowances and/or deduction under section S16G on assets used outside Hong Kong when their profits are assessable to Hong Kong tax.

D9 Unilateral tax credits grantable for overseas withholding tax on royalties and interest income

Hong Kong taxpayers who grant the use or the right to use of their intellectual properties to persons outside Hong Kong would normally suffer overseas withholding tax in respect of the royalty income, as the same would likely to be regarded as being sourced in the overseas countries concerned.

However, following the source rule for royalties adopted in Hong Kong after the TVBI case, such royalty income of the Hong Kong taxpayers would probably also be liable to tax in Hong Kong under section 14 as the income is derived from their business carried on in Hong Kong. This has the effect of the royalty income earned by the Hong Kong taxpayers being doubly taxed.

Similarly, interest income of Hong Kong taxpayers, in particular, financial institutions, may also be subject to overseas withholding tax as well as profits tax in Hong Kong in respect of their loans granted to persons outside Hong Kong.

At present, Hong Kong taxpayers would probably only obtain a tax deduction in Hong Kong in respect of their overseas withholding taxes paid on royalties and interest, under either section 16(1) or section 16(1)(c) of the IRO. That means there is no full tax credit of the overseas taxes paid against the Hong Kong profits tax payable on the same income, since Hong Kong has not entered into any comprehensive tax treaty arrangement with any other countries or territories (except with Belgium, Thailand and the Mainland of China) which may grant full tax credit on overseas taxes suffered to avoid double taxation.

Unlike a full tax credit, tax deduction for overseas taxes paid is only a partial tax relief and does not fully eliminate double taxation. As such, in the absence of a comprehensive tax treaty network, unilateral tax credit should be allowed to taxpayers under the IRO in respect of their overseas withholding taxes suffered on royalties and interest. This measure will give full tax incentives for Hong Kong businesses to exploit fully the overseas markets and for international companies to invest in Hong Kong.

We propose:-

Unilateral tax credit should be allowed to taxpayers under the IRO in respect of their overseas withholding taxes suffered on royalties and interest. This measure will give full tax incentives for Hong Kong businesses to exploit fully the overseas markets and for international companies to invest in Hong Kong.

D10 Full tax exemption for international shipping income of Hong Kong based shipping companies

According to the last Policy Address by the Chief Executive of the Government, it is clear that Hong Kong will position herself as an international finance centre, trading centre and shipping centre.

Currently, Section 23B of the IRO only exempts international shipping profits derived from ships registered in Hong Kong. However, it is understood that due to operational needs, Hong Kong based shipping companies may often have to charter foreign registered ships for their operations and therefore cannot enjoy the tax exemption granted to Hong Kong registered ships – even though as far as the shipping companies are concerned the mode of operations is essentially the same whether the ships involved are registered in Hong Kong or overseas.

To promote Hong Kong as an international shipping centre, we consider that there is a case to grant a total exemption of profits tax on shipping profits derived from international transportation by a shipping company incorporated or normally managed or controlled in Hong Kong regardless of the flags flying on the mast of a ship. It is believed that such tax incentive may attract foreign liner companies which currently pay profits tax under Section 23B to be based in Hong Kong, and would thus enhance the competitiveness of Hong Kong as an international shipping center.

In this regard it should be noted that Singapore adopted the same measure in 1998 under Section 13A(1) of the Income Tax Act with a view to promoting the local shipping industry.

We propose:-

To promote Hong Kong as an international shipping centre, consideration should be given to grant a full exemption of profits tax to international shipping income derived by a company incorporated or normally managed or controlled in Hong Kong regardless of the place of registration of the ships concerned.

D11 Double Taxation Agreements (DTAs) For Hong Kong

Multinational corporations ("MNC") headquartered in Hong Kong face a competitive disadvantage in terms of tax when doing business in many foreign territories. This is the result of a lack of sufficient DTAs entered into by the Government, compared with many other territories. Currently, Hong Kong has only three comprehensive DTAs signed with Belgium, Thailand and the Mainland of China. Apart from the MNCs, many local companies in Hong Kong engaging in cross-border businesses are also facing the same problem. The resulting adverse tax impacts are many, including the full payment of withholding taxes on dividends, interest or royalties paid to Hong Kong resident companies.

We understand that one of the reasons for Hong Kong not being able to conclude more DTAs with other countries may be due to the insufficient manpower and the relevant resources.

In the absence of sufficient DTAs entered into by the Hong Kong SAR Government, Hong Kong shipping companies, for example, suffer the most. Many territories impose a flat tax on freight income received by foreign shipping companies on a deemed income basis irrespective of the actual profit and loss positions of the shipping companies. These territories include Australia, Bangladesh, India, Pakistan, the Philippines, Taiwan, Vietnam, Russia and

Poland. In some territories, the profit margins deemed by the foreign governments could be very high. This directly increases the costs of the Hong Kong shipping companies doing business in these territories. Since shipping companies from territories having a large network of DTAs may be fully or partially exempted from these freight taxes, Hong Kong shipping companies are therefore not competing on a level playing field with these overseas shipping companies. Moreover, the lack of a broad DTA network in Hong Kong will be an impediment to economic and trading activities between Hong Kong and the corresponding foreign territories.

We propose:-

The Government to put more manpower and resources on the DTA negotiations so as to expedite successful conclusion of the same, with priority being given to entering limited scope of reciprocal exemption agreements for shipping income first over the more time-consuming comprehensive DTAs.

D12 Extending the interest deduction regime to include overseas government and government bodies for interest deduction purposes

The interest deduction rules under Sections 16(1) and 16(2) of the IRO are fairly restrictive when interest payments are made to overseas lenders. (The bank interest deduction rules are further subject to the anti-avoidance provisions in sections 16(2A) to 16(2H)). Whilst we do not propose making any substantial changes to these provisions, there is a case for interest payments to overseas governments and government bodies to be afforded the same deduction rules when such interest is paid to overseas financial institutions.

We are aware that some overseas government bodies are concerned that they were being treated unfairly (when compared with overseas financial institutions) when they lend to a domestic Hong Kong entity. We believe it is unlikely that an overseas government or a government body should pose any risk of collaborating with a borrower in Hong Kong to obtain excessive interest deductions.

We suggest adding a new subsection 16(2)(dd) after subsection 16(2)(d) to allow interest deduction where "money has been borrowed from an overseas government".

By not scarifying the certainty of the term "overseas government", such term can still be defined more generally. We find that such definition can be borrowed and adopted from some of the DTAs which Hong Kong or China has entered into.

By way of an example, we suggest that an "overseas government" can mean:

(i) an overseas central government;
(ii) the central bank of such government;
(iii) an export credit agency or a similar institution established by such government; or

(iv) any institution established by such government and recognised by the Commissioner.

We propose:-

To amend relevant sections of the IRO so as to allow deduction of interest paid to overseas government and overseas government bodies.

E Tax incentives to individuals

E1 Increase of child allowance

Hong Kong is still facing the problem of low fertility rate which could be attributable to long working hours, stress, unhealthy life style and crowded living environment. In addition, the cyclical fluctuation in business environment can cause immense hardship to Hong Kong people, particularly the middle class. Without a sufficient young and talented pool of people to replenish our workforce, Hong Kong will not be able to maintain its strength as an international financial and services centre.

We propose: -

To increase the child allowance from the current amount of HK$40,000 to HK$60,000 for each eligible child up to the 9th one so as to cater for the cost of living and education of those middle class taxpayers having one or more children and to boost the birth rate of the local people in Hong Kong.

E2 More generous deductions for membership subscription fees paid to professional bodies under salaries tax regime

Under the present salaries tax regimes, membership subscription fee of only one professional body is allowable. With the change of education environment and the policy of encouraging the workforce to equip oneself with more skills for the future, the present deduction limit is outdated and should be released.

We propose:-

To allow deduction of paid membership subscription fees for professional bodies without limit in salaries tax regime.

E3 Extend the scope of courses qualifying for self-education expense deduction

It has been the government policy of encouraging the people of Hong Kong to carrying on life-long learning so as to maintain the quality of workforce in Hong Kong. The relevant part of the IRO should provide corresponding incentives to the taxpayers who have been struggling with their own budget for enhancement of their employment skills. However, the present tax incentive for deduction of

self-education expenses is limited to those courses which maintain a qualification for use in any employment. The relevant part of the IRO should be amended to extend the scope of courses that could be qualified for deduction for self-education expenses.

We propose:-

To extend the scope of courses qualifying for deduction of self-education expenses without limit so long as the expense is actually spent by the taxpayer.

E4 Deduction of insurance premium

The cost of providing medical services to the public will increase year after year with the increase of the proportion of the elderly population in Hong Kong. Rather than leaving the Government alone to shoulder the cost of the medical services, we suggest that the public should be encouraged to take out medical insurance and that the insurance premium so paid will qualify for deduction, subject to a maximum of $30,000 a year. Deduction of the medical insurance premium will not cause a significant loss in revenue to the Government because the premium so received by the insurance companies will be assessed to Profits Tax. If compensations are received by the insured (that is, the taxpayers), the sums will set-off the cost of the medical services which will otherwise be borne by the Government. Further, provision of this kind of deduction will enhance the business environment of the financial services industry in Hong Kong.

We propose:-

To amend the IRO to allow deduction of, say, $30,000 a year for insurance premium paid for medical insurance so as to assist the middle class taxpayers, relieve the Government of part of the burden in the provision of medical services to the pubic and enhance the business environment of the financial services industry in Hong Kong.

E5 Salaries Tax relief

Although our economy recovers significantly in 2006, it is still faced with many challenges such as fluctuation of oil prices, US dollars exchange and interest rates coupled with the erratic movements of foreign funds in Hong Kong. For the benefit of the taxpayers, we suggest that the Government should implement some salary tax relief for the taxpayers by widening each tax band from the current level of $30,000 to $35,000 and reducing the progressive rates back to the level of those in 2002/03. We anticipate such tax relief would not cause much loss in tax revenue nor narrowing the existing tax base but can have the favorable effect to the taxpayers upon the economy's recovery since 2005.

We propose:-

To widen the tax band from $30,000 to $35,000 and reduce the progressive rates back to the level of those in 2002/03 so as to allow some relief of the taxpayers of the middle class to enjoy the gain of economic recovery.

E6 Extend the personal assessment right to one spouse

With the present personal assessment regimes, in the case of married couples, the 2 spouses should be joined together to have personal assessment election. They do not have their own right to make the election. This election right to personal assessment is obviously outdated. Nowadays, men and women are of equal status in many, many aspects. Each spouse should be allowed personal assessment and he or she need not get the agreement of the other party to have personal assessment.

We propose:-

Personal assessment election right should be allowed to each spouse and he or she need not obtain the agreement of the other party to the marriage for personal assessment of his or her income.

F Creating a caring community

F1 Charitable donation limit

We mentioned in our last year budget proposal that to encourage taxpayers in recognizing their social responsibilities and to enable charitable organizations and quasi-government bodies to continue in providing a quality education and other social services, the existing 25% limit on charitable donations to approved charities or trusts of public character should be increased to 50%. Such suggestion is also in line with some international tax practices and would have the benefit of alleviating the financial burden on the Government in respect of the education and welfare sectors.

We believe the loss of tax revenue by increasing the deduction limit would be less than the additional savings on the government public expenditure.

We propose:-

To increase the charitable donation limit for tax deduction from 25% to 50% of a taxpayer's assessable profit or income.

F2 Extend the meaning of charity by statute to include advancement of sports

As also suggested in our last year budget proposal, we consider that promoting sports activities within Hong Kong could fit well into the overall context of maintaining good health for Hong Kong citizens. A healthy population would

also relieve the Government from spending excessive resources on the public health care system, in particular, when we are facing an aging population in the 21st century.

The specific inclusion of advancement of sports as a charitable object for the purposes of Section 88 of the IRO is in line with the development of HK as a vibrant international city. The effect of the proposal will allow organizations involved in the promotion of sports to be specifically recognized as charitable bodies which then will have an easier task to raise funds for their professional activities. With Hong Kong achieving good results in the Asian Games which were closed in December 2006, the proposal will arouse the interest of the people of Hong Kong in sports and the fact that Beijing will host the Olympic Games in 2008 and Hong Kong will host the East Asian Games in 2009.

We propose:-

To adopt a clear policy so that the meaning of charity will unequivocally include advancement of sports (at the moment one can only rely on the very general meaning of charity to convince the IRD on a case by case basis that a sports organization qualifies as a charity) in order to make sports bodies easier to raise funds for their activities and to make the people of Hong Kong aware of the importance of good health.

F3 Additional Parent allowance and Grandparent allowance

Due to the increase in life expectancy of the Hong Kong population and the increase in the old age population as a percentage of the general population, it is foreseeable that the burden of taxpayers (who may need to maintain aging family members and who may also face a higher tax charge as the aging population takes a toll on the social welfare of Hong Kong) who are within their working age will increase in the next couple of decades. We consider that a second tier of parent allowance and grandparent allowance can be introduced in order to alleviate the extra burden of taxpayers when they need to maintain parents or grandparents who are aged 80 or above at any time during a year of assessment.

We propose:-

A relief of an additional parent allowance or grandparent allowance at an amount of $15,000 for dependent parent/grandparent who is aged 80 or above at any time during a year of assessment.

Yours sincerely,
For and on behalf of
The Taxation Institute of Hong Kong

(Signed)

Richard Chow
President