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By Post

Tax Reform
Financial Services and the Treasury Bureau
The Government of the Hong Kong Special Administrative Region
4/F Main Wing Central Government Offices
Lower Albert Road
Central
Hong Kong

30 March 2007

Dear Sir/Madam,

Consultation on Broadening the Tax Base and Tax Reform in Hong Kong

We refer to the consultation document published by the Government of the Hong Kong Special Administrative Region ("the Government") in July 2006 entitled "*Broadening the Tax Base, Ensuring our Future Prosperity: What's the Best Option for Hong Kong?*".

PricewaterhouseCoopers ("PwC" or "we") welcome the Government's move towards a public consultation on tax reform in Hong Kong. As one of the largest firms of professional tax advisers in Hong Kong, we are pleased to participate in the consultation and contribute our views and comments on the subject matter.

Accordingly, please find enclosed PwC's submission document in response to the Government's consultation for your perusal. Should you wish to discuss further with us any of the comments in the submission document, please contact the undersigned by telephone on or by email at

Yours faithfully,
For and on behalf of PricewaterhouseCoopers Limited

(Signed)

Rod Houg-Lee
Partner
Tax Services

PricewaterhouseCoopers' Submission on the Government's Consultation on Broadening the Tax Base and Tax Reform in Hong Kong

This submission is made by PricewaterhouseCoopers ("PwC" or "we") in response to the consultation document entitled *"Broadening the Tax Base, Ensuring our Future Prosperity: What's the Best Option for Hong Kong?"* ("the Consultation Document") published by the Government of the Hong Kong Special Administrative Region ("the Government") in July 2006. We set out in the submission our views and comments on tax reform in Hong Kong and what we consider as the viable options to broaden the tax base in Hong Kong for the Government's consideration.

Is Tax Reform Required in Hong Kong?

We agree that the existing tax base of Hong Kong is too narrow and the Government should take action to broaden the existing tax base for two important reasons; namely, to secure a more stable source of government income in the future and to align Hong Kong's taxation policy with the international trend so as to maintain its international competitiveness.

Based on the latest statistics published by the Inland Revenue Department ("the IRD"), profits tax and salaries tax together contributed 74% of the total revenue collected by the IRD for fiscal year 2005/06 and this percentage was constantly maintained at above 70% for the past three years. This revenue pattern reflects that under the current tax system, the Government is heavily relying on revenue collected from a limited group of businesses and individuals that are paying direct taxes. As pointed out in the report prepared by the Advisory Committee on New Broad-based Taxes in 2002 ("the Report") and the Consultation Document, this is in contrast to the international trend towards a less reliance on direct corporate and individual taxes as sources of government revenue.

As compared to the other OECD developed countries, Hong Kong's reliance on non-tax revenue is also relatively high. The Consultation Document shows that non-tax revenue, primarily derived from land sales and investment earnings from accumulated reserves, has contributed almost 40% of the Government's total revenue from 1996/97 to 2005/06, whereas the OECD's total reliance on non-tax revenue for the period from 1995 to 2003 only averaged 12.4%.

Moreover, we agree that broadening the tax base would help ensure Hong Kong's future prosperity by providing a broader and more stable revenue base for the Government. It would also provide the Government with additional means to preserve and enhance Hong Kong's competitiveness by providing a more flexible tax system. For example, it would provide greater flexibility for a reduction in direct taxes, such as salaries tax and profits tax; should such a move be necessary in the face of global or regional trends. We also believe that the current reviving economic condition in Hong Kong makes it an appropriate time for the Government to push ahead with any program of tax reform.

Our Comments on Goods and Services Tax

The Government announced in early December 2006 during an interim review of the Goods and Services Tax ("GST") consultation that it has decided it would no longer be advocating the introduction of a GST in Hong Kong during the remaining public consultation process. On the one hand, we understand the Government's decision given the numerous concerns and oppositions the Government has received from different sectors of the society since the

launch of the Consultation Document. However, on the other hand, we believe that it may be premature to conclude whether a GST would work for Hong Kong.

In our opinion, GST is still one of the most viable options to broaden the tax base in Hong Kong and warrants further consideration. GST has the advantage of being very broad based and there can be no doubt that it can effectively address the problem of a too narrow tax base. Being an indirect tax levied on general consumptions rather than a direct tax charged on profits or income, a GST would be better insulated from adverse economic cycles. It would be a more stable source of revenue that does not fluctuate to the same extent as that of profits tax, salaries tax or other non-tax revenue such as income from land sales and the investment income from the exchange fund. GST is also a relatively fair tax in a sense that it has a wider coverage of economic activities and is not focusing on selected consumptions (such as tax on luxury goods) or income from a particular type of activities / transactions (such as tax on interest or dividends). As most of our key competitors in the Asian region (e.g. China, Singapore, Japan, Taiwan, Korea) have already implemented a GST or a tax of similar nature with a rate of 5% or more, despite the opposition and concerns about a GST expressed by many in the community, we remain of the view that introducing a GST with a rate of 5% or less would be unlikely to have a very significant impact on the international competitiveness of Hong Kong in the long term.

Recognising however that the Government has decided that it no longer wishes to advocate a GST for now, we will not comment in this submission on the specifics of the GST framework presented in the Consultation Document. We will however devote the rest of this submission to other possible ways in which Hong Kong's tax base could be broadened.

Other Options to Broaden the Tax Base

We are of the opinion that there should be a more open debate and discussion over the ways to broaden the tax base and that this debate should not be just restricted to the two viable options identified by the Report, being a significant reduction in personal allowances and an introduction of a GST. We provide below our comments on some of the options that have been addressed in the Report or discussed by the public.

1. Increasing Tax Rates or Progressiveness of Profit Tax / Salaries Tax

Our view is that neither increasing the profits tax rate and/or salaries tax rate nor increasing the progressiveness of these taxes is a viable option.

Firstly, it is against the public expectation and strong opposition is likely. Secondly, increasing the rates or the progressiveness will only mean the existing taxpayers have to pay more and cannot serve the purpose of broadening the tax base. Thirdly, some of our competitor economies have already reduced or are considering further reducing their corporate or individual tax rates. Increasing the tax rates will further narrow the gap between Hong Kong and its competitors and erode Hong Kong's competitive edge. This is also against the international trend of moving away from reliance on direct taxes.

2. Reducing Personal Allowances / Concessionary Deductions under Salaries Tax

Reducing the personal allowances and/or concessionary deductions under salaries tax will result in more people within the working population falling into the salaries tax net. This can serve the purpose of broadening the salaries tax base. Given that currently only around one-

third of the working population is paying salaries tax, we believe that this is an option that could be further explored.

However, this will undoubtedly result in a large number of new taxpayers who are required to lodge tax returns, and additional administrative resources will be required to process returns which have minimal tax liabilities. Further, if the Government's objective is to broaden the tax base rather than to raise additional tax revenue, our view is that if the personal allowances and /or concessionary deductions are to be reduced, the marginal tax rates and tax bands under salaries tax must also be adjusted correspondingly such that the existing taxpayers will not have to pay more tax as a result.

We would reiterate at this juncture that the objectives of any tax reform in Hong Kong must be clearly defined and explained to and ideally understood by, all in the community. Actually, being clear on whether the objective is to broaden the base and or to raise additional revenues, and what the reasons are for that, is very important for community buy-in.

3. Increasing Stamp Duty on Land / Property related Transactions

Again, increasing stamp duty on land / property related transactions does not serve the purpose of broadening the tax base as it just increases the amount of tax currently levied on a particular type of transactions.

Stamp duty collected from these transactions is also highly susceptible to fluctuations in the market condition and therefore would not help to stabilize the Government's revenue. The possible adverse impacts on the land and property market, which constitutes one of the few major economic activities in Hong Kong, will also need to be carefully assessed. Other issues that need to be considered include whether any concessions should be given for residential properties bought for self-use, etc.

4. Tax on Capital Gains

Capital gain tax is another option considered by the Advisory Committee. We agree with the conclusion of the Advisory Committee that this is not an option to pursue.

Although a capital gain tax could broaden the tax base to a certain extent (that is, gains derived from capital transactions that currently are not caught under profits tax will be captured under this tax), experience in other countries (such as the UK and the US) shows that the tax often involves complicated tax legislations and the high collection and compliance costs may outweigh the potential benefits, not to mention the possible detrimental effect on Hong Kong's position as Asia's premier regional financial and listing centre. Complicated issues inherited in taxing capital gains include making a distinction between short-term and long-term gains, dealing with realised versus unrealised gains, offsetting capital losses against capital gains, and valuation issues in computing the gains or losses, etc. Moreover, a capital gain tax would be susceptible to adverse market conditions so it would not help to improve the stability of the Government's revenue.

5. Tax on Dividends

Similarly, numerous issues arise from the introduction of a dividend tax. Under international practice, a dividend imputation system has to be put in place to eliminate double taxation of the amount in the hands of the companies and the shareholders. If Hong Kong is to maintain its international competitiveness and follow international practice, it would have to introduce a

complex dividend imputation system which is not in line with the maintenance of a simple Hong Kong tax system. Further, the additional revenue generated from taxing dividends would not be significant, not to mention the complication of administering the dividend imputation system. Therefore, we do not see a dividend tax being a viable option for Hong Kong.

6. Tax on Interest

Tax on interest can serve the purpose of broadening the tax base. However, we do not see it as an efficient way to achieve the said objective because of various reasons.

The major problem with tax on interest is that it can easily be avoided by moving the monetary assets offshore. Individual depositors can choose to move their monetary assets offshore and financial institutions will likely be quick in developing various offshore banking products for their investors. The yield on local deposits will also be unstable and susceptible to changes in the market interest rates. Also, the tax is inflexible as it does not easily deal with financial returns from derivative products that are in forms other than interest.

7. Tax on Worldwide Income of Businesses and Individuals

Taxing worldwide income has the capacity to broaden the tax base and increase revenue, taking into consideration the volume of offshore claims lodged by taxpayers and the tax amount involved in respect of various types of income in the past. However, we believe this would not be a right direction to go because of the reasons noted below.

Firstly, this will fundamentally change the territorial source concept of the Hong Kong tax system. Secondly, Hong Kong's competitiveness will be seriously undermined if it is taxing worldwide income without extensively expanding its current double tax agreements network as the international norm is to grant a tax credit for any foreign tax paid. On the other hand, if foreign tax credit is made available for tax paid outside Hong Kong, significant additional revenue is unlikely to be raised given the relatively low tax rates in Hong Kong. Finally, high collection and administration costs are likely to be involved in tracing and identifying all offshore income. The introduction of a foreign tax legislation will also add considerable complexity to the current tax system.

8. Increase Rates on Tenements

Rates itself is a broad-based tax but the problem with increasing rates is that it only produces additional revenue from an existing source but does not widen the sources of the Government's revenue. Therefore we do not consider this as an option for broadening the tax base.

9. Land and Sea Departure Tax

We believe that a land and sea departure tax is one of the viable options that warrants further consideration because of the following reasons.

Firstly, it will be a broad-based tax as it is levied on every person departing Hong Kong by land or sea and including people from different sectors of the community. Secondly, it is fair in the sense that it follows the "pay as you use" principle and that people departing Hong Kong by air are already paying a departure tax. Thirdly, the costs of administration and collection for departure tax are relatively low and avoidance is difficult so it is an efficient way of raising

additional revenue and broadening the tax base. The final point is more to deal with the psychological effect rather than the practical impact of the tax on the society. As there is currently a tax charged on air departures, a land and sea departure tax may less likely be perceived by the public as being a new tax introduced by the Government. This may reduce the public's negative perception on the move of levying such tax.

There may be concerns that the revenue raised from introducing such tax may not be significant enough. According to the Report, based on the number of departures in 2000, the tax would yield around HK\$1 billion a year if it is set at HK\$18 per departure. In our opinion, the revenue yield of the tax would very much depend on the level of tax charged per departure and the number of departures. The combination of an increasing number of people travelling between Hong Kong and the Mainland (and other locations) by land and sea and a rate of departure tax of more than HK\$18 per departure could result in much higher revenue collections than suggested in the Report.

10. Green Taxes

This is another suggestion brought to the Advisory Committee during its consultation process. The Advisory Committee said in the Report that they were not in a position to discuss green taxes as introduction of such taxes involves complex considerations related to environmental protection that go beyond fiscal justifications. We agree that the subject of environmental protection represents another facet of the social problems facing Hong Kong and the subject should itself be a separate topic that needs further studies and public discussions.

From a purely fiscal point of view, green taxes can either be very broad based (e.g. tax on use of plastic bags or electricity) or narrow based (e.g. tax on use of tyres or car batteries) depending on the category of environmental consumptions on which the tax is to be levied.

Our primarily view is that tax on electricity usage is not recommended as this is one of the basic utilities essential for everyone and the cost of electricity in Hong Kong has already reached a relatively high level by international standards.

A moderate plastic bag tax may gain some public support given its environmental protection objective. However, experience in other locations suggests that the tax may only have initial success and may not yield drastic result in the long term in terms of reducing usage. If the Government is going to consider this option further, we suggest that experience from those European countries with plastic bag tax, such as Ireland and Denmark, should be taken into consideration.

11. Tax on Luxury Goods

During the consultation process, the idea of a tax on luxury goods has also been raised. In reality this is little different to a VAT or sales tax, and would likely be met with similar opposition. We already have a luxury goods tax in the form of a vehicle first registration tax and importers of vehicles have come up with ideas, such as "unbundling", to minimise this vehicle first registration tax. A clear definition of what a luxury good might be would be very important to the success of any such tax. In practice, this would be difficult to do, and would be compounded by the fact that what is a "luxury good" to one person may be seen as a commodity by someone else.

What's the Next Step?

To conclude, we have identified the following four options as the most viable options to broaden the tax base in Hong Kong and would recommend that the Government conducts further studies and public consultation on these four options as the next step of the tax reform consultation:

1. Reducing personal allowance/concessionary deductions under Salaries Tax
2. Introducing a Land and Sea Departure Tax
3. Introducing a GST
4. Introducing green taxes

In addition to the above four options, that involve either an introduction of a new tax or a change in the current taxes, we believe that a better policing or enforcement of the existing tax law in certain areas – including for example taxing profits of offshore companies doing business in Hong Kong or short-term trading gains derived by individual investors on speculative stock transactions - would also help to broaden the tax base, as this could draw more taxpayers into the tax net.

This said, we recognise that taxing short-term trading gains realised by individual investors may be difficult given the current tax legislation and the existing case law in this area; individuals who are not prominently connected to the stock dealing industry are often considered as not carrying on a trade or business, and therefore the gains derived by them are often not taxed. Practical problems such as how to identify these individual investors and the huge volume of transactions involved also exist.

PricewaterhouseCoopers
Hong Kong
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