A Tax Reform Discussion Paper

Prepared by the British Chamber of Commerce in Hong Kong

For

The Financial Secretary of the Hong Kong SAR Government

Submitted to the Financial Secretary

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The British Chamber is one of Hong Kong's largest international business organisations, comprising major multinational companies and institutions, as well as a substantial number of SMEs. The Chamber represents a broad spectrum of British, Hong Kong, international and Chinese companies. Collectively, this membership makes a significant contribution to the Hong Kong economy and to employment, employing approximately 10% of Hong Kong's workforce. The Chamber therefore constitutes a representative cross-section of business opinion in Hong Kong and has a major interest in Hong Kong's continued success.

Introduction

The Chamber wishes to make a submission to the HKSAR Government on the July 2006 GST/Tax Reform Consultation Document ("2006 CD"), which reflects the various views of Chamber members, and which also makes practical and sensible suggestions as to how a new tax regime could be implemented to broaden the tax base in Hong Kong.

The Chamber had been advocating for a broader tax base and the possible use of indirect taxation for the past 5 years. The recent CD had not been well received by the public, partly because of the way in which the consultation was packaged and launched by the government, and partly because the general public had not considered the substance of the government's proposals in detail.

Framework for response from the British Chamber

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Executive Summary

At the Chamber we are concerned that taxation and revenue raising policy in Hong Kong is not strategically planned, and as a result is volatile and unpredictable and could harm business and investments here, especially from overseas. This would undoubtedly harm the future prosperity of "Hong Kong Inc", especially if the inequity in the Government's revenue raising system grows. We are therefore keen to support the Government in its initiatives in conducting a thorough, independent and transparent review of the whole basis of collecting revenue in Hong Kong, not just from the direct taxation system, but from all sources, local and overseas. With a view to formulating a strategic approach to revenue collection in light of the need for expenditure and redistribution of revenue collected, for the future.

In order to carry out a thorough tax reform review looking at both the success and equity of the existing direct and indirect taxation systems, a high level Tax Reform Committee would need to be established, as had been done recently in the US and which is currently underway in the UK under the aegis of Professor James Mirrlees (Nobel Laureate economist). China itself has just conducted a review of its taxation system and most recently implemented fundamental and far reaching changes to it.

A Tax Reform Committee for Hong Kong would be made up of renowned scholars and professionals from overseas, and some from Hong Kong, including representatives from social and concerned groups. A broad range of knowledge and interests would result in balanced proposals supporting the social and economic developments for the medium to long term in line with the development strategy of the Government. A neutral committee such as this would be more successful at introducing tax reform, if it conducts fact finding at the grassroots level. Education on the need for the Hong Kong public to contribute to the public purse is also needed.

The Chamber believes that in conjunction with the above Tax Reform Committee, an immediate critical review of the Inland Revenue Ordinance by a subgroup of the Tax Reform Committee, the creation of an Inland Revenue Department Review Body, as well as a thorough review of the operations of the Board of Review should also be implemented. These may have temporary impact, however, as one of the scenarios we suggest later in this report is the possible abolition of all direct taxes in Hong Kong. So that Hong Kong reverts to its "Freeport Status" - as there are so few real direct taxation contributors under the existing laws, it would not be difficult to abolish direct taxes if reliable alternative revenue raising methods can instead be implemented.

1. Background - An historical perspective

The Hong Kong Inland Revenue Ordinance ("IRO") was enacted in 1947, at a time when the population of Hong Kong was about 400,000 mainly working in international trading and local fishing

industries. The IRO was amended frequently, but not substantively, in the last 60 years and nominally contains 89 sections; although now there are over 160 operative sections. It imposes three direct taxes, Profits Tax, Salaries Tax and Property Taxes. Direct taxation prior to 1947 comprised Hong Kong Estate Duty, originally at 10%. The Estate Duty Ordinance was enacted in 1916, but was finally abolished with effect from 11th February 2006. An influx of immigrants from Shanghai arrived in 1949, and Hong Kong became a trading entrepot and manufacturing mecca, later a property dominated economy and most recently an international financial services centre.

The IRO, as for most other British colonies, was based on the UK taxation legislation at the time. Over the years, therefore, interpretation of the IRO has been the subject of legal decisions ranging from the UK to Australia and South Africa. Most Commonwealth decisions however, do little to explain the development of the "territorial basis" of taxation in Hong Kong. This basis means that unless profits or income are sourced in or derive from Hong Kong, a business or individual will not be subject to tax here. The territorial basis of taxation, still a unique aspect of Hong Kong tax law, and which has in reality made Hong Kong a very popular low tax base, stems from the original Letters Patent issued by Queen Victoria at the time the Territory was leased from Mainland China. These Letters prevented the Governor from controlling any aspects of the economy outside the Territory, including raising taxation from those activities.

The Hong Kong Legislative Council ("Legco") now controls the IRO, and the Inland Revenue Rules ("IRR") which supplement it. As in most democratic systems there is an annual Budget where announcements are made about Government expenditure, changes in the taxation system and tax rates. If a Bill concerning a financial matter is rejected by Legco, the Chief Executive is required to resign from office; this is one of the few "checks and balances" on financial matters which the SAR Government faces.

Another special aspect of the Hong Kong taxation system has been the reliance on individuals and businesses to manage their taxation affairs themselves- a laissez faire approach not common elsewhere, and which makes for a simple taxation system. The Government does not interfere much in the taxation affairs of most businesses and individuals, and in fact many smaller businesses do not prepare accounts regularly, which was probably one of the reasons the recent GST proposal was rejected. Until about ten years ago the Profits Tax Return form was a simple one page form requiring only the taxable profit or loss figure to be declared annually; then the form became four pages long and required slightly more detail. Recent field audit investigations by the IRD focus on approx 1900 cases per year, yielding an average revenue of HK$6m per case in recent years.

After the change in Sovereignty, on 1 July 1997, the National People's Congress of the PRC granted the Hong Kong Special Administrative Region ("SAR") a high degree of autonomy including independent revenue raising powers and financial status for a 50 year period.

- Article 106 of the Basic Law, now the constitutional framework for Hong Kong, provides for independent finances. Under this rule no money is to be handed over to the PRC Government, and no PRC taxes are to be levied in the SAR.
- Article 107 requires Hong Kong to maintain a balanced budget, which must be kept in line

with the SAR's rate of economic growth.

- Article 108 requires Hong Kong to maintain an independent tax system, using its low tax rates as a reference for formulating new taxation laws and policy. It is believed the territorial basis will be retained whilst the basis law applies.

Therefore, the bulk of the IRO and IRR and related case law that existed under British rule remains applicable in the SAR. The UK Privy Council is no longer the final court for Hong Kong taxpayers. The Court of Final Appeal, established under the Basic Law, is now the final court for resolving taxation disputes.

We believe the Basic Law does not preclude Hong Kong from implementing a turnover based tax.

Current perspective on the Hong Kong direct taxation system

With per capita GDP of HK$214,700 (US$27,600) per the 2007/08 Budget data, the SAR Government currently spends HK$37,850 on average on public expenditure for every man woman and child in Hong Kong every year (HK$265B divided by approx 7m people). Recurrent Government expenditure is forecast at HK$205B in 2006/07.

Government Direct Tax Revenue totaling HK$195.3B is received approx as follows in 2006/07:

- Salaries tax/property taxes - 100,000 individuals pay 60% of all revenues of HK$40B. In effect this is an average salaries tax bill of HK$240,000 each for them.
- Profits tax - 800 companies pay 80% of all revenues of HK$75B. In effect this is an average profits tax bill of HK$75m each for those businesses, some of whom receive tax credits overseas for profits taxes paid in Hong Kong.
- Stamp Duty and property rates total HK$50B
- Other levies including Hotel Duty and Betting Duty account for another HK$ 25B

Although there are 3.2m employees over 60% (1.9m) pay no Salaries Tax at all. The average salaries tax bill of the remaining 40% and excluding the 100,000 above is therefore HK$13,333 each (also noting that the foreign domestic helpers training levy is equivalent to HK$4,800 per year per person). In the 2006 Consultation Document ("2006 CD") it stated there are 750,000 Business Registrations, of which the Government says only 250,000 are active. This implies that of the 240,000 or so businesses that pay the remaining 40% of profits tax, each pays on average HK$62,500. There are currently about 800, 000 Hong Kong companies on the Company Register – those most recently incorporated (about 100,000 in the last year) will not have started to pay profits tax yet. The figures do not include (anecdotally) the 500,000 or so other "offshore' companies which are operating in HK with no Business Registration (and often paying no taxes). Compliance is an increasing problem in the SAR, which the Government does not acknowledge. This position is unlike the UK, the US, most of the EU, Canada or Australia, which are relatively tax compliant jurisdictions. Fewer and fewer people and businesses contribute to the Public Purse in Hong Kong every year through the direct taxation regime,

although those who are compliant, contribute a growing percentage of the overall tax burden.

2. Tax reform initiatives in the past

The most recent systematic review of the IRO, by the IRO Review Board chaired by Arthur Duffy (a former Commissioner of Inland Revenue) was in the mid 1970's. Relatively few amendments to the taxation system were made at that time.

The suggestion to broaden Hong Kong's tax base was first made 20 years ago, by Sir John Bremridge, the Financial Secretary in 1986/87. This suggestion was supported by his successor, Sir Piers Jacobs, who took the next step asking Legco members for their opinions on the principle of levying a more broadly based indirect tax.

Sir Piers published a Consultation Document in mid-1989 on a Wholesale Tax to solicit opinions from a number of professional bodies and other organizations on the technical aspects of introducing a wholesale tax. Most of those consulted felt that Hong Kong was not ready for a wholesale tax at that time and concern was expressed over the potential negative impact on the domestic economy. There was also doubt whether it would provide a more stable source of tax revenues. Despite these concerns about the effects of a wholesale tax itself, there were no major technical hurdles uncovered during the consultation. The government action was then limited to reading the report. That was the end of discussions on wholesale tax for several years.

In 1997 the domestic economy was hit by the Asian financial crisis. The HKSAR Government suffered big budgetary deficits and so it appointed an Advisory Committee on New Broad-based Taxes (AC) in 2000 to consider broadening the tax base in order to generate stable and more tax revenues. In August 2001 a Consultation Document titled, "A Broader-based Tax System for Hong Kong?" was published and the public was asked to consider the desirability of the 13 broadly-based taxes.

The majority of the public's submissions were against the introduction of a GST, but in February 2002 the AC still recommended in its final report that a GST should be adopted if additional revenue was needed. Based on the AC's recommendation, an Internal Committee within the HKSAR Government was formed to consider introducing a GST in Hong Kong. A further Consultation Document on "Broadening the Tax Base, Ensuring our Future Prosperity: What is the Best Option for Hong Kong?" (the 2006 CD) was published in July 2006. This covered the objectives, measures and impacts of introducing only one type of tax to Hong Kong – GST. Again the public opinion was sought. Nine months was allocated for the collection of public feedback, and this review results from that request for feedback.

The 2006 CD was considered by some as incomplete. It failed to describe the nature and performance of the existing tax system and budgetary management in Hong Kong, and to provide background information on Hong Kong's fiscal system. The ensuing debate between the private sector and the HKSAR Government focused on the controversial issues regarding the need for broadening the tax base and the regressive nature of a GST. The Government did not respond directly with facts and figures to the sensitive tax issues raised during this subsequent period of discussions and as a result these crucial issues were not dealt with.

A Narrow Tax Base in Hong Kong?

The assumption has been made that Hong Kong's current tax base is narrow and that this prevents the Government from collecting consistent levels of tax revenues. Therefore the consequential belief that it has to stockpile reserves at a high level to be able to handle volatility in the revenue collections. Hong Kong enjoys special "independent finances" status from the PRC and as a small SAR it does not have a sub-tier governmental setting. A lack of sub-tier governments also means there is no need for the Hong Kong Government to assign to them different kinds of taxes, as for example happens with Local Councils in the UK. This system of government in Hong Kong is also why there were no broad-based taxes prior to the introduction of direct taxes in 1947. Interest income tax, dividend tax, capital gains tax and estate duty have either been abolished or have never been introduced in Hong Kong.

Is a broad tax base compatible with a simple tax system?

If the existing tax system is not or will not be able to generate sufficient tax revenues, owing to there being fewer and fewer taxpayers, then we believe it should be analysed and amendments considered before introducing a new broad-based tax system, such as a GST. The 2006 CD did not take this approach. The GST was the stated as the first choice replacement, rather than a last resort, based presumably on the earlier recommendation of the IMF and the 2000 AC.

Op**erational Surplus, Revenue Stability and Financial Stability**

The level of fiscal reserves represents the state of financial stability and the operating (account) surplus measures the degree of revenue stability. Guidelines on the operating surplus are set to assist budgetary planning, setting the surplus at a percentage of capital expenditure. It is subject to change, reflecting the changing financial position of the Government and the economic environment at the time.

The importance of this guideline has changed over the decades, from being the most important budgetary guideline in the mid-seventies to an unspecified one since 1995/96. This is a dramatic shift of budgetary management in reflects the diminishing importance of the revenue stability objective.

For the 2006 CD to be a comprehensive guide to understanding the tax alternatives, it should have examined the relationship between the operating surplus guideline and the guideline on fiscal reserves along with the relationship between revenue stability and financial stability. None of these relationships were addressed in the 2006 CD.

3. Economic analysis of need for tax or other revenues in light of population growth and aging

There has been concern with the aging population and demographics in Hong Kong that there will be greater and greater healthcare costs and fewer and fewer contributors to the public purse. On the other hand some commentators have noted that only 5% of GDP is in fact currently spent on healthcare in

Hong Kong which is much lower than the norm in other western jurisdictions where the healthcare cost is usually about 15% of GDP.

However, contrary views about the impact of an aging population do exist - especially if the public is sufficiently self-reliant and relatively healthy, regardless of age.

Is our Narrow Tax Base Unable to Cope with an Aging Population ?

The Population Projection conducted by the Census and Statistics Department in 2003 predicted that the percentage of persons aged 65 and above will increase to 27% by 2033 from the current level (2003) of 12%. It comes with a warning that "the growth in revenue from income-based taxes could slow down in line with GDP and shrinkage in the number of labor force participants." Health and welfare costs associated with the aging population are predicted to increase requiring a greater share of the government's expenditure.

Before accepting this conclusion, it is necessary to consider the following points:

(a) Would Salaries Tax Revenue Fall with an aging population?

The annual revenue derived from the Salaries Tax depends on:

- The growth rate and productivity of the economy, and hence the number of employees
- The threshold of personal allowances (the increase in allowances from 97/98 to 06/07 has seen the percentage of working population paying tax drop from 42% to 36%)
- The marginal tax rate structure, NOT just the number of taxpayers

The growth of the Hong Kong economy hinges on:

- The overseas economic environment
- The competitiveness and productivity of the domestic economy, which in turn depend on:
  - The long-term development strategy
  - Balanced economic structure
  - Appropriate economic and fiscal policies
  - Good employer-employee relationship
  - Emphasis on education and labour training
  - Research and development
  - Technological development and innovation

In a knowledge-based economy such as Hong Kong's, the emphasis is on innovation and creativity, and quality becomes more important than the quantity of the labour force. Hong Kong also still has a relatively strong inward flow of professionals from overseas which arrive annually, adding to the labour supply (about 2% per annum).

The 2006 CD did not provide convincing evidence of a declining GDP growth due to an aging population.

(b) Use of Additional Revenue and Expenditure Growth

In the 2006 CD the main purpose of introducing a GST would appear to be to raise revenues to pay for the increasing health and social welfare costs of an aging population. Would it mean that all GST revenues will go towards these costs? Another issue that needs to be examined is the ratio of health to social welfare spending. The 2006 CD did not address these issues.

(c) Tax Policy and Population Policy

A growing population is good alternative instrument to manage the economic problem of an aging population.

There are many reasons why Hong Kong's population growth rate is now less than 1% – a culture of long working hours, life-long learning pressure, lack of long-term job security, and high cost of raising children. All these keep family size small or discourage young couples from having children at all. Incentives in the form of one-off cash bonuses, increasing the child allowance and introducing an education allowance to the Salaries Tax regime could all possibly aid the drive towards population growth.

To reduce the demand on social welfare from the aged population the retirement age for civil servants and employees of NGOs could be raised and the private sector encouraged to follow. Subsidies could be provided to these businesses. Tax incentives could also possibly be introduced to attract more MPF contributions and long-term savings. This would reduce the Government's pressure to provide more CSSA's to retirees.

4. Comments on current functioning of the existing direct taxation system

1) A Review of the Inland Revenue Ordinance ("IRO")

As stated both last year and this year in our Budget Submission, the Chamber's view is that the IRO has become outdated; it is nearly 60 years old and would benefit from an overhaul.

The Chamber still advocates that a complete review/update of the IRO is urgently required, whatever the outcome of the Tax Reform review process. This said, we appreciate that this might pose certain challenges; but believe these have to be tackled and not ignored. Thus, we still fully support the establishment of an Independent Review Body, analogous to the earlier IRO Review Board mentioned above, to examine specific issues relating to the IRO. Its members should be experts in the field with no previous involvement in formulating or drafting Hong Kong's tax legislation.

Amongst the areas which the Chamber believes should be reviewed are the following:

a) Timescale for issuing Tax Assessments

The IRO currently grants the IRD a period of six years in which to revisit tax assessments. Where a taxpayer has incurred tax losses, the period is unlimited. Members of the Chamber, as well as the taxpaying community at large, have experienced an increasing trend for their tax affairs to be re-examined and reassessed, for the full six year period, in relation to issues considered resolved many years earlier. It is entirely proper that taxpayers who make false claims or who mislead the IRD should be exposed to the risk of later re-examination and re-assessment. But where taxpayers

have properly complied with their obligations, they should be protected from unreasonable or spurious assessment and claims for payment of tax on account. The independent review body for the IRO should therefore address the circumstances in which reassessment may be undertaken and the appropriate period for reassessment based on international best practice. The UK, in its recent Budget , and following the Carter review, has announced an amendment to its taxation penalty regime, aligning the penalty system to the circumstances of the default and the amount of tax; the new regime will be the same for UK Income Taxes, Corporation Taxes, NI, PAYE and VAT.

b) Update guidance on source of profits

One of Hong Kong's key attractions to foreign investors as mentioned above is the apparent simplicity of its system of taxation. However, recent case law decisions, and reported Advance Tax Rulings, which appear to be inconsistent with the spirit and intent of Departmental Interpretation and Practice Note ("DIPN") No 21 on the Locality of Profits, coupled at times with what seems to be a selective use of the "totality of facts" test by the IRD to reject offshore profit claims lodged by taxpayers, have caused undue frustrations among the international business community.

For example:-

- The IRD has indicated that it may still seek to tax the profit of a re-invoicing company, even though its operations in Hong Kong are in line with the relevant DIPN 21 provisions, on the argument that the profit represents commission (rather than trading profit) derived from activities performed by the re-invoicing company in Hong Kong.
- Activities such as opening letters of credit and the keeping of books of account in Hong Kong, which used to be regarded as auxiliary to the derivation of trading profits, may be used by the IRD to justify its rejection of offshore trading profit claims notwithstanding that the relevant sales and purchase contracts may have been effected by taxpayers outside Hong Kong.

The lack of sufficient guidance and of a reasonable degree of certainty in the IRD's interpretation and of a fair and consistent application of the tax legislation and principles dealing with source of profits may result in Hong Kong losing its international attractiveness as well as tax revenues because:-

- International investors may become discouraged from setting up their global operations in Hong Kong for fear of having all their profits potentially being considered as having a source in Hong Kong and fully assessable to Hong Kong profits tax;
- Existing Hong Kong taxpayers decide to shift their operations to other jurisdictions (e.g., Macau or Singapore) which offer better tax incentives to encourage investments; and
- More and more taxpayers use offshore incorporated companies to evade tax.

Part of the IRO review process should ascertain the extent to which this has already happened (there is some anecdotal evidence to suggest a number of international businesses have left Hong Kong on being reassessed on **all** their profits as being onshore), and whether the rate of departure or non-arrival is increasing.

c) Use of anti-avoidance provisions to challenge legitimate tax planning

Although DIPN 15 has provided assurance that the tax anti-avoidance provisions such as Section 61A will only be used by the IRD to strike down "blatant or contrived tax avoidance arrangements",

taxpayers and tax practitioners have noted an increasing tendency of the IRD to seek to apply these sections to commercially legitimate transactions undertaken by taxpayers. This approach not only unfairly penalises taxpayers who undertake tax planning measures to legitimately arrange their tax affairs within the acceptable parameters of the Hong Kong tax legislation, but also potentially encourages the use of “offshore” companies to carry out activities in Hong Kong without properly complying with the existing tax legislation (i.e. by means of non-disclosure).

d) Use of IT

Whilst the IRD has announced some initiatives in the extension of the use of IT in receiving Tax Returns and Information from taxpayers, under the Information Systems Strategy “ISS” in terms of the portal for 2008 and as part of the “Digital 21” ESD strategy, this is still some two years away, and is not apparently going to be mandatory. In contrast, many other tax authorities have moved to digital input of tax information, and paper based tax return systems are being phased out completely. We believe Hong Kong is behind in this area, compared to many other jurisdictions and more emphasis needs to be given to these projects.

e) Other Areas for Clarification

Other measures to improve the understanding and operation of the Hong Kong tax system would include:

- Formal inclusion of OECD transfer pricing principles into the IRO, or as a minimum the issue of a DIPN to clarify the IRD’s views on the application of these principles;
- The introduction of statutory provisions specifying the taxation treatment of trusts; and
- Allowing public access to assessors’ manuals.

(2) Review body for the Inland Revenue Department

Unlike the Police Department and most major Government departments there is no independent review body handling complaints against the Inland Revenue Department. Such a body should be created immediately. There should be objective and independent oversight within Government of the IRD.

(3) Review of the operation of the Board of Review.

The Board of Review (the “Board”) is an important “check and balance” against unreasonable tax assessments issued by the IRD. Accordingly, it is vitally important that the Board is seen to be independent of the IRD, to act fairly and objectively, and to consider all facts and evidence presented to it by both the IRD and taxpayer alike. There has been a decrease in the number of Board of Review cases and an increase in the number of cases awarded against the taxpayer/appellant, in the last few years. Perhaps more worrying is a growing perception that the Board is too partisan towards the IRD and may be lacking the necessary objectivity.

Accordingly, the Chamber believes that in conjunction with any review of the IRO, and the creation of an Inland Revenue Department Review Body, a review of the operations of the Board should also be conducted, perhaps with a view to separating complex technical tax cases to be heard by a different and more specialised body than general tax cases. In particular, currently tax practitioners cannot be

members of the Board of Review, so by definition the existing Board comprises members who are not lawyers or accountants and who often know little about tax.

(4) Enforcement Measures

A key aspect of the IRD in recent years has been the establishment of field audit teams, resulting in significant additional revenue for the SAR Government that may not otherwise have been collected. The field audit teams impose penalties on taxpayers who have evaded tax. Penalties are normally regarded as a means of encouraging full and timely compliance by taxpayers, providing financial compensation for loss of revenue in delinquent cases, and acting as a deterrent to tax evasion as penalties in such cases are normally punitive and/or involve prosecution. That said, imposing penalties in cases where taxpayers have made inadvertent errors in tax returns, but voluntarily disclosed the errors, can be counter productive, especially when there is no certainty as to the level of penalty that will be imposed should a taxpayer wish to rectify an erroneous return.

(5) Targeting the use of offshore companies

Despite the presence of field audit teams, tax evasion remains widespread in certain areas of the economy, such as the use of "offshore" companies which operate in Hong Kong but which do not file tax returns. The Chamber would support and encourage the IRD to broaden their attack against tax evasion beyond the taxpayer groups which are already registered with the IRD.

The Chamber is pleased to note that there is some progression in this area – such as the requirement for more disclosure of transactions with offshore related companies in a taxpayer's profits tax return. Similarly, the requirement for offshore companies owning Hong Kong property to pay a Business Registration fee (recently reconfirmed by the IRD) and file a Profits Tax Return is helpful. In this regard, the deeming provisions of the new Offshore Funds exemption legislation, which require certain investors in offshore entities to impute and report income of the offshore entity as their own Hong Kong taxable income, may help reduce the number of tax avoidance cases, although it remains to be seen how many of these potential Hong Kong taxpayers will comply with this requirement.

(6) The new Offshore Funds Exemption legislation

Related to the disclosure point noted above, it seems clear that the IRD expect many Hong Kong based investors in offshore entities, not just properly recognised mutual funds, to deem income from their investment and subject it to taxation in their Hong Kong Tax Returns for 2006/07 and thereafter, as a result of the enactment of this new tax legislation. Consultation with industry and interested parties on these new disclosure requirements in Hong Kong Tax Returns would be helpful.

(7) Other Tax Reform measures

The Chamber continues to support measures which would modernise Hong Kong's tax system without unduly prejudicing its simplicity. The abolition of Estate Duty and exemption from Hong Kong tax for Offshore Funds in recent years are excellent examples of positive steps in this regard. However, as we

noted in last year's submission, the Chamber believes that there is still room for more initiatives in this area, including:

a) Revamping tax filing and payment deadlines so they are more closely linked to financial year ends;
b) Introducing full 'self assessment', with a view to further improving the efficiency of the IRD;
c) Charging interest on tax underpayments and repayments, in order to fairly compensate both the SAR Government and taxpayers where tax is owed by one party to the other after the due date for payment has passed;
d) Withholding salaries tax at source, allowing for a constant flow of revenue to the SARG over the financial year, and simplification of the tax return and assessment process;
e) The Chamber was disappointed that in both his 2006/07 and 2007/08 Budget speeches, the Financial Secretary ruled out the need for any group loss relief regime or loss carry-back arrangements in Hong Kong. The Chamber still believes that such measures would be welcomed by Hong Kong businesses and would help enhance Hong Kong's competitive position. Anecdotal evidence suggests that the abuse of group positions is already happening; because there are no legitimate avenues for group tax planning in Hong Kong. The Financial Secretary had amongst other matters rejected group relief on the basis it was too expensive but at present Hong Kong could apparently afford it and all other major countries in the world have some form of group loss relief.

5. Need for systematic review of existing direct tax regime tax rates

Quite apart form the above specific tax measures, there should be a systematic review of the level of personal allowances, and the tax rates themselves – both marginal and the absolute level of tax rates and the relationship between the unincorporated Profits Tax rate (currently 17.5%) and the unincorporated Profits Tax rates (currently 16%), and Salaries Tax and Properties Tax rates. In particular, the 1.5% differential between the incorporated and unincorporated Profits Tax rate (which carries through to the maximum effective Salaries Tax rate of 16%) arose in the 1980's when a temporary surcharge of 1.5% was implemented. This "temporary" surcharge was never lifted, or rationalised. A detailed study as to whether it should remain implemented should be part of the overall review.

A study published in 2006 by Mr Hines of the University of Michigan and Mssrs Desai and Foley at Harvard Business School provides evidence that reducing direct tax rates is a multiplier of economic activity - because the amount of economic activity in the world is not fixed (ie a dollar profit booked in Hong Kong is not a dollar less for the Mainland). Tax havens next to onshore jurisdictions have often been found to complement them rather than substituting for them. Research in reducing all direct tax rates in Hong Kong, and the differentials between them, or even abolishing them completely , given the relatively few numbers pf businesses and individuals who actually pay taxes in Hong Kong, over a phased period should be conducted.

A study on degrees of compliance with the existing direct system

There is anecdotal evidence to suggest decreasing compliance levels amongst many business sectors. For those business which do not have to locate in Hong Kong for strategic reasons there is less likelihood they will locate in Hong Kong if they feel disadvantaged because they are foreign owned, and because they will need to comply with the system. Reducing direct tax rates encourages individuals and businesses to comply with the taxation system.

6. Need for systematic review of other Government fees and levies

It has been reported that there about 5,200 different types of Government fees and levies already charged, ranging from fees collected for issuing dog licenses to Immigration Department fees, and so, on and so forth. These fees and levies are each collected by Government Departments but it is unclear whether their collection process is necessary or efficient. Of the few Government departments which are self-funding the Companies Registry is a shining example. This should be part of the overall review on Government revenue collection systems recommended.

7. Green taxes principles to be adopted in HK? As an integrated measure or separate from the direct tax system?

1) Environmental issues

In the Chamber's view the urgent need to improve Hong Kong's environment will have a dramatic impact on Hong Kong's fiscal prosperity in the medium to long term. Due to its importance and complexity, we would refer to our previous Chamber submissions on this topic. However, we would reiterate in this submission that there are a number of measures we believe that the SAR Government must address in this area as a matter of priority as part of its review of the taxation and revenue collection systems, and as a way of encouraging socially and environmentally responsible behaviour, at least amongst those who do pay taxes, including:

a) Schemes designed to promote the recovery and recycling of tyres and to reduce the use of plastic bags;
b) The introduction and enforcement of border emissions testing and substantial spot fines to prevent free entrance into Hong Kong of fuel and commercial and tourist vehicles that do not meet Hong Kong emissions standards;
c) The introduction and enforcement of severe financial penalties for environmental damage, including increased fines and penalties for any hot air or dangerous gas or other waste or emissions and polluters of the air, harbour and other marine areas;
d) The encouragement of public and private sector investment in advanced recycling techniques, including tax deductions for individuals or businesses , who spend on environmentally friendly plant and machinery items such as solar panels, windmills, bicycles , air conditioning monitors, insulation, geothermal pumps etc or other energy efficient devices ("microgeneration") for

their homes or businesses. Such tax reliefs are already available at an individual or business taxpayer level in many countries;

e) Current trial waste reduction and recycling schemes for household, construction and commercial waste need to be expanded into comprehensive territory-wide schemes, with suitable tax and other incentives, and penalties for non-compliance; and

f) Investment in schemes to enable and encourage greater energy efficiency across Hong Kong.

g) Review of the implementation of a possible Carbon Emissions Trading exchange.

Following the Stern Report in the UK, the recent UK Budget made a number of detailed taxation recommendations on Green Taxes, including an increase in the Climate Change Levy, Landfill Taxes, Duties on Vehicles, doubling Air Passenger Departure taxes and implementing a Stamp Duty exemption from 1st October 2007 for five years on Zero Carbon Homes bought for less than GBP500,000, with a GBP15,000 Stamp Duty Land Tax reduction if the purchase was greater (thus encouraging smaller homes).

It has been suggested that if a percentage of electricity and gas bills in Hong Kong is contributed to the Government as some sort of Climate Change Levy, a significant amount of revenue can be raised by the Government and would be broadly based and reflective of ability to pay.

8. Degree to which overseas investors pay, or should pay Hong Kong taxes

It is very unclear who bears the majority of the tax burdens here in Hong Kong - for example, overseas investors or local businesses or both; and a whether this ratio is slowly shifting. In practice most economies have a stated policy for either encouraging or discouraging overseas investments via the tax regime. Whilst it is widely believed there is a "level playing field" on taxation in Hong Kong this may not actually be the case.

In practice most Government expenditure is for the benefit of the local population; and the degree to which tax and other revenues are returned to the local population, or stockpiled, is also the subject of much discussion.

This policy aspect should be addressed in the comprehensive review we are recommending.

9. A critical review of the Tax Reform Consultation process.

With reference to the findings of the Government Task Force on Review of Public Finances in the 2000 AC , the main questions asked in the 2006 CD were:

(i) Is there a need to broaden Hong Kong's base?

(ii) Is a goods and services (GST) tax the best way to broaden the tax base in Hong Kong?

(iii) What other options are there?

(iv) Pros and cons of a GST.

(v) Is GST compatible with maintaining a simple, low-rate tax regime?

(vi) What are the specific proposals that the government is putting forward?

(vii) What is the likely impact of those proposals, on your business?

(viii) What measures should be taken to mitigate the effects of a GST on different income groups and on business?

Our Chamber collected members' views and herewith takes them into account in preparing this submission. Our objective is that Hong Kong's tax base is to be broadened to stabilise tax revenue rather than generating additional revenue, and to enhance the competitiveness of Hong Kong (How to improve "Hong Kong Inc"?).

Key concerns which arose were:

Education about and the basis for and administration of a new tax system

The overriding principles to be considered in launching any new tax, for example the GST, e.g. to keep exemptions and zero-rated items to a minimum, how to allocate the net GST revenue, whether and how the relief measures put forward, e.g. for the lower-income group, the middle-income group, and for businesses, could be further refined and enhanced, were never discussed with the public before the 2006 CD was launched.

In our view, if a future initiative on taxation is to be launched on the Hong Kong public, detailed consultation will be needed with the public and professionals on the many practical aspects first.

At Appendix 1 we include detailed comments collected during our discussions with Chamber members on issues arising out of the possible implementation of a GST. If the introduction of a GST will be revisited these should be taken into account and clarified up front.

Equity Considerations

The most severe criticism against the recently proposed introduction of a GST was in relation to its regressive nature, and the perception that wealthy businesses and individuals contribute too little to the public purse. The marginal utility of income of lower income households is much higher than that of higher income households and a GST would result in the lower income households paying a much higher proportion of their income than those on a higher income; felt to be most unfair.

Taxation is used by the majority of countries as the most important fiscal instrument to obtain a more equitable income distribution. To maintain this balance after the introduction of a GST, which is a regressive indirect tax, counter measures in the form of progressive direct taxation are often introduced.

The 2006 CD did recognize the regressive nature of a GST, and proposed compensation and tax relief packages to households and business for a minimum of five years. However, these measures were felt not to offer a substantial reduction in the regressiveness of the tax. In addition the following (conceptual) issues should have been addressed:

(a) Shifting the Emphasis for Tax Equity to Fairness

Fairness was re-defined by the 2000 AC to align the broadening of the tax base with the equity principle. The report took the view that a good tax system is equitable vertically, preserving equity by taxing in proportion to taxpayer's ability to pay and that a narrow tax base is inconsistent with equity because the overall tax burden is borne by relatively few taxpayers.

Despite the attempt by the AC to draw links between a narrow tax base and tax inequity, it did not

explain how broadening the tax base with a regressive GST is consistent with equity, the 2000 AC recommended the implementation of a GST. The IMF had also favoured a GST although the reason why the IMF favoured the GST for Hong Kong particularly was not explained either. Although more people and businesses would be paying GST (and lower incomes would be compensated in some form), it was all too vague.

The 2006 CD employed the same concept of fairness, with the argument that fairness should not be based on income alone and that the "capacity to pay" was the best indicator of a standard of living. The tax burden of the individual is determined by the level of consumption and spending. However, a fair tax is not equivalent to an equitable tax. If the GST had one flat rate only, it is not an equitable tax because it worsens, rather than reduces income disparity through imposing a relatively higher tax burden onto the lower income households, when there is no well understood compensation mechanism.

(b) The Relevance of the Existing Tax Equity Objective

Introducing a broad-based, single rate GST with no or minimal exceptions would deviate very much from the tax philosophy and the current Government policy of helping the lower income households. This would be a move by the Government away from the paternalistic approach it had maintained since the seventies of lessening the tax burden on lower income households.

The official policy on tax equity, which was adopted in the seventies, still exists :

" The tax system is equitable between different classes of taxpayers or potential taxpayers and between different income groups. This means, among other things, setting relatively high thresholds for personal taxation and generally ensuring that the system rests as lightly as possible on the disposable incomes of those at the lower end of the income spectrum, or leaves them virtually untouched."

It was hoped that the 2006 CD would analyze the equity concept and present a balanced argument, but it did not really address this aspect.

A Competitive Hong Kong Tax System

If Hong Kong was to raise its taxes during a recession under its current narrow based system in order to maintain its budget balance, then its fiscal position would be weakened and also its competitiveness. A broad tax base would enhance its competitiveness as it would sustain the prosperity of the domestic economy. These were the forecasts in the 2006 CD.

The raising of taxes as a deterrent to foreign investment is not supported by evidence in the 2006 CD. Instead the opposite effect was demonstrated in 2004/05 and 2005/06 when the standard tax rate of taxation was raised and new foreign firm registrations in Hong Kong and direct foreign investments was the highest it had been for years.

Having a narrow tax base does not make Hong Kong less competitive. In 2006, Hong Kong was ranked No. 2 in the overall competitiveness scoreboard of 61 economies in the IMD's (International Institute for Management and Development) annual publication on ranking of competitiveness of the world's important economies. One of the 20 indicators used to determine the overall ranking is fiscal

policy. Hong Kong has been No. 1 in fiscal policy since 2002.

The 2006 GST Consultation Document: A Genuine Tax Reform Proposal?

On balance there were many failings in the 2006 CD, which may have contributed to the lack of public support for the GST.

- the report did not live up to its name – "Broadening the Tax Base, Ensuring our Future Prosperity: What's the Best Option for Hong Kong?" It presented a possibly biased view in favour of a GST, instead of comparing and contrasting a variety of tax reform solutions different to those already considered in the 2000 AC
- there was no in-depth analysis of the Government's objectives for budgetary management and financial situation
- details and evidence were missing in support of the GST arguments.
- there was limited explanation of compensation and tax relief packages
- it focused on broad technical issues, avoiding sensitive equity issues (who really pays?)
- lack of information created confusion – were the public considering a new tax item or a revamp of the tax system?

This was the third time a Hong Kong Government had tried to gain the support of the public for the introduction of a GST, and failed.

Is this a result of the Government's approach to tax reform? Their approach is to appoint their own committee, to review a specific tax issue or issues, to publish a consultation document and then solicit public support. This is not the best approach, because the Committee is usually chosen by the Government and influenced to follow the Government's stance.

10. Recommendations

Independent Review of the existing Revenue Collection mechanism by an International Panel

In the light of all the above, we would suggest that there is a grass roots review of existing revenue collecting systems in Hong Kong, both direct and indirect , by an independent panel of experts (to contrast with the top down approach adopted in the most recent GST CD), to see who really bears the costs of paying for and administering revenue in Hong Kong, and whether this is a sustainable basis, for the population needs forecast.

As mentioned, in the UK, Professor James Mirrlees has been asked to thoroughly review the UK taxation system and has been given funding and a free hand to consult as he wishes.

The 2000 AC on Broad Based taxes established in Hong Kong was felt by many to be too constrained in its review process, and it was always considered to be too lacking in independence to come out with any other outcome than that a GST was appropriate for Hong Kong (even though the Public rejected the GST at that stage). This would not be the format for the proposed Tax Reform Committee. Indeed Hong Kong has clearly suffered from not having an effective and independent committee to review its

taxation system since the Duffy Committee mentioned above in the mid 1970's, more than 30 years ago. The Government does not have a Policy unit specifically focusing on taxation policy and has tended to rely on the IRD to articulate tax policy.
The Government must also set guidelines for the revenue it needs and why (12 months of expenses?). The current guideline of 20% of GDP etc is too vague. The guideline set by the IMF of a Fiscal Reserve of 30-50 % of GDP is also open to question, and should be reviewed; with the IMF and with others.
In order to carry out a thorough tax reform looking at direct and indirect taxation, in our view, a high level Tax Reform Committee would need to be established. This committee would be made up of renowned scholars and professionals from overseas, and some from Hong Kong including representatives from social and concerned groups. A broad range of knowledge and interests would result in balanced proposals supporting the social and economic developments for the medium to long term in line with the development strategy of the Government. A neutral committee such as this would likely be more successful at introducing tax reform.
In particular the Tax Reform Committee, apart from reviewing the effectiveness of the existing revenue systems should consider alternative taxation systems, such as Green Taxes /Polluter pays (mentioned above), Tobin taxes (taxes on financial transactions) or indeed altering the mechanism whereby the Government sells land for an upfront land premium and collects thereafter a 3% Government Rental. Instead, should Government rent be increased to market rates, but a lower up front land premium charged to even out Government income? Income received by Government from land has always been a controversial topic in Hong Kong but perhaps now is the time to address this also.
Other radical solutions such as reducing all maximum direct tax rates to say 10% over say a 5 year period, or indeed abolishing direct taxes altogether should be considered and quantified .

Conclusion

At the Chamber we are concerned that taxation and revenue raising policy in Hong Kong is not strategically planned , and as a result is volatile and uncontrolled and could harm business and investments here, especially from overseas. This would undoubtedly harm the future prosperity of "Hong Kong Inc". Especially if the inequity in the revenue raising systems grows. We are therefore keen to support the government in its initiatives in conducting a thorough, independent and transparent review of the whole basis of collecting revenue in Hong Kong, not just from the direct taxation system, but from all sources, local and overseas, with a view to formulating a strategic approach to revenue collection and also expenditure, for the future.

March 2007

Appendix 1

Detailed comment collected on the practical aspects to be addressed in any proposed GST implementation - (in no particular order):

- The overriding principles underpinning the new tax who would bear the cost, and who would benefit.

- Whether the IRD would have a separate division which deals with the administration – would it integrate with Profits Tax and Salaries Tax and Property Tax records as well? Will the search and entry / inspection powers under the new tax be greater than or the same as in the current IRO? Will there be different tax investigation teams? Will there be similar anti-avoidance provisions as in the IRO?

- Much more detail is needed on who will be a taxable/registerable entity/business and when the registration threshold will be treated as reached – if for a GST for example would this be based on expected turnover or actual? In HK or outside? i.e. what happens to a non Hong Kong company with a bank account in Jersey, but where all the directors are in HK? Would the new tax system follow the Business Registration ("BR") system? Will the BR system follow the new system? Would the BR system go?

- Impact on record keeping of Hong Kong businesses. The IRO requires accounting records to be kept for 7 years; this does not necessarily mean that audited accounts are prepared, on a timely basis by most SME businesses in Hong Kong. New requirements for keeping accounts may be needed as most small and medium sized companies do not keep monthly management accounts up to date but write up their books at the year end for audit purposes; in the past there has been no other reason to write up their books monthly or quarterly.

- Timing of submission of the new tax returns, and payments – what timeframes? But could a taxpayer smooth cash flows? If so, under which criteria would this be allowed?

- Impact of group transactions will need to be addressed as it will be easy to abuse any tax system within a group, by teaming and lading intragroup transactions.

- Appeal procedures for disputes - will this be dealt with by the Board of Review or another similar tax tribunal/body?

- Retails schemes will be needed for a turnover tax so GST/ VAT invoices do not need to be issued by all retailers to all customers, and so the system is simplified for them.

- Standard methods for calculating GST payable for partially exempt businesses (ie most developers and land owners) will be needed.

- Details of GST invoices and tax points will be needed, to avoid lots of fake GST input claims (as in the PRC), and "carousel" schemes (as in the EU - where the input tax on the same items is claimed many times). Also the impact on Letter of Credit type transactions, which are still very common in Hong Kong; what will be the tax point?

- There was no mention of GST supplies which are "outside the scope:" of GST in the CD but implicitly this would seem to cover foreign investments and dividend income (as in the UK). So that foreign investors are not adversely affected. This was perhaps the most important thing for Hong Kong going forward, in implementing any new taxes.

- To consider whether second hand goods schemes and other special retail schemes will be adopted.

- What to do with conventions and exhibitions - presumably these types of meetings will be able to claim exemptions for goods temporarily imported, displayed and sold? At present Profits Tax is not usually charged on items sold in exhibitions in HK, for example at the jewellery fair.

- Specific details on tourist refund schemes to be set out

- Specific details on documentation/processes/reporting required for bonded warehousing, import agents etc, transshipment activities. The amount of documentation is causing concern. Especially on import/export agents.

- Specific details on bad debt reliefs – a very tricky area as in the UK, payment of VAT on income which then becomes a bad debt, and where the VAT is not recoverable, is the largest reason for businesses failing.

- A "reverse charge" mechanism so that GST would be charged on importing/using a service provider outside Hong Kong to perform services, to avoid paying GST on using a service provider within Hong Kong.