



A Tax System to Enhance the Business Environment

May 2008

Competitiveness of Hong Kong's Tax System

Aims:-

- To assess the business competitiveness of HK's tax system
- To provide recommendations on tax policy changes
- To provide recommendations on priority for actions

Improving business competitiveness will benefit the whole community


Study included:-

- A literature review of recent competitiveness studies identifying the future macro-economic goals for HK
- A survey of the HK business sector
- Interviews of senior business executives
- Interviews of businesses that have recently located key functions in a competitor jurisdiction (e.g. Singapore and Macau)



Hong Kong's Macro-economic Goals

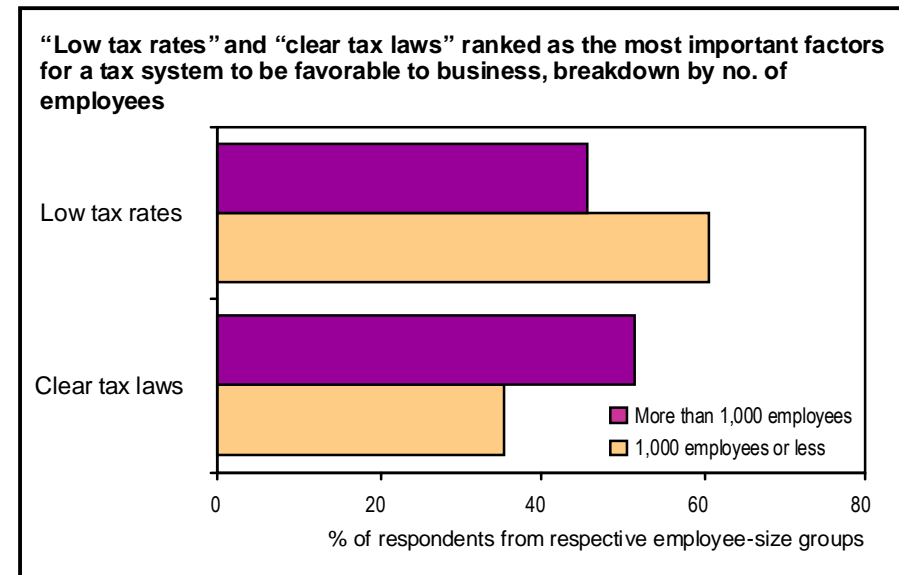
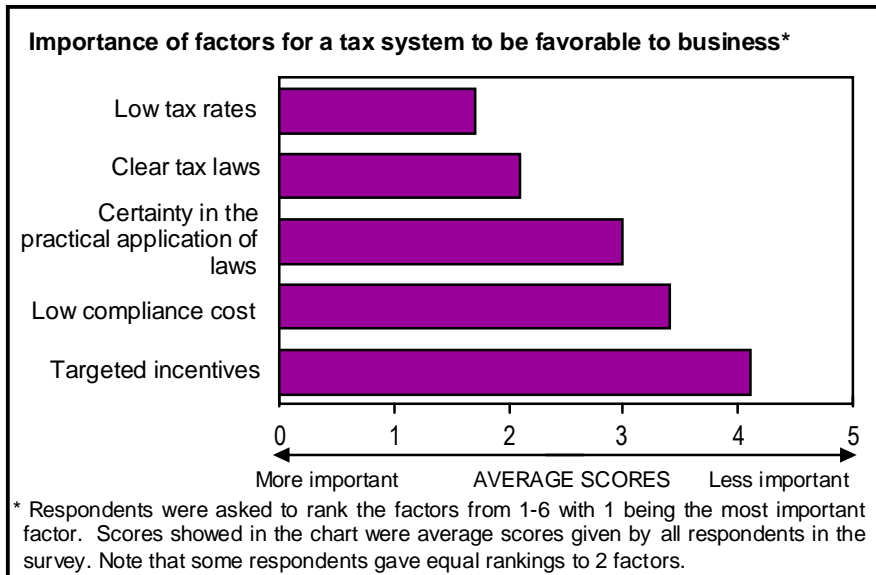
Hong Kong's Macro-economic Goals

Goals	Descriptions
Sourcing centre	<ul style="list-style-type: none"> • A premier one-stop shop for international buyers / procurement offices of manufactured goods
"Brand Hong Kong" 	<ul style="list-style-type: none"> • Image of HK as an international city with a vibrant, trendy, colourful and cosmopolitan lifestyle • Image of HK as a fashionable and cosmopolitan city, i.e. international visitors will not only be confined to shopping and dining, but will be engaging in cultural and leisure activities that are a fusion of East and West • Image of HK's products that are contemporary and with high quality, and services that are efficient and international
Centre for Chinese entrepreneurs	<ul style="list-style-type: none"> • Home to Mainland entrepreneurs eager to set up a base outside the Mainland
Asset management centre	<ul style="list-style-type: none"> • Home to international traditional asset management firms (e.g. subsidiaries of banks, securities firms and insurance companies) • Home to international alternative investment firms (e.g. hedge funds and private equities)
Wealth management centre	<ul style="list-style-type: none"> • A major destination for private wealth deposits / investments
Preferred IPO platform	<ul style="list-style-type: none"> • A preferred platform for companies worldwide to raise equity funds
International financial intermediation platform for the Mainland	<ul style="list-style-type: none"> • A preferred platform for Mainland companies to raise funds (equity and debt)
Gateway for Mainland's outbound capital	<ul style="list-style-type: none"> • A preferred platform for Mainland enterprises to invest internationally
Logistics hub	<ul style="list-style-type: none"> • A highly efficient transport hub for passenger and cargo movement that is supported by the application of information technology
International aviation hub	<ul style="list-style-type: none"> • Home to international passenger and cargo airlines • A preferred air transport hub for passengers and cargoes
International maritime centre	<ul style="list-style-type: none"> • Home to international ship management and shipping-related companies • A preferred trade port for bulk and containerized cargoes
Cosmopolitan city for services	<ul style="list-style-type: none"> • Home to Mainland and international services providers (including legal services, accounting, management consulting, investment advisory, financial intermediation consulting and information services)
Headquarters economy	<ul style="list-style-type: none"> • Home to Mainland and multinational companies' headquarters for central management, finance and research and development
Knowledge-based economy	<ul style="list-style-type: none"> • An economy in which productivity and growth are driven by knowledge and technology



Business Survey

Ranking of Important Factors



- Survey results showed “low tax rates” to be the most important factor, with 59% of all the respondents giving it the highest ranking. This was followed by “clear tax laws” (36%), “certainty in the practical application of laws” (11%), “low compliance cost” (6%) and “targeted incentives” (4%).
- “Low tax rates” appeared to be a more important factor to smaller companies than their larger counterparts. Among respondents with 1,000 or less employees, 61% gave this factor the highest ranking, while a lower percentage (46%) of the respondents with more than 1,000 employees gave this factor the highest ranking.
- Respondents with more than 1,000 employees viewed “clear tax laws” as the most important factor, with 51% of them giving it the top ranking. A much lower percentage (35%) of the respondents with 1,000 or less employees gave this factor the top ranking.

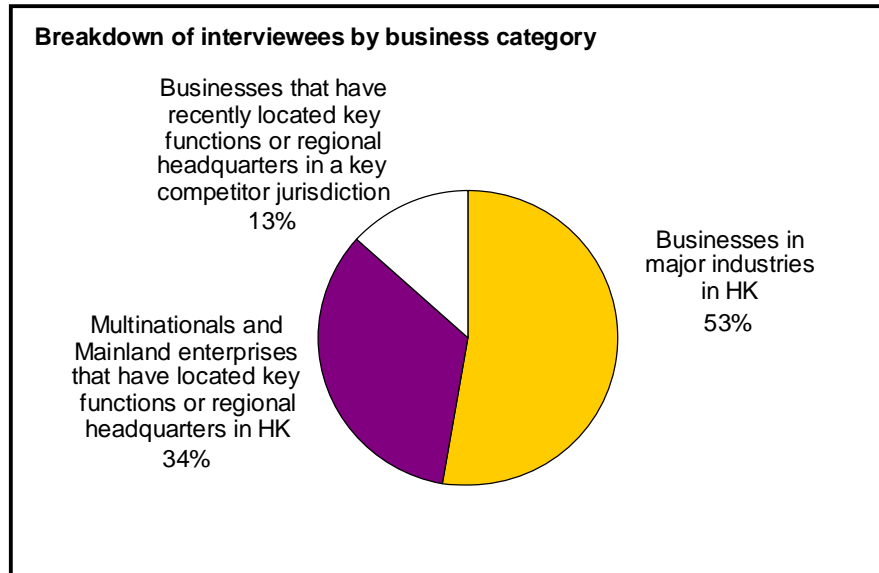
Business Survey Results

Issue	All respondents	Respondents relocated business elsewhere (22% of total respondents)
Found one or more of key aspects of HK tax laws to be confusing (practical application of source concept, distinction between capital/revenue)	38%	50%
Supportive of one or both of following:- <ul style="list-style-type: none"> - Group loss relief & loss carry-back - More double tax treaties 	85%	89%
Regarded other jurisdictions as being more attractive than HK from a tax perspective	35%	45%
Cited by most as the jurisdiction with a more attractive tax system than HK	Macau	Singapore



Business Interviews

Background of Interviewees



- 53 one-on-one interviews conducted
- The executives come from:-
 - Businesses in major industries in HK
 - Multinationals and Mainland enterprises that have located key functions or regional headquarters in HK
 - Businesses that have recently located key functions or regional headquarters in a key competitor jurisdiction (for the purpose of the interviews, Singapore and Macau have been chosen)
- They hold positions as business proprietors, general managers, finance managers and other specialists (economists, researchers)

Summary of Perceived Strengths and Weaknesses of HK's Tax System

Strengths	Weaknesses
<ol style="list-style-type: none"> 1) Simple <ul style="list-style-type: none"> • List of taxable items is short • Dividend and capital gains are not taxed • Limited withholding taxes 2) Low tax rates <ul style="list-style-type: none"> • Compared to other jurisdictions, profits and salaries tax rates are among the world's lowest • Operates on the basis of "source concept" 3) Low administrative costs <ul style="list-style-type: none"> • Filing requirements are straight-forward 4) Has high regard for level-playing field <ul style="list-style-type: none"> • All industries benefit equally 5) Confidentiality of taxpayers' information is safe-guarded <ul style="list-style-type: none"> • Under normal circumstances, tax authorities cannot disclose documentation to third parties, including other government departments 	<ol style="list-style-type: none"> 1) Increasingly uncertain application of tax laws <ul style="list-style-type: none"> • More grey areas than before because of globalization and rising cross-border transactions • The distinction between "onshore" and "offshore" income in determining both taxable profits and salaries is becoming vague; so is the distinction between "capital" and "trading" profits • The definitions of concepts such as "totality of facts" and "head and centre of management" are unclear 2) Tax features available elsewhere are missing in HK: <ul style="list-style-type: none"> • Comprehensive double tax treaty (DTA) network • Consolidated tax reporting; group loss relief and loss carry-back • Bonus deductions for expenses such as R&D 3) Narrow tax base 4) High effective Profits Tax rates 5) Lack of a clear tax policy that complements HK's development goals (e.g. to develop into an international financial centre, a preferred location for regional headquarters, etc.)

Activities Regarded as Better Off being Located outside HK

Activities cited	Preferred jurisdictions	Reasons
International or regional headquarters	Singapore	Concessionary tax rate
SMEs	Singapore	Tax exemption
Research & development	Mainland China, Taiwan, Singapore, and wherever “super deductions” of 150-200% are offered	Super deductions
Investment holding	Macau, BVI, Mauritius, Barbados, Netherlands, Singapore, Luxembourg, Belgium	Zero tax for offshore entities
Intellectual property ownership	BVI, Switzerland, Luxembourg, Cyprus	Tax exemption
IT Projects and e- or web-based businesses	Not specified	HK has no advantage because there is no clear guideline in this area
Royalty-related activities	Not specified	Tax exemption
Fund & trust management, funds and REITs	Singapore	Concessionary tax rate
Listing of bonds	Luxembourg	Tax exemption
Captive insurance	Cayman Islands, Singapore	Concessionary tax rate
Any business involved in acquisition of Mainland ventures, holding companies	BVI	Zero tax for offshore entities
Manufacturing	Mainland China, Vietnam, India	Tax holiday, concessionary tax rate
Invoicing, re-invoicing, offshore trading	Macau	Zero tax for offshore entities
Supply chain business	Singapore	Tax incentives
Back office services	Mainland China	Tax holiday, concessionary tax rate



Overview of Recommendations

Overview of Recommendations

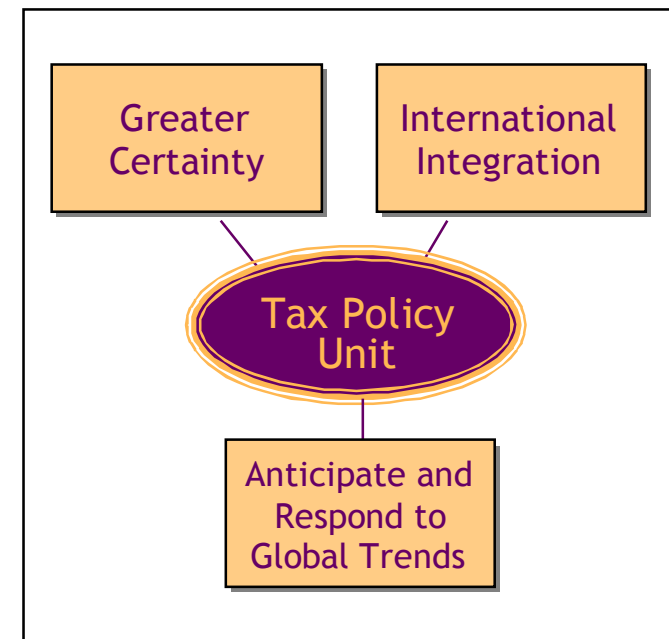
- Overall, HK's current tax system is competitive, with many attractive features including:-
 - a limited number of taxes
 - low statutory tax rates
 - application of source concept of taxation
 - tax exemption of profits from the sale of capital assets
 - a limited withholding tax regime
 - efficient tax administration
- But with increasing global competition, HK cannot afford to rest on its laurels
- Must align HK's tax system with macro-economic goals
- Key area for immediate attention – level of certainty in practical application of HK's tax laws
- Study Group has five recommendations on fundamental issues and twelve detailed recommendations



Recommendations on Fundamental Issues

(1) Tax Policy Unit and Approach to Maintaining Competitiveness

- We recommend the establishment of a new specialist Tax Policy Unit within the Financial Services and the Treasury Bureau (“FSTB”) and a three-pronged approach to monitoring the competitiveness of HK’s tax system comprising of i) providing greater certainty ii) effecting better international integration iii) anticipating and responding to global trends.
- The unit should be staffed by officials with sufficient seniority, technical knowledge and relevant practical experience. The key mandate of the unit should be tax policy research and policy formulation.
- Role of the unit:-
 - research and analyse international trends;
 - review and formulate recommendations on how to improve and upgrade tax policies to meet HK’s economic and social objectives;
 - implement tax changes;
 - Liaise and work with other bureaux to formulate tax policies in line with other government policy objectives e.g. in the areas of environmental protection, job creation, poverty alleviation etc.
 - solicit views from business and professional sectors.
- We recommend the Financial Secretary to appoint and chair a standing advisory committee to advise the unit.
- The Tax Policy Unit will form an important anchor and pillar to keep HK’s tax system efficient and competitive. The Study Group regards this as the most important among all of its recommendations.



(1) Tax Policy Unit and Approach to Maintaining Competitiveness

Three-pronged approach to improving competitiveness of HK's tax system

Providing greater certainty

1. Source concept for profits tax
2. Source of employment income
3. Shortened time-bar provisions
4. Participation exemption
5. Improving guidance and certainty to taxpayers

Effecting better international integration

6. Double tax treaty network
7. Transfer pricing
8. Implications of international accounting standards

Anticipating and responding to global trends

9. Corporate tax rate
10. Tax loss relief
11. Stamp duty exemption for unquoted shares and instruments
12. Tax deductions

(2) Underlying Principle to Fiscal Policy

- HK prides itself on a simple tax system with low rates of taxation.
- Simplicity is an important principle for a good tax system when it represents:-
 - Clarity in tax laws
 - Certainty in the practical application of laws
 - Low compliance and administrative costs
- However, with business transactions becoming ever more complex and sophisticated, a simple tax system may not be able to cater to changes in the business world. The result could be uncertainty and uncompetitiveness. There are situations where simplicity per se should be sacrificed (e.g. in favour of competitiveness).
- We recommend a new value proposition for HK's fiscal policy based on competitiveness as the key underlying principle, and striking a balance amongst the following principles:-
 - Certainty
 - Efficiency and effectiveness
 - Low rate

(3) Comparative Advantages

Before considering the necessary changes, it is useful to begin by considering the good elements of the existing tax system. The following are generally regarded as comparative advantages which should be retained:

- limited number of taxes
- source concept of taxation
- tax exemption of profits from the sale of capital assets
- tax exemption of dividend income
- low statutory tax rates
- no tax on death transfers

(4) Use of Tax Incentives

- HK Government's traditional approach is in contrast to many of HK's regional competitors which have made liberal use of tax incentives to attract investments.
- We acknowledge that mobile business activities could be more affected by tax incentives. Nevertheless, the results of our business survey and interviews covering all major industries confirm that clarity of tax law and certainty of tax administration are more important factors than tax incentives.
- For the time being, we believe HK should focus on providing an across-the-board favourable tax environment, rather than being distracted by calls for sector/industry specific tax incentives where the cost/benefit is unclear, and which could be perceived as inequitable.

(5) Broadening the Tax Base

- There is a general consensus that HK has a narrow tax base.
- The revised estimate of the 2007/08 fiscal surplus at more than four and a half times of the original estimate is in fact a reflection of the unreliable and unstable nature of the revenue base in HK. Until this issue is resolved, the Government could face large fiscal deficits when HK next faces a downturn in its economic cycle.
- In recent years, there is a clear tendency among economies in competition to reduce their direct tax rates and seek to make up the shortfall with increases in indirect taxes. Without an alternative new source of revenue, it will be difficult for HK to continue to reduce its direct tax rates in response to international competition, as any reduction will put pressure on HK's budgetary position.
- As a community, HK must continue to study and debate options for broadening the tax base with the aim of reaching a consensus on the appropriate option.



Detailed Recommendations

Providing Greater Certainty

Issue	Recommendation	Revenue implication
1) An urgent need to provide greater certainty in the practical application of the source concept for Profits Tax	Amendment of Departmental Interpretation and Practice Notes No. 21 (“DIPN No. 21”) by the Tax Policy Unit, in consultation with business and professional sectors	Providing greater certainty should not in itself give rise to tax revenue implications. In the long run, this should retain and attract more businesses to HK and hence generate positive revenue effects
2) A need to provide greater certainty in the determination of source of employment income	The law to be amended to provide for source of employment to be determined based on where services are performed	Immediate effect would depend on administrative limits to be introduced. The long-term effect should be revenue positive as more senior mobile executives are attracted to HK
3) A need to shorten the period within which tax affairs are finalised	<ul style="list-style-type: none"> i) Performance pledge by IRD to review tax returns within one year of submission ii) Shorten time-bar provisions from six to four years iii) Tax losses to be accorded the same timeframe for review as assessable profits 	None. But this will have resource implications for the IRD
4) Participation exemption	To introduce an exemption regime from Profits Tax for profits from the disposals of certain share investments	Not material
5) Improving guidance and certainty to taxpayers	<ul style="list-style-type: none"> i) IRD to publish more advance rulings and provide more timely guidance on ad-hoc technical issues ii) Review composition of Board of Review 	Providing greater certainty should not in itself give rise to tax revenue implications. In the long run, this should retain and attract more businesses to HK, and hence generate positive revenue effects

Effecting Better International Integration

Issue	Recommendation	Revenue implication
6) Building a comprehensive DTA network	i) HK to make greater efforts in building a DTA network and amend the law to enable HK to comply with the necessary exchange of information (“EOI”) provisions ii) Before HK is able to adopt the latest EOI clause, to give priority to negotiation with Asian countries and with countries where China outbound investments are heading (e.g. Australia) or where the tax regime is very aggressive (e.g. India)	Minimal given HK’s limited withholding tax regime, but additional administrative costs for the IRD to deal with EOI requests
7) Need to adopt conventional transfer pricing provisions to enhance its position as a link to the global supply chain	HK to adopt transfer pricing provisions consistent with the approach adopted by HK’s major trading partners. This could be done by enacting specific legislation or by issuing a detailed practice note	No immediate revenue effect but in the long run should be revenue positive as HK would be better equipped in dealing with transfer pricing adjustments to protect its tax base
8) Implications of international accounting standards	To implement a systematic and timely review of the tax implications of each provision under the International Financial Reporting Standards being incorporated into HK’s financial reporting standards	Revenue neutral, aimed at preserving HK’s tax policy objectives as HK effects a better global integration with the adoption of international accounting standards

Anticipating and Responding to Global Trends

Issue	Recommendation	Revenue implication
9) Corporate tax rate	To reduce Profits Tax rate to 15% and introduce a lower rate for businesses with assessable profits of less than \$1 million	i) A reduction of the Profits Tax rate from 16.5% to 15% is estimated to cost \$6.6 billion per annum (based on 07/08 projected revenue figures) ii) A reduction of the Profits Tax rate to 10% for businesses with assessable profits of less than \$1 million is estimated to cost a further \$678m per annum (based on 05/06 figures)
10) Tax loss provisions to be improved to enhance competitiveness	i) To introduce a group loss transfer system ii) To introduce a tax loss carry-back regime	No long-term impact on government revenue as the current tax loss regime already allows losses to be carried forward indefinitely
11) Stamp duty on unquoted shares and instruments	Abolish stamp duty on unquoted shares and instruments to:- <ul style="list-style-type: none"> - Increase the use of HK incorporated companies - Reduce administrative burden for stamping 	Based on actual revenue figures for 2006/07, estimated to cost approximately \$1.36 billion, representing not more than 1% of the total tax collected
12) Tax deductions on expenditures for intellectual properties ("IP"), research and development ("R&D") and manufacturing plant and machinery	i) To provide bonus tax deductions for R&D expenditures at a rate of 150% to 200% ii) To extend the range of purchased IP eligible for tax deductions to include trademarks, brand names, designs etc. iii) To allow 100% outright tax deductions for plant & machinery expenditures incurred for processing trade	A reduction in revenue anticipated, but unable to estimate given lack of published statistics on the relevant expenditures

“Short” – for immediate actions

- Source concept for Profits Tax
- Tax loss relief
- Source of employment income
- Corporate tax rate
- Tax deductions

“Medium” – for second stage actions

- Shorten time–bar provisions
- Stamp duty exemption for unquoted shares
- Transfer pricing
- Participation exemption

“Ongoing” – requires ongoing attention

- Guidance to taxpayers
- Double tax treaty network
- Implications of international accounting standards

Matching Detailed Recommendations with Macro-economic Goals

- The following table matches the twelve detailed recommendations with the macro-economic goals envisioned for HK
- All twelve recommendations should improve HK's general business environment, and hence should promote all of the macro-economic goals
- A tick mark is used to indicate those goals that would benefit from the adoption of the recommendation to a greater extent than the other goals

Matching Detailed Recommendations with Macro-economic Goals

Tax Recommendations	Action Priority (short / medium / ongoing)	General Business Environment	Sourcing Centre	“Brand HK”	Centre for Chinese Entrepreneurs	Wealth Management Centre	Asset Management Centre	Preferred IPO Platform
<u>Certainty</u>								
• Source concept for Profits Tax	Short	✓	✓		✓	✓	✓	✓
• Source of employment income	Short	✓	✓	✓	✓	✓	✓	
• Shorten time-bar provisions	Medium	✓	✓		✓	✓	✓	
• Participation exemption	Medium	✓			✓	✓	✓	✓
• Guidance to taxpayers	Ongoing	✓	✓	✓	✓	✓	✓	✓
<u>International integration</u>								
• Double tax treaty network	Ongoing	✓	✓	✓	✓	✓	✓	✓
• Transfer pricing	Medium	✓	✓		✓			
• Implications of international accounting standards	Ongoing	✓				✓	✓	
<u>Anticipate and respond to global trends</u>								
• Corporate tax rate	Short	✓	✓	✓	✓			
• Tax loss relief	Short	✓	✓	✓	✓			
• Stamp duty exemption for unquoted shares	Medium	✓			✓	✓	✓	✓
• Tax deductions:- - IP / R&D - Plant & equipment	Short	✓	✓	✓	✓			

Matching Detailed Recommendations with Macro-economic Goals

Tax Recommendations	Gateway for Mainland Outbound Capital	International Financial Intermediation Platform for Mainland	International Maritime Centre	International Aviation Hub	Logistics Hub	Cosmopolitan City for Services	Head-quarters Economy	Knowledge Based Economy
<u>Certainty</u>								
• Source concept for Profits Tax	✓	✓					✓	✓
• Source of employment income		✓				✓	✓	✓
• Shorten time-bar provisions	✓	✓	✓	✓	✓	✓	✓	✓
• Participation exemption	✓	✓	✓				✓	✓
• Guidance to taxpayers	✓	✓	✓	✓	✓	✓	✓	✓
<u>International integration</u>								
• Double tax treaty network	✓	✓	✓	✓	✓	✓	✓	✓
• Transfer pricing	✓	✓	✓	✓	✓	✓	✓	✓
• Implications of international accounting standards		✓	✓	✓			✓	✓
<u>Anticipate and respond to global trends</u>								
• Corporate tax rate	✓	✓			✓	✓	✓	✓
• Tax loss relief	✓	✓	✓	✓	✓	✓	✓	✓
• Stamp duty exemption for unquoted shares	✓	✓	✓	✓			✓	✓
• Tax deductions:- - IP / R&D - Plant & equipment					✓	✓	✓	✓