



A Tax System to Enhance the Business Environment

May 2008

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Acronyms

BOR	Board of Review	IPO	Initial public offering
BVI	British Virgin Islands	IRD	Inland Revenue Department
CFC	Controlled foreign company	IRO	Inland Revenue Ordinance
DIPN	Departmental Interpretation and Practice Notes	IT	Information technology
DTA	Double tax treaty	JLCT	Joint Liaison Committee on Taxation
EoI	Exchange of Information	OECD	Organisation for Economic Cooperation and Development
EU	European Union	PE	Permanent establishment
FAQ	Frequently asked questions	PRC	People's Republic of China
FS	Financial Secretary	R&D	Research & development
FSTB	Financial Services and the Treasury Bureau	REIT	Real estate investment trust
HK	Hong Kong	SME	Small and medium enterprises
HKFRS	Hong Kong Financial Reporting Standard	UK	United Kingdom
IASB	International Accounting Standards Board	WHT	Withholding tax
IFRS	International Financial Reporting Standard	WRIE	Wholesale and retail, import and export trade
IP	Intellectual property		

Introduction

Introduction

Introduction

2007 marked the 10th Anniversary of the establishment of the Hong Kong Special Administrative Region (“HK”). As HK celebrated this landmark anniversary, increasingly questions are being raised regarding HK’s future macro-economic development, in particular in relation to the economic integration between HK and the Mainland. Studies have been conducted by various organisations (including the Bauhinia Foundation Research Centre) to identify the conditions and policies that would attract the flow of business, funds and people through HK and thereby enhance HK’s economic competitiveness in the long run.

Tax policy is a key driver to the competitiveness of a jurisdiction as tax measures can be effectively employed to retain and attract capital and talent. The Bauhinia Foundation Research Centre set up this Study Group on the competitiveness of HK’s tax system with the aim of assessing the competitiveness of the existing system from a business perspective and identifying areas where changes are necessary in light of the future macro-economic goals identified for HK. Improving business competitiveness will benefit the whole community.

Study scope

The aim of this study is to assess the business competitiveness of HK’s tax system and provide recommendations on tax policy changes and priorities.

This study includes the following elements:-

- Identification of the future macro-economic goals for HK recommended in industry-level and activity-level competitiveness studies, in studies on the impact of China’s 11th Five-Year Plan on HK, and in major government documents such as the Policy Address and Budget Speech.
- Surveys and interviews of business leaders in various industries in HK to gauge their views on the competitiveness of the existing tax system and attractions of HK’s competitor jurisdictions from a tax perspective.
- Interviews of 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 as comparative jurisdictions).
- Based on the findings from the above elements and with reference to policies adopted by competitor jurisdictions, identify and propose tax policy changes, initiatives and priorities for HK.
- Where possible, estimate the revenue implications of the proposed tax policy changes.

Introduction (cont'd)

Membership of Study Group

Co-convenors

Anthony Wu	Chairman, Bauhinia Foundation Research Centre
Ayesha Macpherson	Partner, KPMG

Members

Vaughn Barber	Principal, KPMG
Roy C P Chung	Vice-Chairman, Techtronic Industries Co Ltd
Lester Garson Huang	Partner, P.C. Woo & Co. Solicitors & Notaries
Peter Hung	Chairman, Hop Hing Holdings Ltd
Michael Olesnicky	Partner, Baker & McKenzie, Hong Kong
Moi Ying Rule	Consultant, MY Consultancy
Kennedy Y H Wong	Managing Partner, Philip K H Wong, Kennedy Wong & Co. Solicitors & Notaries

Consultants

TeamOne Economist Limited was engaged to conduct the business survey and interviews and to provide research support on the literature review of economic competitiveness studies.

Executive Summary

Executive Summary

Overview

- Overall, HK's current tax system is competitive. HK has fewer numbers of taxes than most other developed jurisdictions. Its statutory tax rates are still amongst the lowest in the world and many features of its tax system are attractive to businesses (e.g. application of a source concept of taxation, tax exemption of profits from the sale of capital assets, and a limited withholding tax ("WHT") regime). In addition, HK's tax administration is more efficient than many of its competitors.
- However, HK cannot afford to rest on its laurels. Many of its competitor jurisdictions are actively making use of their tax systems to retain and attract capital and talent. In the past decade, many jurisdictions have significantly lowered their statutory tax rates and have introduced preferential tax treatments and additional tax deductions leading to lower effective tax rates. As demonstrated in a study released by the World Bank (see details on page 67), HK has a high effective tax rate despite its low headline rate. In the absence of policy actions, HK runs the risk of lagging behind its competitors.
- The key area which requires immediate attention is the level of certainty in the practical application of HK's tax laws. The business sector in general has noted increasing areas of uncertainties which are harming HK's competitiveness. In a climate of global tax competition, HK cannot afford to allow for significant uncertainties to exist over the practical application of its tax system. Ignoring the issue will only lead to businesses choosing other jurisdictions over HK, and once they have left, it would be difficult to entice them to return.

Business survey and business interviews

- As part of this study, a survey of the HK business sector and one-on-one interviews with senior business executives were conducted. A summary of the business survey results is on pages 12 to 14 with details included in the Appendix. Summary comments from the interviews are set out on pages 15 to 19.
- In general, the HK business sector acknowledges the comparative strength of the existing HK tax system but notes the potential danger of being overtaken by competitor jurisdictions in the absence of actions on areas for improvement. The areas cited include improving certainty, building a double tax treaty ("DTA") network, introducing group loss relief and loss carry-back, and providing bonus tax deductions for research and development ("R&D").

Executive Summary (cont'd)

Recommendations

- The Study Group has five recommendations on fundamental issues and twelve detailed recommendations.
- We regard our recommendation to set up a new specialist Tax Policy Unit within the Financial Services and the Treasury Bureau (“FSTB”) as the most important of all of our recommendations. Given the importance of tax policy to the overall competitiveness of HK, we believe it is the right time for the HK Government to dedicate full time specialist resources to tax policy setting. In the absence of such a unit, the Study Group is doubtful of HK’s ability to anticipate and respond in a timely manner to the ever increasing international competition on the tax front.
- Our five recommendations on fundamental issues are as follows:-
 - To set up a new specialist Tax Policy Unit adopting 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.
 - HK’s fiscal policy to adopt a new value proposition using competitiveness as the underlying principle.
 - To retain existing comparative advantages of i) limited numbers of taxes ii) application of a source concept of taxation iii) exemption of profits from the sale of capital assets iv) exemption of dividend income v) low headline tax rates vi) no tax on death transfers.
 - To focus on providing an across-the-board favourable tax environment for business and avoid distractions caused by calls for sector/industry specific tax incentives.
 - To continue to study and debate options for broadening the tax base.

Details on these five recommendations on fundamental issues are set out in pages 23 to 32.

- Adopting a three-pronged approach to reviewing the competitiveness of HK’s tax system, the Study Group’s twelve detailed recommendations are as follows :-

Certainty

- *The need for certainty in the application of the source concept for Profits Tax*

There is an urgent need to provide greater certainty in the practical application of the source concept for Profits Tax. This can be achieved by amending Departmental Interpretation and Practice Note No. 21 (“DIPN No. 21”), which should be led by the Tax Policy Unit within the FSTB in full consultation with the business and professional sectors.

Executive Summary (cont'd)

- *The need for certainty in the determination of the source of employment income*

We recommend an amendment to the tax law to provide for the source of employment income to be determined based on the location of services.

- *Time-bar provisions*

We recommend shortening the time-bar provisions by one third from six to four years, with the same shortened time frame to be adopted for the agreement of tax losses and for the re-opening of tax affairs by taxpayers for errors or omissions of claims.

- *Participation exemption*

To provide greater certainty to investors, HK should consider the introduction of a “participation exemption” style regime. This regime would operate to exempt from Profits Tax gains arising from share investments when certain conditions are satisfied.

- *Improving guidance and certainty to taxpayers*

We recommend more frequent and timely technical guidance to be released by the Inland Revenue Department (“IRD”) and a review of the composition of the Board of Review (“BOR”) to improve the technical quality and timeliness of its decisions.

International integration

- *Double tax treaty (“DTA”) network*

We recommend HK making greater efforts in building a comprehensive DTA network, including amending its tax laws to enable the adoption of a more liberalized Exchange of Information (“EoI”) clause that is a prerequisite for reaching agreements with many Organisation for Economic Cooperation and Development (“OECD”) countries.

- *Transfer pricing*

HK should adopt conventional transfer pricing provisions consistent with international practice

- *Monitor implications arising from the adoption of international accounting standards in HK*

There is an ongoing need to conduct a timely review of the tax implications of each International Financial Reporting Standard (“IFRS”) (to be adopted in HK as Hong Kong Financial Reporting Standards (“HKFRS”)).

Executive Summary (cont'd)

Anticipating and responding to global trends

- Corporate tax rate

We support the lowering of the Profits Tax rate to 15% and the elimination of the rate differential between incorporated and unincorporated businesses. To assist small and medium enterprises (“SMEs”), we recommend a lower tax rate for businesses with assessable profits of less than HK\$1 million.

- Tax loss relief

HK should improve its tax loss relief provisions by introducing group loss transfer and tax loss carry-back rules.

- Abolish stamp duty on unquoted shares and instruments

In support of various macro-economic goals envisioned for HK, we recommend the abolition of stamp duty on unquoted shares and instruments.

- Tax deductions

We recommend tax deductions to be enhanced for expenditures on i) R&D ii) intellectual properties (“IP”) and iii) manufacturing plant & machinery

Details on our twelve recommendations are set out on pages 33 to 81.

Priority

- Given the potential resource constraints preventing actions on all of our detailed recommendations at the same time, we have prioritised our recommendations as follows:-

“Short” – for immediate actions

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

Executive Summary (cont'd)

"Medium" – for second stage actions

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

"Ongoing" – requires ongoing attention

- Guidance to taxpayers
- Double tax treaty ("DTA") network
- Implications of international accounting standards

Alignment to macro-economic goals

- HK's tax system must align with the macro-economic goals envisioned for HK. As part of this study, a literature review of recent competitiveness studies was conducted, which identified the following goals:-
 - Sourcing centre
 - "Brand Hong Kong"
 - Centre for Chinese entrepreneurs
 - Asset management centre
 - Wealth management centre
 - Preferred initial public offering ("IPO") platform
 - International financial intermediation platform for the Mainland
 - Gateway for Mainland's outbound capital
 - Logistics hub
 - International aviation hub
 - International maritime centre
 - Cosmopolitan city for services
 - Headquarters economy
 - Knowledge-based economy

Information on the literature review is contained in pages 20 to 22.

- All of our five recommendations on fundamental issues should assist in the promotion of all macro-economic goals. Similarly, all of our twelve detailed recommendations should improve HK's general business environment and as such should support all of HK's macro-economic goals. However, each detailed recommendation may benefit some of the goals to a greater extent. The table on pages 37 and 38 matches each detailed recommendation to those goals which are considered to benefit most from the change.

Business Survey

Summary

Introduction

- To assist the Study Group in its assessment of the competitiveness of HK's tax system and in its deliberation of tax policy recommendations, a survey of the HK business sector was conducted between 26 November 2007 and 7 January 2008. A total of 404 responses were received.
- A survey of this nature is bound to have its limitations: including i) the results are dependent on the profile of the respondents, ii) it does not capture views of businesses not based in HK iii) the replies are more focussed on the existing tax system and less on the future goals envisioned for HK. Given these limitations, the Study Group has made references to the survey results in its analysis of tax policy recommendations, balancing the findings with the comments from the one-on-one business interviews and the experience of the members of the Study Group.

Key findings

The key findings of the survey are summarised as follows:-

All respondents

- The most important factors for a tax system to be favourable to the businesses surveyed were ranked by the respondents in the following order: "a low tax rate" (59% of respondents giving it the highest ranking), followed by "clear tax laws or certainty in the application of laws" (47%). Generally speaking, smaller-scale companies viewed "a low tax rate" to be the most important, while larger companies regarded "clear tax laws" as the most important.
- A significant 38% of the respondents found one or more of the following aspects related to HK's tax laws confusing: the practical application of the source concept for Profits Tax and Salaries Tax, and the distinction between capital assets and trading/revenue assets. In each of these areas, around 17% - 21% of the respondents thought there was a lack of clarity.
- A substantial 85% of the respondents supported one or both of the following changes in HK's tax system: allowing group loss relief & loss carry-back, and entering into more comprehensive Double Tax Treaties ("DTAs") with other jurisdictions.
- The respondents do not seem to have a strong opinion on the attractiveness of HK's tax system relative to other jurisdictions. Nearly half of the respondents (42%) said they "don't know" if other jurisdictions had more attractive tax systems than HK. For the 35% of all respondents who regarded other jurisdictions as having more attractive tax systems than HK, Macao was cited by most to have a more attractive tax system than HK, followed by Singapore.
- More than three quarters of the respondents (77%) believed HK still had an edge in attracting a host of activities to locate in HK from a tax perspective. Among these activities, "investment holdings" was cited by most (51%) as an activity that benefited from being located in HK, followed by "financial services" (43%) and "regional headquarters" (41%).

Summary (cont'd)

There are material differences in the feedback from respondents who had relocated or set up another business outside HK from the feedback of the total surveyed sample. In general, this group of respondents rated the current HK tax system less highly; and the material differences in response are summarised in the next section.

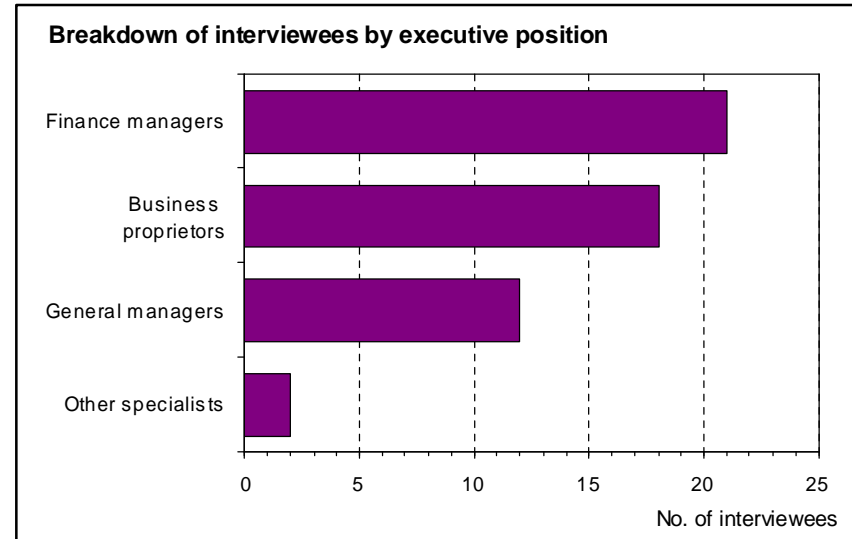
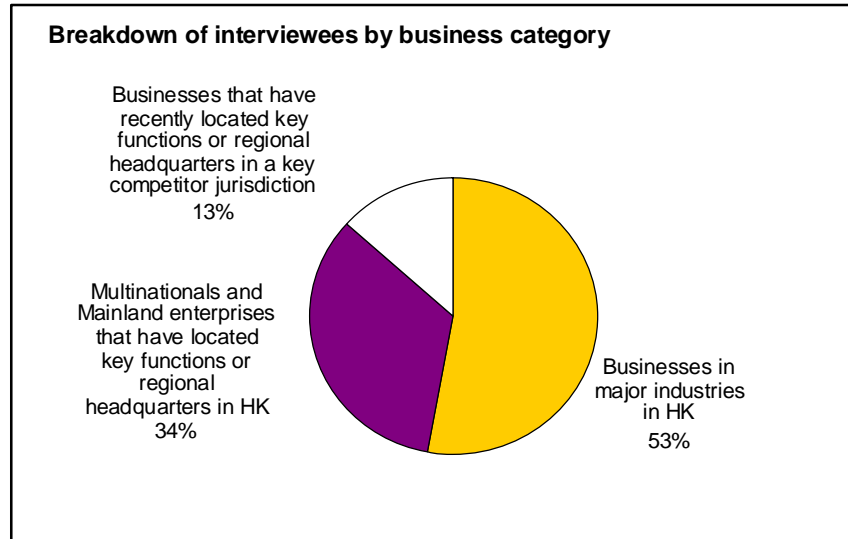
Respondents who had relocated or set up another business elsewhere in the past 10 years

- 22% of the survey respondents had relocated or set up another business activity outside HK in the past 10 years where tax was an important consideration.
- This group of respondents seemed to have a stronger opinion on the attractiveness of HK's tax system relative to other jurisdictions. 45% of them found other jurisdictions as having more attractive tax systems than HK, compared to only 35% for the general surveyed sample. Among the jurisdictions cited by this group of respondents, Singapore was seen by most to have a more attractive tax systems than HK. In the general surveyed sample, Macao was seen by most to be more attractive.
- Compared with the general surveyed sample, a substantially higher percentage of the respondents from this group (50% vs 38%) found one or more of the following aspects related to HK's tax laws confusing: the practical application of the source concept for Profits Tax and Salaries Tax, and the distinction between capital assets and trading/revenue assets. In each of these areas, 24%-27% of the respondents from this group thought there was a lack of clarity.
- A slightly higher percentage of this group compared with the general surveyed sample (89% vs 85%) supported one or both of the following changes in HK's tax system: allowing group loss relief & loss carry-back, and entering into more comprehensive Double Tax Treaties ("DTAs") with other jurisdictions.

Further details on the business survey results are contained in the Appendix.

Business Interviews

Background of Interviewees



- One-on-one interviews were conducted between November 2007 and February 2008 with 53 senior business executives to gauge their views on the competitiveness of HK's existing tax system.
- The executives come from the following categories of businesses:-
 - 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 Macao have been chosen)
- They hold positions as business proprietors, general managers (chairmen, presidents, managing directors, executive directors), finance managers (financial directors, finance controllers, chief accountants, tax managers), and other specialists (economists, researchers).

Summary of Key Comments

The following is a summary of the key comments provided during the interviews:-

- Interviewees identified “simplicity of tax structure” and “a low tax rate” as the key advantages of HK’s tax system. However, there are concerns that HK’s competitiveness would be eroded as globalization has caused the practical application of the source concept to be less certain, and competitor jurisdictions are way ahead in enhancing their tax features (e.g. more Double Tax Treaties (“DTAs”), and allowing group loss relief and loss carry-back).
- Under the “totality of facts” approach for both Profits and Salaries Tax, whether income is “derived from HK” is no longer a simple matter of looking at where the contract is drawn. Interviewees feel a need for clear guidance as to what factors are actually assessed under the “totality of facts” approach. In addition, the definition of “head and centre of management”, which is seen as critical under the “totality of facts” approach, needs to be spelt out.
- Interviewees seek clearer guidelines for distinguishing between “capital assets” and “revenue/trading assets”. They feel the current case-by-case approach in the treatment of capital gains is too arbitrary.
- Interviewees feel that the retrospective application of tax principles adds to taxpayers’ confusion and frustration. As the definitions of “onshore” vs. “offshore” income are no longer consistently held over time, taxpayers are increasingly prone to be probed on prior years’ operations. Even the most diligent taxpayers could be exposed to these queries because the application of the source concept is becoming less certain.
- To keep HK’s tax regime simple, incentives should be carefully considered and ideally be offered only if they can be applied across-the-board to all industries engaged in activities such as performance of headquarters functions, conducting R&D, trademark & intellectual property (“IP”) activities and investing in environment-enhancing facilities. Lowering the tax rate could also be an incentive benefiting all industries equally.
- A “low tax rate” is seen as the most important factor for a tax system to be attractive to businesses, as it affects a company’s bottom line directly. Interviewees rank the other factors for a tax system to be favourable to businesses as follows: “clear tax laws or certainty in the application of laws”, “low compliance cost”, and “tax incentives”. The first two factors help to lower taxpayers’ administrative costs while the last factor helps to lower the effective tax rate.
- Interviewees cited a number of activities which would be better off located outside of HK. It is worth noting that included among them are areas wherein HK has been aiming to take up a leading international position, such as regional headquarters, investment holding, and fund & trust management. For these particular activities, Singapore has been cited as the preferred jurisdiction.
- In view of the aggressive moves of competitor jurisdictions, interviewees called on tax authorities to provide a more effective communication channel for taxpayers to clarify tax issues, step up efforts to conclude more comprehensive DTAs, and to consider allowing group loss relief and loss carry-back to make HK’s tax features more attractive to businesses.

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 • Dividends and capital gains are not taxed • Limited withholding taxes (“WHT”) 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 a level-playing field <ul style="list-style-type: none"> • All industries benefit equally 5) Confidentiality of taxpayers’ information is safeguarded <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 • 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, and 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 ("IP") 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

Hong Kong's Macro-economic Goals


Hong Kong's Macro-economic Goals

Introduction

To enable the Study Group to consider changes to HK's tax system in support of the goals envisioned for HK, a literature review of recent competitiveness studies was conducted to identify the future macro-economic goals for HK. The table on the next page summarises the goals identified for HK by development fronts and industries.

Macro-economic goals for HK

Set out below is a brief explanation of each goal:-

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 R&D
Knowledge-based economy	<ul style="list-style-type: none"> • An economy in which productivity and growth are driven by knowledge and technology

Hong Kong's Macro-economic Goals (cont'd)

Development fronts	Goals	Industries directly affected	Sources
Trade & business	<ul style="list-style-type: none"> • Sourcing centre • "Brand Hong Kong" • Centre for Chinese entrepreneurs 	<ul style="list-style-type: none"> • Merchanting & merchandising • Other trade-related services • Convention & exhibition • Hotels & restaurants • Retail • Wholesale & distribution • Manufacturing, franchising • Ports & airports • Shipping, aviation, road & rail • Cargo handling & storage 	<ul style="list-style-type: none"> • Economic summit on "China's 11th Five-Year Plan and the Outlook for HK" • Business sector interviews conducted for Bauhinia's Study on the Competitiveness of HK's Tax System • 2008-09 Budget
Financial services	<ul style="list-style-type: none"> • Wealth management centre • Asset management centre • Preferred IPO platform • Gateway for Mainland's outbound capital • International financial intermediation platform for the Mainland 	<ul style="list-style-type: none"> • Private & commercial banking • Private equity & venture capital • Asset & fund management • Insurance • Custodian • Brokers/dealers • Corporate finance • Management & financial advisory • Legal & accounting 	<ul style="list-style-type: none"> • Economic summit on "China's 11th Five-Year Plan and the Outlook for HK" • 2006-07, 2007-08 Policy Address • 2007-08, 2008-09 Budget • Business sector interviews conducted for Bauhinia's Study on the Competitiveness of HK's Tax System
Maritime, Logistics and Infrastructure	<ul style="list-style-type: none"> • International maritime centre • International aviation hub • Logistics hub 	<ul style="list-style-type: none"> • Ports & airports • Shipping, aviation, road & rail • Cargo handling & storage • Construction & engineering 	<ul style="list-style-type: none"> • Economic summit on "China's 11th Five-Year Plan and the Outlook for HK" • 2006-07, 2007-08 Policy Address
Professional services, Information & Technology, and Tourism	<ul style="list-style-type: none"> • Cosmopolitan city for services • Headquarters economy • Knowledge-based economy 	<ul style="list-style-type: none"> • Legal & accounting • Commercial banking • Research & development • Telecommunications • Convention & exhibition • Broadcast, film, and interactive media • Sports 	<ul style="list-style-type: none"> • Economic summit on "China's 11th Five-Year Plan and the Outlook for HK" • 2006-07 Policy Address • 2007-08, 2008-09 Budget • Bauhinia Industry Level Competitiveness Study • Bauhinia Report on China's 11th Five-Year Plan: Opportunities & Challenges for HK • Business sector interviews conducted for Bauhinia's Study on the Competitiveness of HK's Tax System

Recommendations on Fundamental Issues

Overview

The Study Group has the following recommendations on fundamental issues to HK's tax policy:-

Tax Policy Unit and approach to maintaining competitiveness

- The Study Group recommends the establishment of a new specialist Tax Policy Unit within the Financial Services and the Treasury Bureau ("FSTB"), adopting a three-pronged approach to monitor 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.

A new value proposition

- HK's fiscal policy should adopt a new value proposition based on competitiveness as the key underlying principle and striking a balance between the principles of "certainty", "efficiency and effectiveness" and "low rate".

Comparative advantages to be retained

- There are a number of comparative advantages of the existing tax system which should be retained. These are:-
 - Limited number of taxes
 - Source concept of taxation (i.e. exemption of non-HK sourced profits)
 - Exemption of profits from the sale of capital assets
 - Exemption of dividend income
 - To base. Relatively low headline tax rates
 - No tax on death transfers

Use of tax incentives

- Notwithstanding the possibility of mobile business activities being attracted by tax incentives, we recommend HK for the time being to focus on providing an across-the-board favourable tax environment for all businesses and not be distracted by calls for sector/industry specific tax incentives.

Broadening the tax base

- As a community, HK must continue to study and debate options for broadening the tax base.

Details on these recommendations are set out in the following pages.

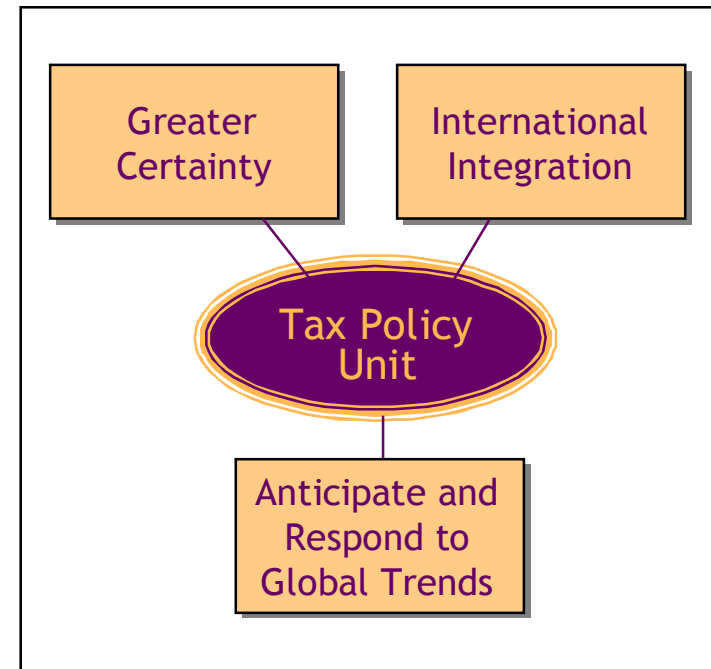
Tax Policy Unit and Approach to Maintaining Competitiveness

Overview of recommendation

- We recommend the establishment of a new specialist Tax Policy Unit within the Financial Secretary 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.

Tax Policy Unit

- Tax policy setting is an iterative process and is fundamental to the competitiveness of a tax system. Under the Principal Officials Accountability System, tax policy setting in HK is the responsibility of the Financial Secretary (“FS”) as assisted by the Secretary for Financial Services and the Treasury (“SFST”). The bureau providing research and tax policy formulation support is the FSTB, while the Central Policy Unit also provides research support to the FS.
- Given the increasing complexity of tax issues and the importance of tax policy to the overall competitiveness of HK, we recommend the setting up of a full-time Tax Policy Unit within FSTB.
- 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 providing policy formulation support to the SFST and FS.
- 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 the business and professional sectors.



Tax Policy Unit and Approach to Maintaining Competitiveness (cont'd)

- Since one key role of the unit is to actively solicit views from the business and professional sectors, we recommend the Financial Secretary to appoint and chair a standing advisory committee to advise the unit, and invite people with the relevant expertise and interests to serve on the committees.

Three-pronged approach to maintaining competitiveness

- *Providing greater certainty*

A key aspect to competitiveness of a tax system is certainty. In business surveys conducted around the world, clarity of the tax law and administrative certainty are often ranked as key factors by investors.

- *Effecting better international integration*

As an international business centre, HK is integrated with the rest of the world in terms of trade and investment. To enhance its competitiveness, it is important for HK's tax system to reflect this international integration.

- *Anticipating and responding to global trends*

Competitiveness is a relative concept; therefore, being able to anticipate and respond to global trends and actions of competitor jurisdictions is a key element to maintaining competitiveness.

Each of our detailed tax recommendations falls under one or more aspects of the three-pronged approach.

Underlying Principle to Fiscal Policy

Traditional approach

- HK Government's traditional approach to fiscal policy is to keep HK's tax system simple and with low rates of taxation. This underlying principle to HK's fiscal policy has been reiterated in various senior government officials' public speeches and official documents. For example, in the Information Pack for the Financial Secretary's Consultations for the 2008/09 Budget, it is stated that "we also adhere to a low and simple tax regime"

Basic Law provisions

- The Basic Law provisions governing HK's fiscal policy:-

Article 107

"The HK Special Administrative Region shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product."

Article 108

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

- Simplicity is not mentioned in the above provisions.

Is simplicity always appropriate?

- 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

Underlying Principle to Fiscal Policy (cont'd)

- 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 clearly simplicity per se should be sacrificed, for example:
 - in favour of competition, be it making HK businesses more competitive or at least not at a disadvantage relative to their global competitors
 - in order to attract and retain capital and talent
 - to provide clarity in tax laws and certainty in the practical application of the laws
 - to promote the macro-economic goals envisioned for HK
- In other words, upholding simplicity of the tax system should not be the excuse for not introducing necessary changes.

Recommendation

- HK's fiscal policy should adopt a new value proposition based on competitiveness as the key underlying principle, and striking a balance amongst the following principles:

Certainty	it should be transparent and predictable, providing certainty to taxpayers so that they are able to reliably anticipate the tax consequences of transactions
Efficiency and effectiveness	it should minimise compliance costs for businesses and administrative costs for the Government
Low rate	it is crucial to retain our low rate tax regime which is well recognised as one of the key competitive features of HK (and attention should be paid to both the statutory and the effective tax rates)

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

- HK has a low number of taxes relative to its competitor jurisdictions. This is an advantage which should be retained as a limited number of taxes generally means that the total tax cost for businesses is low. Furthermore, fewer taxes should result in lower compliance costs for businesses and lower administration costs for the government.

Source concept

- The source concept whereby tax is levied on a territorial basis is seen as a key attraction of HK's tax system. Despite the practical confusion that can be caused by the classification of income as HK or non-HK sourced, there is a strong consensus for the source concept to be retained.

Exemption of profits from sale of capital assets

- The non-taxation of profits from the sale of capital assets is seen as an advantage of the HK tax system vis-à-vis its competitor jurisdictions. It encourages investments in capital assets and provides more flexibility to businesses. Moreover, there is a growing international trend to reduce taxation of capital assets.

Exemption of dividend income

- Exemption of dividend income is key to the promotion of HK as an investment holding location and should be retained in HK's tax system.

Relatively low headline tax rates

- The headline or statutory corporate tax rate is the most high-profile comparator from the corporate tax perspective. International comparisons of competitiveness of tax systems often focus just on this tax rate. Therefore, the existing low tax policy should continue as a key principle of HK's fiscal policy.

No tax on death transfers

- The abolition of Estate Duty has enhanced HK's position as a wealth management centre. The global trend is moving towards abolition of estate duty or similar forms of taxation. Therefore, HK should retain the policy of not imposing tax on death transfers.

Use of Tax Incentives

Traditional approach

- The HK Government's traditional approach to fiscal policy is to keep HK's tax system simple and the tax rates low, benefiting all industries equally. As such, there are generally no tax incentives offered in HK, other than limited specific exemptions (e.g. exemption of income and gains from specified investment schemes, and exemption pursuant to the *Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006*).

Arguments for and against the use of tax incentives

- The 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.
- Most of the arguments made in favour of the use of tax incentives fall within two categories: first, it is argued that tax incentives will increase the total flow of new investments; that is, investments will be made where they would not be made in the absence of incentives. Second, it is argued that tax incentives can affect the spatial distribution of investments; that is if governments of alternative locations for foreign investments offer tax incentives, then the Government eager to attract the investments must match these incentives or face the prospect of losing the investments to the competing jurisdictions.
- The arguments made against the use of tax incentives can also be summarised into two categories. The first is that tax incentives have little, if any, effect on the total foreign investment that is made worldwide, and thus in aggregate, incentives only create a net transfer from taxpayers to investors. The second argument is that even if the first argument does not fully stand up (i.e. tax incentives do increase the total investment worldwide), the cost to the public of incentives exceeds the additional benefits that are created by the investment that would otherwise not occur.
- Over the years, a number of studies and research projects on the effect of tax incentives have been conducted by academics and international organisations. While recent research is inconclusive on the effectiveness of tax incentives, it can be seen on balance as cautionary over the introduction of special tax incentives. When faced with calls for the introduction of tax incentives, policy makers are advised to first consider what are the impediments inhibiting investments, and then to question whether these should be tackled through the tax system, or through structural policy changes in other areas. Often a preferred approach would be to address non-tax policy related impediments prior to, or at a minimum, parallel with, the introduction of tax incentives. Further, where tax is identified as a significant factor influencing investments, transparency, clarity, stability and certainty in the application of tax laws and in tax administration are often ranked by investors ahead of special tax incentives.
- Recent research is also on balance more in favour of a reduction in the statutory corporate income tax rate. It is recognised that this simpler approach benefits both existing and new investments. However, it avoids the pitfalls associated with tax incentives. The pitfalls basically involve the use of techniques to shift non-qualifying income to the targeted regime; and as such, incentive regimes generally impose a significant administrative burden.

Use of Tax Incentives (cont'd)

- Another potential problem relates to the difficulty in performing a cost/benefit analysis of a tax incentive. An estimate of the cost of a tax incentive should begin with an estimate of the redundancy rate – being the percentage of investors receiving tax benefits who would have come (or would have remained) even if they had not been granted incentives. If tax incentives are given only to investors who would not otherwise have come (or who would have left), and are exactly the amount required to attract (or retain) them, then there is no revenue loss from the tax incentive. On the other hand, if a tax incentive is granted to investors who would have come (or who would have remained) anyway, there is redundancy and the foregone revenue from those redundant incentives represents a cost to the treasury. That cost is equivalent to a subsidy to attract the incremental investors. There is an additional source of redundancy if the tax incentive granted to investors whose decisions are influenced by them exceeds the amount required to attract them. In practice, determining the redundancy rate and calculating the costs are not easy.

Recommendation

- In general, we recommend caution in the use of industry specific tax incentives, which could be perceived as inequitable, opening a floodgate for different industries to clamour for special tax treatments.
- The use of tax incentives to promote specific industries would amount to “Government leads, Market follows”, in direct contrast to the current philosophy of “Market leads, Government facilitates”. In any case, given HK’s current political structure and the time required to enact legislative changes, it is doubtful that HK has the necessary administrative infrastructure to direct market changes.
- 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 environments, rather than being distracted by calls for sector/industry specific tax incentives where the cost/benefit is unclear.

Broadening the Tax Base

Issue

- In the long run, HK needs to broaden its tax base.

Discussion

- There is a general consensus that HK has a narrow tax base. For the year of assessment 2007/08, of the estimated total working population of 3.5 million people, only 1.3 million (i.e. 37%) have to pay Salaries Tax. The top 100,000 taxpayers are expected to contribute to almost 62% of the total revenue from Salaries Tax. With an ageing population, the Salaries Tax base is expected to continue to narrow. On Profits Tax, about 65% of the total revenue is contributed by the top 800 taxpaying corporations out of more than 70,000 taxpaying corporations.
- HK's government revenue is particularly reliant on income taxes and revenues from land sales and investment earnings. Since income from these sources is very volatile and fluctuates with economic conditions, HK's public finances are unstable. For example, the revised estimate of the 2007/08 fiscal surplus being 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 HK Government could face large fiscal deficits when HK next faces a downturn in its economic cycle. Furthermore, as long as HK continues with its current revenue base, the Government may never be in a position to accurately forecast its budgetary position.
- In recent years, there is a clear tendency among economies in competition with HK, 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.
- During an economic upturn when the Government has significant fiscal surpluses, it may be easy to forget the underlying structural problem with the tax base. But in the long run, this is an issue that must be resolved.

Recommendation

- 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.
- In the long run, a broadened tax base should produce more reliable and stable revenue sources for the Government. Further, it will give HK more flexibility to make changes to its tax system in response to global competition.

Detailed Recommendations

Overview

Twelve detailed recommendations

- Adopting a three-pronged approach to reviewing the competitiveness of HK's tax system, the Study Group has the following twelve recommendations:-

Providing greater certainty

- *Source concept for Profits Tax*

There is an urgent need to provide greater certainty in the practical application of the source concept for Profits Tax.

- *Source of employment income*

The law needs to be amended to provide for the source of employment to be determined based on the location of where services are performed.

- *Shortening time-bar provisions*

The time-bar provisions should be shortened by reducing the period for issuing original or additional tax assessments from six to four years.

- *Participation exemption*

HK should introduce a participation exemption regime to exempt from tax profits from disposals of certain share investments.

- *Improving guidance and certainty to taxpayers*

The Inland Revenue Department ("IRD") should publish more advance rulings of general interest and provide more timely guidance on ad-hoc technical issues. There is a need to review the composition of the Board of Review ("BOR").

Effecting better international integration

- *Double tax treaty ("DTA") network*

HK should continue to build a comprehensive double tax treaty network and to amend the law to enable compliance with the necessary exchange of information ("EoI") provisions of double tax agreements.

- *Transfer pricing*

Adopt conventional transfer pricing provisions that are consistent with the approach of HK's major trading partners.

- *Implications of international accounting standards*

Implement a systematic and timely review mechanism of the tax implications of each provision under the International Financial Reporting Standard ("IFRS") being incorporated into HK's financial reporting standards.

Detailed Recommendations

Overview (cont'd)

Anticipating and responding to global trends

- *Corporate tax rate*
Reduce Profits Tax rate to 15% and introduce a lower rate for businesses with assessable profits of less than \$1 million.
- *Tax loss relief*
Introduce group loss relief and tax loss carry-back provisions.
- *Stamp duty exemption for unquoted shares and instruments*
Abolish the stamp duty on transfers of unquoted shares and instruments.
- *Tax deductions*
Improve tax deductions on expenditures for i) intellectual property (“IP”), ii) research & development (“R&D”), and iii) manufacturing plant and machinery.

Matching recommendations with macro-economic goals

- The table on the following pages matches the twelve detailed recommendations with the macro-economic goals envisioned for HK.
- All twelve recommendations should improve HK’s general business environment and in this respect should assist in the promotion of all of the macro-economic goals. A tick mark is used to indicate those goals which would benefit from the adoption of the recommendation to a greater extent than the other goals. For example, for “source concept for Profits Tax”, a tick mark is placed under the following goals:-
 - Sourcing Centre
 - Centre for Chinese Entrepreneurs
 - Wealth Management Centre
 - Asset Management Centre
 - Preferred Initial Public Offering (“IPO”) Platform
 - Gateway for Mainland Outbound Capital
 - International Financial Intermediation Platform for Mainland
 - Headquarters Economy
 - Knowledge Based Economy

Detailed Recommendations

Overview (cont'd)

- We believe that uncertainties currently exist in the application of the source concept to those activities that are particularly relevant to the nine goals listed above. However, providing greater certainty in the application of the source concept should also benefit the other five goals envisioned for HK.

Priority

- We have prioritised our recommendations according to the order in which we consider they should be tackled. “Short” means actions should be taken immediately in respect of the recommendation. “Medium” means the recommendation can be tackled at a later stage if there are resource constraints in working on all recommendations at the same time. “Ongoing” means the recommendation requires ongoing work. Our recommendations have been classified as follows:-

“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

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

“Ongoing” – requires ongoing attention

- Guidance to taxpayers
- Double tax treaty (“DTA”) network
- Implications of international accounting standards

- Details of each of the twelve recommendations are set out in this section.

Detailed Recommendations

Matching Detailed Recommendations to 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 (“DTA”) 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	✓	✓	✓	✓			

Detailed Recommendations

Matching Detailed Recommendations to Macro-Economic Goals (cont'd)

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 ("DTA") 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					✓	✓	✓	✓

The Need for Certainty in the Application of the Source Concept

Issue

- There is a need to provide greater certainty in the application of the source concept for Profits Tax.

Discussion

- HK Profits Tax operates a source concept so that only profits that are sourced from HK are subject to tax. Specifically, Section 14 of the Inland Revenue Ordinance (“IRO”) provides that only profits arising in or derived from HK, from a trade, business or profession carried on in HK, are liable to Profits Tax.
- The interpretation of Section 14 has developed over the years by a series of court decisions – the more significant of which includes the Privy Council decisions in Hang Seng Bank, HK-TVB International and Orion Caribbean, the Court of Final Appeal and Court of Appeal decisions in Kwong Mile and Magna Industrial, and the most recent Court of Final Appeal decision in ING Baring Securities. Further, as guidance for taxpayers and tax representatives, the Inland Revenue Department (“IRD”) has published a Departmental Interpretation and Practice Note No. 21 entitled “Locality of Profits” “DIPN No.21” (first published in 1992, revised in 1996 and 1998).
- Although the law to determine the source of profits is clear, its practical application can be confusing and has created a level of uncertainty that is harming HK’s competitiveness. In an environment where HK’s competitor jurisdictions are proactively making use of their tax systems to attract internationally mobile capital, HK cannot afford to allow for significant uncertainties to exist over the practical application of its tax system. A more certain approach is needed to retain the attraction of a source-based taxation system and to retain and attract businesses in and to HK. The need is all the more urgent given the increasing trend globally of reducing headline corporate tax rates, taking away HK’s distinctiveness of a relatively low tax rate.
- The following are examples of areas where the application of the source concept is causing confusion.
 - i) Taxation of trading profits*
 - In practice, the principal determining factor adopted by the IRD has been taken as the place where the trading contracts (i.e. the purchase and sale contracts) are effected. Where both trading contracts are effected in HK, the profits would be fully taxable. Where both of these contracts are effected outside HK, no part of the profits would be taxable. However, if either contract is effected in HK, the whole profits would usually be treated as taxable.
 - Following certain court decisions on the source of profits, the IRD’s recent practice has moved away from simply examining the location where the purchase and sale contracts are effected, to a “totality of facts” approach in determining the source of trading profits.

The Need for Certainty in the Application of the Source Concept (cont'd)

- However, the “totality of facts” approach has been ruled as incorrect in the latest Court of Final Appeal decision in the ING Baring Securities case (see further comments below).
- Uncertainties arise when ancillary administration functions that are not central to the profit making process are used to justify treating the whole of the trading profits as HK sourced. For example, keeping books of accounts in HK, arranging letters of credit and operating a bank account are arguably activities that are ancillary in nature. Moreover, this approach could blur the line between carrying on a trade or business in HK and deriving HK sourced profits from that trade or business.

ii) Re invoicing

- For many years, it has been an accepted practice that where a HK company, as a member of a group and pursuant to group directives, carries out restricted administrative activities (which do not include the acceptance or issue of sale or purchase orders in or from HK) relating to trading transactions and “books” the profits in HK, the profits would not be taxable. Such arrangements are commonly referred to as “re invoicing”
- However, uncertainty has arisen as to whether the “re invoicing” offshore claim is still available as the Inland Revenue Department (“IRD”) has begun to challenge these claims. The IRD has indicated that the spread derived by a re invoicing company could be chargeable to Profits Tax on the basis that it is derived from services rendered in HK.

iii) Role of agent or subcontractor

- As a result of case law developments, there is now considerable uncertainty regarding the relevance of activities undertaken by persons other than the taxpayer (e.g. by an agent or a subcontractor). The question is whether in determining the source of profits, activities of an agent or subcontractor should be attributable to the taxpayer and hence the locations where these activities are carried out would be relevant in determining the source of profits of the taxpayer.

iv) Financial instruments

- More taxpayers are using an ever increasing number of financial instruments as part of their trading operations. Some of these financial instruments are issued by and traded with traditional banking institutions, whilst others are transacted between non-financial institutions. The types of financial instruments being used include credit linked notes; foreign exchange swaps; equity linked notes; and interest rate swaps. Taxpayers are also investing in more complex financial assets such as convertible corporate bonds and debentures, collateralised debt obligations, and other asset backed securities.
- The application of the traditional sourcing rules on these financial instruments remains unclear. For example, it remains far from clear whether these instruments should be taxed based on their legal form or their economic substance (in line with the accounting treatment), and how the source of the profits should be determined. Although the IRD has attempted to provide some clarity on this issue in Departmental Interpretation and Practice Notes (“DIPN”) No. 42, further detailed guidance is required on the various specific instruments being used by taxpayers so as to provide further clarity on the application of the source rules to taxpayers.

The Need for Certainty in the Application of the Source Concept (cont'd)

There are also areas where the Inland Revenue Department's ("IRD") practical application of the source concept are regarded as debatable, for example:-

i) Taxation of manufacturing profits

- The IRD accepts that where a HK company manufactures goods partly in HK and partly outside HK (the vast majority being in the Mainland), the part of the profits which relates to the manufacture of the goods in the Mainland will not be regarded as arising in HK. In the interest of administrative convenience and to avoid protracted arguments on the basis of apportionment, the IRD adopts an automatic 50:50 approach in apportioning these profits.
- As a matter of practice, the IRD will only accept a 50:50 apportionment for "contract processing" cases and will not agree to any apportionment for "import processing" cases despite the fact that the substance of the arrangements is very similar.
- Under contract processing, legal title of the imported raw materials remains with the HK company while the People's Republic of China ("PRC") factory charges a processing fee for the processing services. In import processing arrangements, legal title of the imported raw materials is transferred from the HK company to the PRC factory and the legal documents indicate a sale of the raw materials. On completion of processing, the PRC factory will sell the finished goods back to the HK company.
- The IRD regards the HK company in an import processing case as a trader and not a manufacturer, and hence in determining the source of its profits no account can be taken of the manufacturing activities done in the PRC by the PRC factory. However, in reality, even though the transaction is documented as a buy-sell to satisfy PRC regulatory requirements, the HK company is usually just as involved in the manufacturing process as it would be in a contract processing arrangement. Taking into account the substance of the arrangement, for many years, taxpayers and practitioners have been calling for the IRD to extend the 50:50 apportionment treatment to import processing. Since more and more manufacturing arrangements are moving away from contract processing to import processing, less manufacturing offshore claims are being approved by the IRD.

ii) Taxation of royalty income

- It is the IRD's stated view that the source of royalty income should be determined on the same basis as trading profits. The logic behind this view is difficult to understand as royalty income does not arise from purchases and sales. Rather, the royalty income arises from the acquisition or self-creation of intellectual property ("IP") rights and the subsequent exploitation of those rights through licensing. Under the current practice, it would be difficult for a HK based company to lodge a successful offshore claim on royalty income even if the royalty rights are being exploited outside HK. This does not seem to be in line with HK's macro-economic goals of "Brand HK", "Headquarters economy" or "Knowledge-based economy". To encourage the use of HK for IP development and ownership, it would seem more logical to determine the source of royalty income based on the location of use.

The Need for Certainty in the Application of the Source Concept (cont'd)

iii) Apportionment of profits

- Uncertainty continues to surround the extent to which profits can be apportioned to recognise that they have been derived from activities in HK as well as outside of HK.
- The Inland Revenue Department (“IRD”) has stated in Departmental Interpretation and Practice Notes (“DIPN”) No. 21 that profits are generally taxed on an all-or-nothing basis, except for manufacturing and service income and commission income where the relevant profit generating activities took place both in and outside HK. In practice, the IRD clearly prefers the “all-or-nothing approach”. Such an approach discourages mobile businesses from locating their functions in HK for fear that this could make them liable to Profits Tax on a larger portion of the profits than what is in fact attributable to their HK activities.

Guiding principle re-affirmed by Court of Final Appeal

- The decision of the Court of Final Appeal in the case of ING Baring Securities (Hong Kong) Ltd v. Commissioner of Inland Revenue has set out in clear terms the correct approach in the determination of the source of profits. It has held that the “totality of facts” approach, as adopted by the IRD and reflected in the current version of DIPN No. 21, is incorrect as it fails to focus only on those activities which are truly proximate to the creation of profits. The antecedent or incidental activities of a company, which would be examined under the IRD’s “totality of facts” approach, may be commercially essential to the business operations but they are legally irrelevant for the determination of the source of profits.
- The Court of Final Appeal in this case has also ruled as incorrect the use of a “brain” analogy or the place of administration of the business as a criterion for ascertaining the geographical source of profits. This is a clear reiteration of the fundamental principle that the tests of carrying on a business in HK and the determination of the source of profits are two separate and distinct tests to be ascertained independently.
- Just because a business is carried on in HK does not necessarily mean that all profits of that business are derived from HK. The correct approach is to identify the location where the relevant activities giving rise to the profits have been carried out and such an exercise should not be contaminated by the existence of significant presence in HK.
- Given that important parts of the IRD’s DIPN No. 21 and its approach in practice have been ruled as incorrect in the ING Baring Securities case, it is essential for DIPN No. 21 to be revised and for the IRD to apply the law in practice to reflect the decision of this case. Any delay in action would add to confusion on the practical application of the key concept of source in HK’s tax system.

The Need for Certainty in the Application of the Source Concept (cont'd)

Desired attributes of revenue bodies

- Providing greater certainty on a key concept for HK Profits Tax is consistent with what is generally regarded as desired attributes of revenue bodies.
- In the Organisation for Economic Cooperation and Development *Study into the Role of Tax Intermediaries* (OECD 2008), the OECD Study Team consulted business and tax intermediary representatives for their views on the desired attributes of revenue bodies. The consistent response was that taxpayers (in particular large corporate taxpayers) want early certainty and a “problem-solving attitude” and that the following attributes contribute directly to achieving this:-

Understanding based on commercial awareness

Without an understanding of the commercial drivers, there is the potential for revenue bodies to misunderstand the broader context of an activity or transaction and to respond in a way that results in potentially costly disputes and uncertainty

Impartiality

Revenue bodies need to bring a high level of consistency and objectivity to issue resolution. This is principally a matter of the overall approach taken by revenue bodies in the issue-resolution process which should be consistent and focused on the right amount of tax, not maximising the amount of tax receipts.

Proportionality

Revenue bodies' dealings with taxpayers generally and tax audits in particular need to be reasonable, balanced and proportionate. Proportionality is about the choices revenue bodies make in allocating resources, deciding which taxpayers, which tax returns and which tax issues to prioritise and how to respond appropriately.

Openness and transparency

Taxpayers will want to see openness and transparency from revenue bodies. The extent of this is a matter for each country to decide at both a conceptual level and on a case-by-case basis.

Responsiveness

Taxpayers should receive prompt, efficient and professional responses when they make requests of revenue bodies. They can also expect a fair and efficient decision-making process and definitive resolution of issues.

- These attributes are linked to what is described as an “enhanced relationship”, where taxpayers engage in a relationship with revenue bodies based on co-operation and trust, with both parties going beyond their statutory obligations. In HK, greater certainty on the practical application of the source concept should go a long way towards an “enhanced relationship”.

The Need for Certainty in the Application of the Source Concept (cont'd)

Recommendation

- The source concept of taxation is a key advantage of HK's tax system which must be retained.
- The increasing uncertainty in the application of the source concept is harming HK's competitiveness; therefore restoring certainty must be a policy priority. We cannot afford further delay as the longer we wait, the more businesses will decide not to come to HK or even to leave HK. Once they have chosen another location, it would be difficult to convince them to uproot and return to HK.
- Amending Departmental Interpretation and Practice Notes ("DIPN") No. 21 is preferred over a legislative approach as i) the legislative process takes too long and ii) it is impossible to legislate to cover all possible business scenarios.
- Since laying down guidelines on the application of the source concept is fundamental to HK's tax policy, the amendment of DIPN No. 21 should be led by the Tax Policy Unit within Financial Secretary and the Treasury Bureau ("FSTB"), in full consultation with the business and professional sectors. Amending DIPN No. 21 is imperative given that key parts have been ruled as incorrect by the highest legal authority in HK.
- Once the practice note has been amended and issued, it should be binding on the Inland Revenue Department ("IRD") with changes only applying prospectively not retrospectively, and with the approval of the Tax Policy Unit.

Revenue implication

- Providing greater certainty in the application of the source concept should not in itself give rise to revenue implications. However, since certainty is a key aspect to the competitiveness of a tax system, improvement in this respect should retain and attract more businesses to HK and hence should result in positive revenue implications in the long run.

The Need for Certainty in the Determination of Source of Employment Income

Issue

- There is a need to provide greater certainty in the determination of the source of employment income under HK Salaries Tax.

Discussion

- HK Salaries Tax adopts a territorial concept whereby income arising in or derived from HK is subject to tax, and conversely, income that is not regarded as arising in or derived from HK falls outside the scope of tax. Although in theory, this concept should result in a simple basis of taxation, in practice this has not happened. The main problem arises from using the location of employment to determine the source of employment income. This was the principle established in The High Court decision in *Commissioner of Inland Revenue v George Andrew Goepfert, 2 HKTC 210*, which held that employment income arises where the employment relationship is located and not necessarily where the services are performed. Determining the location of employment has proved difficult in practice as it cannot be done based purely on objective tests.
- In recent years, uncertainties and protracted disputes between taxpayers and the Inland Revenue Department (“IRD”) have increased to the extent that the advantage HK has in terms of its relatively low rate of tax is being eroded due to the frustration at the lack of certainty in respect of how employment income will actually be taxed. Left unresolved, this situation would be harmful to HK’s competitive position. To remain an international business and financial centre, it is essential for HK to be an attractive base for mobile executives who have responsibilities across a number of jurisdictions and who are required to travel frequently. However, the current state of affairs often results in these executives being uncertain of their Salaries Tax positions.
- Using the “location of employment” to determine the source of income is always likely to be problematic. If an objective test is adopted to determine the location of employment, taxpayers can easily exploit the rules; for example a multinational group can easily arrange any group company in the world to act as the employer, the contract can be negotiated and signed outside HK and the payment of remuneration can also be arranged offshore. On the other hand, if a subjective test is adopted (e.g. using a “totality of facts” approach), taxpayers are left with no certainty.
- Despite the practical problems in applying the principle of determining the source of employment income based on the “location of employment”, it is difficult if not impossible to abandon this principle without a legislative change given that this principle was laid down by precedent case law. Therefore, the only solution available appears to be a change in the law so that the source of employment can be determined based on a clear and objective factor.
- The Joint Liaison Committee on Taxation (“JLCT”) has recently recommended an amendment to the law to provide for the source of employment income to be determined based on the location of services. For administrative convenience, the JLCT recommended a defined time threshold which would exempt from tax those individuals who perform services under employment in HK for less than a specified period during the year of assessment. Currently, a similar rule exists whereby no Salaries Tax is payable by an employee who renders services in HK during visits not exceeding 60 days. Similarly, the JLCT recommended a time threshold (e.g. 60 whole days during the year of assessment) for the lodging of time-apportionment claims to prevent claims from employees who work in HK most of the time or from employees who spend part of a day across the border in China or in Macau.

The Need for Certainty in the Determination of Source of Employment Income (cont'd)

Recommendation

- We support Joint Liaison Committee on Taxation's ("JLCT") recommendation to amend the law to provide for the source of employment income to be determined based on the location of services. This approach i) would preserve the source concept of taxation and would provide a clear basis for determining the source of income ii) is consistent with the international norm which generally regards employment income as arising where the employee's services are rendered iii) is consistent with the general principle of determining the source of profits under Profits Tax (the broad guiding principle being one looks to see what the taxpayer has done to earn the profits in question and where he has done it).
- We also agree with JLCT's recommendation to retain the "60-day" exemption rule and to introduce a time threshold to prevent non-taxable claims from incidental overseas travel. For administrative convenience and protection of revenue, it may also be worth considering putting a further limit to time apportionment claims based on the number of years in which the claim may be lodged. Reference can be made to Singapore's "Not Ordinarily Resident" scheme under which an individual fulfilling certain conditions can lodge a time apportionment claim for up to five consecutive years of assessment. For example, a limit of seven years can be considered for HK to tie the claim to the time of residency required to apply for permanent residence status.
- Imposing a *de minimis* time threshold and a limit on the number of years in which a time claim can be lodged would mean moving away from a pure "location of service" test. Nevertheless, given the importance of avoiding a significant revenue cost and for the sake of administrative convenience, it would be appropriate to consider adding conditions to a time claim. The exact rules should be determined based on estimates of revenue implications.

Revenue implication

- Changing the basis for the determination of the source of employment income would affect the revenue take, the extent of which would depend on the detailed administrative limits to be introduced (i.e. the *de minimis* time threshold and limit on the number of years in which a time claim can be lodged) and the travel pattern of the HK working population.
- In the long run, providing certainty in the taxation of employment income should attract and retain mobile executives in HK with positive implications for government revenue.

Time-bar Provisions

Issue

- HK could improve its level of certainty for taxpayers by shortening the period within which tax affairs are finalised.

Discussion

- Section 60 of the Inland Revenue Ordinance (“IRO”) currently allows an assessor to raise an original or additional assessment at any time within six years from the end of the year of assessment. In the case of fraud or wilful evasion, the time limit is extended to ten years. If no tax is assessed because a tax loss is sustained, the agreement of the tax loss will effectively be kept open until six years after it has been set off against assessable profits. In practice, this means that the tax loss for a year may not be agreed for a period of much longer than six years. This could create a tremendous burden on businesses with changes in personnel and the need to retrieve old records, some of which might not have been retained as they might be more than seven years old (i.e. beyond the statutory requirement for the retention of accounting records).
- In recent years, the Inland Revenue Department (“IRD”) has adopted a tax assessment practice known as “Assess First Audit Later”. Under this approach, an assessor will issue an assessment or a loss statement in accordance with the return submitted by the taxpayer without undertaking any review. The IRD then reserves the right to review the case at any time up to the time-bar period. The IRD also has the right to issue protective assessments just before the expiry of the time-bar period, effectively extending the time for detailed enquiries to be made into potential contentious issues. This means that in practice, tax affairs of a year of assessment might not be agreed for much longer than six years after the end of the year of assessment.
- On the international level, there is a growing trend to shorten the time period for finalization of tax affairs. For example, Singapore has recently shortened its time-bar period from six to four years. The table below sets out the time period for finalization of tax affairs in a selection of major developed economies:-

Detailed Recommendation

Time-bar Provisions (cont' d)

Statute of limitations	
Australia	Generally speaking, corporate tax returns are subject to a limited review period of 4 years from the date of assessment (including in the case where there is no taxable income or tax payable) for the relevant year of income. An unlimited review period applies in the case of fraud or evasion, and other specific transactions listed in the Tax Act (e.g. adjustments relating to transfer pricing etc).
Canada	A 4 year limit applies to companies that are not Canadian Controlled Private Corporations as defined (3 years in such case). An extension to 7 years applies most commonly to transactions with non-arm's length non-residents and can be affected by treaties. There is no time limit in case of fraud or negligence.
France	The time limit for assessments of corporate income tax expires at the end of the third calendar year following that for which the tax is due. When tax fraud is proven, the time limit is increased by 2 years.
Germany	The regular period for the statute of limitations is 4 years. The period is extended to 5 years for negligent tax fraud and to 10 years for wilful tax fraud.
Japan	The basic statute of limitations is as follows: <ul style="list-style-type: none"> - 5 years from the day after filing due date: in case of underreported tax; - 7 years from the day after filing due date: in case of tax evasion; - 7 years from the day after filing due date: in case of adjustment of tax losses; and - 6 years for transfer pricing purposes.
Korea (ROC)	The statute of limitations is 5 years.
Malaysia	The statute of limitations is generally 6 years from the end of the year of assessment. But no time limit exists where there is fraud or wilful default.
Netherlands	The statute of limitations for making an assessment is 3 years from the end of the fiscal year, extended by the granted extension for filing the tax return. The tax authorities can issue an additional assessment within a period of 5 years, starting from the end of the fiscal year (extended by the granted extension for filing the tax return) if new information obtained proves that the initial assessment was made in an amount lower than the actual tax liability. With respect to foreign-source income, the period for making an additional assessment is 12 years.
New Zealand	The period within which amended assessments may be issued is limited to 4 years from the end of the year in which the return was provided, but this limitation is not applicable where the return is fraudulent, wilfully misleading or omits gross income of a particular nature or from a particular source.
Singapore	Assessments and additional assessments may be made within 6 years (if the year of assessment is 2007 or earlier) or 4 years (if the year of assessment is 2008 or a later year). No time limit exists if there is fraud or wilful default.
Taiwan	Five years after the tax return has been accepted as final. The period is extended to 7 years after the due date of the return where the return has not been filed or taxation has been evaded due to fraud.
Thailand	The tax authorities can undertake a tax examination within 2 years following the date a tax return was filed. The tax authorities can issue an assessment within 10 years where it believes a company has evaded tax.
United Kingdom	General rule - if no enquiry is opened then the period is deemed to be agreed 2 years from the end of the accounting period. However, if the tax return is submitted on time, the tax authorities have 1 year from the due date of submission to enquire into the return. In case the tax authorities become aware of something they should have been made aware of, the limit within which the tax authorities may issue an assessment for a particular period is 6 years after the end of that period. Where a company acting on its behalf is guilty of fraudulent or negligent conduct an assessment may be made at any time not later than 20 years after the end of the accounting period to which the assessment relates.
United States	Generally, 3 years from the date of the tax return, or the date of filing, whichever is the later. There are a number of circumstances that could extend the statute of limitations to more than 3 years.

Time-bar Provisions (cont'd)

- In business time is of the essence. It is a disadvantage to businesses to have to operate for long without agreement with the tax authorities on the tax consequences of their transactions. Therefore, the timeframe within which tax affairs can be finalized is a key aspect of certainty. Certainty in tax matters has become even more important given the increasing need to account for and disclose tax uncertainties in audited financial statements.

Recommendation

- Some jurisdictions already offer a more favorable (i.e. shorter) timeframe for finalization of tax affairs. In the context of enhancing the competitiveness of HK's tax system for businesses, there is a case for shortening the time-bar period, especially for taxpayers who submit their tax returns on a timely basis. Taking into account the practice adopted by HK's competitor jurisdictions, it is proposed that:-
 - i) The Inland Revenue Department ("IRD") sets a performance pledge to review all tax returns within one year from the date when the tax return is submitted. If the IRD has not begun any enquiries by the end of one year, the return will become final unless:
 - the IRD discovers an error of which they could not reasonably have been expected to be aware from the information provided in, or with, the tax return; or
 - The tax return was incorrect because of fraud or wilful evasion;
 - ii) The period for issuing original or additional tax assessments be reduced by one third from six to four years, but the ten year period in cases of fraud or wilful evasion be retained;
 - iii) Tax losses be accorded the same timeframe as assessable profits so that no challenge can be raised regarding eligibility of tax losses to be set-off against assessable profits beyond the same timeframe allowed for raising tax assessments;
 - iv) The same shortened timeframe be adopted for re-opening tax affairs for errors or omission claims under Section 70A.

Revenue implication

- Shortening the time-bar period should be revenue neutral. However, the proposed changes would have resource implications for the IRD, including on the workload of the field audit and investigation unit.

Detailed Recommendation

Participation Exemption

Issue

- In addition to an expanded tax treaty network, HK's competitive position as an investment holding location can be enhanced with the introduction of some form of participation exemption.

Discussion

- HK's macro-economic goals include the development of a headquarter economy, a centre for Chinese entrepreneurs, a wealth and asset management centre, and a gateway for the Mainland's outbound capital. In support of these goals, it is important for HK to provide a favourable environment for investment holding.
- HK is positioned as a natural gateway to Mainland China, with its geographic proximity and sophisticated business, financial and legal systems. The HK / Mainland double tax treaty ("DTA") signed in 2006 includes favourable provisions for the elimination of double taxation which are comparable to many other jurisdictions. Outlined on the right is a comparison of the DTA benefits of investing into the Mainland through various holding jurisdictions.

	Barbados	HK	Luxembourg	Mauritius	Singapore
Dividends	5%	10%/5% ²	10%/5% ²	5%	10%/5% ²
Interest	10%	7%	10%	10%	10%/7% ⁴
Capital gains on shares	0% ¹	10%/0% ³	10%/0% ³	10%/0% ³	10%/0% ³

Notes:

- ¹ The 0% rate applies irrespective of the assets held by the relevant PRC company, which potentially makes Barbados very attractive. However, the PRC government is seeking to renegotiate its treaty with Barbados which may result in changes to the capital gains article.
- ² The 5% rate applies if the beneficial owner of the dividends holds at least 25% of the capital of the PRC company paying the dividends.
- ³ Broadly, 0% rate applies where shareholdings of less than 25% in a PRC company, and the PRC company's assets do not principally comprise real property.
- ⁴ The 7% applies to interest paid to a bank or financial institution.

- As the above table shows, apart from the additional protection from tax on capital gains by investing through Barbados, the tax rates under the double tax treaty ("DTA") between HK and the Mainland compare as favourably as any other jurisdiction. Given the additional benefit of HK's geographic location, HK has a clear advantage as a holding jurisdiction for investing into the Mainland.

Detailed Recommendation

Participation Exemption (cont'd)

The table below compares HK's tax treatment of income from a simple share investment to a number of jurisdictions competing as an investment holding location.

	Barbados	HK	Luxembourg	Mauritius	Netherlands	Singapore
Headline corporate tax rate	2.5% down to 1% on a sliding scale	16.5%	29.63%	15%	25.5%	18%
Capital duty	n/a	nominal	0.5%	n/a	n/a	nominal
Stamp duty on share sales	n/a	0.2% of the greater of consideration and market value	n/a	n/a	n/a	0.2% of the greater of consideration and net asset value
Dividend income	Exempt provided the shareholding is at least 10% and the investment is not a mere portfolio investment	Exempt	Exempt if participation exemption applies	Maximum of 3%, depending on availability of credits for overseas tax paid	Exempt if participation exemption applies	Exempt if participation exemption applies
Interest income	Taxable	Taxable if HK sourced	Taxable	Taxable	Taxable	Taxable if Singapore sourced
Gains on sale of shares	Exempt if gain is a 'capital gain'; otherwise taxable	Exempt if gain is a 'capital gain', or non-HK sourced; otherwise taxable	Exempt if participation exemption applies	Exempt	Exempt if participation exemption applies	Exempt if gain is a 'capital gain', or non-Singapore sourced; otherwise taxable
Interest deductions	Yes	Yes if income is taxable and if satisfy specific deduction rules	Yes	Yes for bank debt, and generally yes for shareholder debt	Yes	Yes if income is taxable
WHT on dividends	No	No	0% under EU Parent-Subsidiary Directive; otherwise 15% (unless reduced by a tax treaty), but can mitigate by funding Luxembourg entity with hybrid financing	No	0% under EU Parent-Subsidiary Directive; otherwise 15% (unless reduced by a tax treaty), but can mitigate by using a Dutch co-operative	No
WHT on interest	15% (unless reduced by a tax treaty)	No	No	No	No	15% (unless reduced by a tax treaty)
Thin capitalisation rules	No	No (but specific interest deduction rules)	Yes (but limited potential effect)	No	Yes (but limited potential effect)	No
CFC rules	No	No	No	No	Yes (but limited potential effect)	No
Comprehensive double tax agreements	15 plus the Caricom treaty which includes 12 Caribbean countries	4	51	32	84	56

Note: - We have excluded tax havens such as the British Virgin Islands, Cayman Islands and Bermuda given that they do not have comprehensive double tax agreement networks, notwithstanding that these jurisdictions generally do not impose tax on income.

Participation Exemption (cont'd)

- Overall, HK's tax rules on investment income compare favourably against the other jurisdictions. Dividend income and gains regarded as being on 'capital account' are not subject to Profits Tax, and no withholding taxes ("WHT") is imposed on dividends and interest paid from HK. Investments made from HK are not subject to onerous controlled foreign company ("CFC") provisions, which tax certain profits of offshore subsidiaries on an accrual basis, even if the profits have not been repatriated to the home jurisdiction. Furthermore, HK does not have thin capitalisation rules which restrict the amount of tax deductions corporations may claim for interest expenses if debt funding exceeds a certain limit.
- However, for some investors HK is not always the preferred jurisdiction to establish a holding company. This is due to the uncertainty of being able to establish that a gain is offshore-sourced, or that the gain should be treated as a 'capital gain'.
- To support the position that any gain arising from the purchase and sale of shares is non-HK-sourced, and therefore non-taxable, may be difficult. The difficulty in determining the source of profits arises from the fact that one is required to consider what activities were undertaken by the taxpayer to derive the profits and where those activities were undertaken.
- In the context of the purchase and sale of shares of unquoted shares the source of the gain will generally be determined by where the contracts for the purchase and sale of the shares are 'effected'. The term 'effected' does not merely mean legally executed, but also requires consideration of where the negotiation and, in substance, conclusion and execution of the contracts take place. In cases where the Inland Revenue Department ("IRD") queries the source of gains or losses, it will typically ask the taxpayer to substantiate what activities have been undertaken and where they have taken place, as the onus is on the taxpayer to support any tax position adopted.
- To properly respond to such queries, as a practical matter a taxpayer needs to maintain contemporaneous documentation that supports all of the activities and discussions undertaken by representatives of the taxpayer in relation to a particular transaction. This is a time consuming process and often difficult to fulfil in practice.
- For investors who have people situated in HK with a general authority to effect the purchase and sale of shares on their behalf from HK, any gain arising from the sale of such shares will be taxable in HK, unless the gain can be characterised as a 'capital gain'. Establishing that an investment should be regarded as a 'capital asset' (and hence non-taxable in HK) may prove equally difficult. This is because determining whether an investment should be regarded as a 'capital' asset (as opposed to a 'revenue' asset) requires careful consideration of all of the circumstances relating to the investment, including inter-alia, the investor's profit-making intention at the time of making the investment.
- If the intention of the investor is to realise its investment principally by way of gains on a sale, with little or no other income (such as dividends) to be derived from the investment, the investment would arguably be characterised as a revenue asset. Contrary to popular perception, the risk of the investment being regarded as a revenue asset would exist irrespective of either the investment time horizon, or the fact that the proposed transaction may represent only an isolated, or "one off", transaction.

Participation Exemption (cont'd)

Recommendation

- Given the preference investors have for certainty of tax treatment, the simplest way in which HK could provide such certainty would be to introduce a 'participation exemption' style regime. Similar to such regimes existing in many European countries, a blanket exemption from HK Profits Tax could apply in relation to the disposal of shares provided that certain conditions are fulfilled. This exemption would therefore eliminate the need to consider the source or the revenue/capital nature of the disposal gain.
- The participation exemption regimes in the European Union ("EU") vary slightly, although the regimes often require a minimum holding period (which in most cases does not exceed one year) or a minimum shareholding percentage. In some cases – such as Belgium which provides a 100 percent exemption on capital gains and Germany which provides a 95 percent exemption – no minimum holding period or shareholding percentage is required.
- For HK, a participation exemption regime could operate to exempt from Profits Tax gains arising on the sale of shares in a company, irrespective of its place of incorporation, provided that the shares were held for a minimum holding period of, say, 12 months. By having a minimum holding period requirement, gains made by genuine share traders such as hedge funds would remain within the existing HK tax framework. Moreover, a minimum shareholding requirement of say 5% to 10% can be imposed.
- To protect taxing rights over HK real estate, however, investment gains from the sale of shares in companies whose value derives directly or indirectly principally from HK real estate would fall outside the participation exemption regime.
- By providing an exemption regime for the sale of shares, HK would be distinguishing itself from its competitors in the region in line with the goal of making HK a preferred location for international headquarters.

Revenue implication

- This proposal should not give rise to material revenue implications as the intention is to provide certainty and administrative convenience and not to provide any tax concession in addition to what is currently available.

Improving Guidance and Certainty to Taxpayers

Issue

- A key aspect to the business competitiveness of a tax system is certainty. There should be sufficient guidance on how tax laws are applied in practice so that taxpayers are able to reliably anticipate the tax consequences of transactions. HK could improve in guidance and certainty for taxpayers by i) providing more frequent and timely guidance on ad-hoc technical issues, and ii) by reviewing the composition of the Board of Review (“BOR”).

Discussion

- Since 1998, advance rulings from the Inland Revenue Department (“IRD”) can be obtained on the interpretation of statutory provisions in certain circumstances. A ruling is binding only in relation to the taxpayer to whom it is granted. Nonetheless, the IRD would publish rulings (edited to ensure that the parties cannot be identified) as reference for other taxpayers. To provide ongoing guidance to taxpayers on the application of the source concept as well as on other aspects of the HK tax system, the IRD should continue to publish selected advance rulings where they are considered to be of general interest.
- The IRD could also provide more timely guidance to taxpayers on ad-hoc issues of general application by releasing technical bulletins or making use of the Frequently Asked Questions (“FAQ”) section of the IRD’s website.
- BOR decisions provide important precedents and guidance to taxpayers. Where a taxpayer is dissatisfied with an assessment from the IRD, in the first instance, the appeal is lodged with the BOR which is an informal hearing by an independent panel drawn from a panel of laymen. Although the chairman is always a person with a legal qualification and members of the panel may include persons with legal qualifications, tax practitioners are not invited onto the panel to avoid potential conflicts of interest.
- However, the increasing complexity of tax cases has called into question the composition of the BOR. The experience of the taxpayer in the case of *ING Baring Securities (Hong Kong) Limited vs the Commissioner of Inland Revenue* can be used to illustrate the possible time and complications involved in taking a tax case through the appeal process.
- The taxpayer in this case appealed against the Commissioner’s Determination of its assessments for the years 1990/91 to 1994/95. The Determination is dated 31 July 1997 and the BOR hearing was held in July 2000 with its decision delivered in February 2002, some 19 months after the hearing. The case was appealed to the Court of First Instance, then the Court of Appeal and finally the Court of Final Appeal. It was only in October 2007 when the Court of Final Appeal handed down its decision that the case was finalised, more than 16 years after the first year of assessment in dispute.

Improving Guidance and Certainty to Taxpayers (cont'd)

- In his judgement, Mr Justice Bokhary raised the need to review the composition and operation of the Board of Review (“BOR”). His remarks in paragraph 4 of the judgement were endorsed by the other four judges:-

“Before parting with this case, I would observe that it is but one illustration of the extent to which the work to be performed by the Board of Review has, over the years, grown more complex and time-consuming. So much so that there appears much to be said for urgent consideration being given, in appropriate quarters, to the question of whether the public interest in present-day HK calls for, if not a new body composed of full-time personnel to take over some or all of the Board’s work, then at least an overhaul of the way in which the Board is constituted and resourced. This involves no criticism of those willing to take time out of their busy schedules to serve on the Board. What it does perhaps involve is whether it is fair to expect them to do so under present conditions.”

Recommendation

We recommend:-

- More frequent and timely technical guidance be released by the Inland Revenue Department (“IRD”) through i) technical bulletins or the Frequently Asked Questions (“FAQ”) section of the IRD website, and ii) publication of more advance rulings. The Tax Policy Unit should be involved in the drafting and reviewing of technical guidance on key issues before release.
- The composition of Board of Review (“BOR”) be reviewed on a case-by-case basis to ensure complex cases are heard by BOR members with sufficient technical knowledge. In this regard, consideration should be given to permitting tax practitioners to become BOR members so that in the hearing of more complex cases, at least one member of the BOR could be a tax practitioner. Conflict of interest issues can be managed and reference could be made to the listing committee of the HK Stock Exchange where accountants and lawyers involved in listing work are still invited onto the panel but will not be assigned to cases where there are potential conflicts.

Revenue implication

- Providing greater certainty in the application of the tax laws should not give rise to direct revenue implications. However, since certainty is a key aspect to the competitiveness of a tax system, improvement in this respect should retain and attract more businesses to HK and hence should result in positive revenue implications in the long run.

Double Tax Treaty Network

Issue

- To enhance its position as an international and regional financial and business centre, HK must build a comprehensive double tax treaties (“DTA”) network.

Discussion

- To date, HK has concluded only four comprehensive DTAs, with Belgium, Thailand, the Mainland, and Luxembourg. In addition to full scope DTAs, HK has since the late 1980s entered into limited scope DTAs relating to the taxation of airline and shipping income.
- If HK has an effective network of double tax treaties, HK companies conducting business in other jurisdictions would enjoy tax benefits that would not otherwise be available. There are three main tax benefits:-
 - Reduction in withholding taxes (“WHT”)- almost all of HK’s major trading partners have rules that impose withholding taxes on various forms of income sourced from the jurisdiction. These forms of income usually include interest, dividends, royalties and capital gains. Under the terms of a DTA, withholding tax rates on payments made to a tax resident of the treaty partner are usually reduced substantially or in some instances eliminated completely.
 - Permanent establishment (“PE”) protection - virtually all treaties contain rules that prevent a treaty partner from imposing tax on the business profits of a resident of the other treaty partner unless the resident of that other jurisdiction maintains a “permanent establishment” in the first jurisdiction and the business profits involved can be attributable to the activities of that PE. Each DTA contains the definition of a PE and while this definition varies, certain activities are commonly excluded from the definition of a PE under most DTAs. For example, presences that do not constitute a “regular place of business” and facilities that are maintained only for the purpose of storage, display, or delivery of inventory do not normally constitute a PE. Therefore, a well negotiated DTA can through its definition of a PE provide significant tax savings for HK businesses operating overseas.
 - Exemption from personal tax - a DTA normally permits a resident of a treaty partner to perform services under employment within the jurisdiction of the other partner without being subject to personal tax, provided that certain conditions are met.
- To illustrate the relative disadvantages of investing through HK in the absence of a DTA, the table below compares investing into particular locations (Australia, India, Indonesia and South Korea) through HK, the Netherlands and Singapore.

Detailed Recommendation

Double Tax Treaty Network (cont'd)

- This table highlights the dividend and interest withholding tax (“WHT”) rates (shown under “D” and “I” respectively), and the rates of tax payable on capital gains on shares (shown under “C”).

Jurisdiction	Australia			India			Indonesia			South Korea		
	D	I	C	D	I	C	D	I	C	D	I	C
Hong Kong	30 / 0 ₁	10	30 / 0 ₂	16.995 ₃	21.115 ₄	31.6725 / 21.115 ₇	20	20	5 ₁₀	27.5	27.5	27.5 / 11 ₁₅
Netherlands	15 / 0	10	30 / 0	16.995	105	31.6725 / 21.115 / 0 ₈	10	10 / 0 ₉	0	15 / 10 ₁₃	15 / 10 ₁₄	0
Singapore	15 / 0	10	30 / 0	16.995	15 / 106	31.6725 / 21.115	15 / 10 ₁₂	10	5 ₁₁	15 / 10	10	27.5 / 11

Notes:

- No withholding tax on dividends paid to non-residents to the extent the dividends are franked or are effectively derived from non-Australian operations.
- The 30% rate will apply on the sale of shares in “land rich” companies or shares which are held on “revenue” account, subject to relief under the relevant DTA business profits article.
- Dividends distributed by domestic companies are subject to dividend distribution tax at 15% plus 10% surcharge, with both imposts subject to 3% education cess – payable by the Indian company.
- The 21.115% rate (taking into account surcharge and education cess) applies to interest payments of greater than INR10 million.
- The lower 10% rate applies in accordance with the protocol to the Dutch / India DTA.
- The lower 10% rate applies if the interest is paid on a loan granted by a bank carrying on a bona fide banking business or by a similar financial institution.
- For capital gains on unlisted shares of greater than INR10 million, withholding tax of 30% will apply for short term (ie, one year or less) capital gains and 20% for long-term capital gains, plus surcharge and education cess.
- For the sale of shares in a land-rich company, the 0% rate applies if the shareholding in the company is less than 25%. For the sale by corporations of shares in other companies, Indian tax is generally not payable provided the investor has a 10% shareholding in the Indian company.
- The 0% rate applies if the interest is paid on a loan made for a period of more than 2 years or is paid in connection with the sale on credit of any industrial, commercial or scientific equipment. However, the Indonesian Tax Office is of the view that the 0% rate does not apply because the mode of application to avail the 0% rate has not been agreed.
- The 5% rate applies on the gross sale proceeds for the sale of unlisted shares. For listed shares, 0.1% Indonesian income tax is generally payable on the gross sale proceeds
- Technically, protection from withholding tax could be afforded to a Singapore shareholder under the business profits article of the Singapore / Indonesian DTA. However, the Indonesian Tax Office is of the view that the DTA does not provide for such protection.
- The lower 10% rate applies with respect to shareholdings comprising at least 25% of capital.
- The lower 10% rate generally applies with respect to shareholdings of at least 25% of capital or voting power.
- The lower 10% rate applies to interest paid on a loan made for a period of more than 7 years.
- Withholding tax on capital gains is the lower of 11% on the sale proceeds or 27.5% on the profit on the sale.

- As can be seen from the table, an investment through a jurisdiction which has a double tax treaty (“DTA”) with Australia, India, Indonesia or South Korea provides an investor with a competitive tax advantage. For instance, dividends paid from Australia out of untaxed profits to a shareholder situated in a jurisdiction which has a tax treaty with Australia (e.g. Netherlands and Singapore) will be subject to Australian withholding tax at 15%. However, similar dividends paid to a shareholder situated in a non-treaty jurisdiction (e.g. HK) will be subject to withholding tax at 30%.
- In relation to capital gains, the benefit of holding shares in an unlisted Indonesian company through the Netherlands, which has a comprehensive tax treaty with Indonesia, is that there would be no Indonesian withholding tax on the sale of shares; however, if the shares were sold by a HK company, Indonesian withholding tax equal to 5% of the gross sale proceeds would be payable.

Detailed Recommendation

Double Tax Treaty Network (cont'd)

- From a HK Profits Tax perspective, another advantage of a comprehensive double tax treaty (“DTA”) is that it provides for corresponding adjustments in the event of transfer pricing adjustments made by the treaty partner. For example, where the People’s Republic of China (“PRC”) tax authorities increase the selling price under its transfer pricing provisions on the sale of goods by a PRC entity to its HK associated company, the HK Inland Revenue Department (“IRD”) would be required, under the provisions of the Mainland - HK DTA, to make a corresponding adjustment in the assessable profits of the HK company (by allowing a deduction for the increased purchase cost), provided that the IRD agrees with the transfer pricing adjustment. In the absence of a DTA, a HK company may not be entitled to a corresponding adjustment.
- In recognition of the advantages of a DTA network, the HK Government announced its intention to discuss comprehensive DTAs with HK’s major trading partners in the 1998-99 Budget. Since then, only four comprehensive DTAs have been concluded. The key reason for the low success rate to date and the key stumbling block in HK’s negotiation with Organisation for Economic Cooperation and Development (“OECD”) member countries is the Exchange of Information (“Eol”) clause.
- A typical DTA contains an Eol clause which sets out the terms on which the contracting parties may pass information to each other. In all four of HK’s existing comprehensive DTAs, the clause is based on the 1995 OECD version. This version allows Eol which is necessary for carrying out:-
 - provisions of the DTA; or
 - domestic laws of the contracting parties concerning taxes covered by the DTA.

Under this model, the IRD may only seek tax information for exchange purposes if a domestic tax interest exists. This requirement is in accordance with our current tax legislation where the IRD is only empowered to invoke its information seeking power for matters relating to a tax liability, responsibility or obligation of any person under the Inland Revenue Ordinance (“IRO”) (Section 51(4)(a) of the IRO).

- However, the OECD has moved to a further liberalised Eol clause in the 2004 OECD version. Under this version:-
 - information can be requested as is “foreseeably relevant” for the administration of taxes of any kind, including taxes not concerned by the DTA;
 - the domestic tax interest requirement cannot hinder exchange of information.
- HK cannot adopt this version without amending its legislation to remove the domestic tax interest requirement as a condition for invoking the information seeking power of the IRD. In other words, to enable HK to comply with the 2004 version of the Eol clause, the information seeking power of the IRD would need to be expanded to allow it to gather information requested by a DTA partner solely for exchange purposes.

Double Tax Treaty Network (cont'd)

- In November 2005, HK participated in the meeting held in Melbourne of the Organisation for Economic Cooperation and Development (“OECD”) Global Forum on Taxation. At the meeting HK endorsed the principles of transparency and exchange of information for tax purposes that are reflected in the OECD 2006 report entitled *“Tax Co-operation: Towards a Level Playing Field – 2006 Assessment by the Global Forum on Taxation”*. One of these key principles is that there should be no restriction of information exchange caused by a domestic tax interest requirement. In the OECD 2007 Assessment Report (an update of the 2006 Report), HK is highlighted as one of only 5 countries out of the 82 countries which participated in the assessment that require a domestic tax interest for exchange of information (the other 4 countries are Cyprus, Malaysia, Philippines and Singapore).

Recommendation

- We recommend HK making greater efforts in building a comprehensive double tax treaty (“DTA”) network as this would clearly enhance HK’s position as an international and regional business centre. A reason commonly cited by multinationals for selecting Singapore over HK for the establishment of regional operations is HK’s lack of a DTA network. An effective DTA network is all the more important if HK were to capitalise on the Mainland’s outbound investments.
- HK should proceed to amend its tax legislation to enable it to agree to the more liberalized exchange of information (“EoI”) clause. A more liberalised EoI is an acceptable price as:-
 - HK should not be seeking to position itself as a haven for tax evaders
 - In time, HK will need to agree to more disclosure with or without DTAs
 - HK endorsed the principle of EoI at the 2005 Melbourne meeting of the Organisation for Economic Cooperation and Development (“OECD”) Global Forum on Taxation, and hence arguably HK has an international obligation to amend its domestic law to be able to implement this principle
 - HK is one of only five countries out of 82 which participated in the OECD 2007 Assessment Report that still have not adopted the latest EoI clause
 - The later HK enters into DTAs, the wider will be the scope of EoI
- Before HK is able to adopt the latest EoI clause, HK should give priority to negotiation with Asian countries which in general do not insist on the expanded scope of EoI. Further, a withholding tax (“WHT”) is imposed by many Asian countries on services and HK as a services hub can benefit from DTAs with a reduced rate of WHT.
- HK should also give priority to negotiation with countries where China’s outbound investments are heading, e.g. Australia, or where the tax regime is very aggressive, e.g. India.

Revenue implication

- Given HK’s limited WHT regime (HK only imposes WHT on royalties), entering into a DTA should have minimal revenue implications.
- There could be additional administrative costs for the IRD to deal with EoI requests of DTA partners.

Transfer Pricing

Issue

- To facilitate HK as a link to the global supply chain, HK needs to adopt conventional transfer pricing provisions to be consistent with the approach adopted by its major trading partners.

Discussion

- One of the effects of globalization is that it allows countries to specialize and it enables companies within a country to position themselves at different points on the value chain. As the value chain is now global, each company within a multinational group no longer needs to replicate all the value chain functions on a local basis. The payoff, however, is that the scale of cross-border inter-company transactions can be substantial. Apart from transactions related to the sale and distribution of goods, centralizing R&D and service operations can lead to complex intangible and other inter-company transactions. As a consequence, the value at which transactions are conducted amongst group companies, known as the “transfer price”, has become a key business issue for multinationals.
- From a tax perspective, transfer pricing is probably one of the earliest methods of international tax planning and involves the shifting of profits between jurisdictions through intra-group transactions as a means of reducing the group’s overall tax burden. This is possible because different jurisdictions have different tax rates and different bases of determining assessable income or profits. In the simplest scenario, if a group manufactures a product in a company located in a low tax jurisdiction and sells it through a retailing subsidiary in a high tax jurisdiction, the total group profits will be apportioned between the two jurisdictions on a basis determined by the price at which the product is sold by the manufacturing company to the retailing company. By setting this price high, more profits are derived in the low tax jurisdiction of the manufacturing company and less is derived in the high tax jurisdiction of the retailing company.
- For many years, governments around the world have focused attention on this issue and have taken actions to prevent the erosion of their countries’ tax base from transfer pricing. A key element of transfer pricing provisions is the establishment of arm’s length prices. Typically, jurisdictions would enact specific transfer pricing rules to ensure that they have the legislative power to make transfer pricing adjustments when necessary. That is, to increase income or reduce expenses for tax purposes where they believe related parties are not dealing on an arm’s length basis.
- HK has no comprehensive transfer pricing provisions of the type found in other developed jurisdictions but has a specific anti-avoidance provision (Section 20 of the Inland Revenue Ordinance (“IRO”)) which is difficult to apply in practice. The difficulty arises mainly from the manner in which adjustments can be made. Unlike most arm’s length rules in other jurisdictions, the course of action available to the HK IRD is not the substitution of an arm’s length price for the transaction, but the assessment of the non-resident’s HK sourced profits derived from the business done in pursuance of his connection with the resident, to HK Profits Tax. Unfortunately, although Section 20 deems the non-resident to carry on business in HK, it does not deem the source of profits from that business to be in HK. Under the basic charging principle for Profits Tax, both of these tests must be satisfied before there can be a liability to Profits Tax. Accordingly, where the profits of the non-resident are sourced offshore, Section 20 cannot be used to redress the tax avoidance from the inappropriate transfer price.

Transfer Pricing (cont'd)

- There are other limitations to Section 20. For example, it can only apply to a transaction between a resident and a non-resident (residency of a company being determined by the place where it is centrally managed and controlled). Therefore, it cannot apply to a transaction between a HK branch of an overseas company and its overseas affiliate, nor can it be applied to a transaction between a HK company and its tax haven affiliate where the latter is tax resident in HK by virtue of its central management and control being exercised from HK. It is also possible to avoid Section 20 by using two non-resident companies for the transaction and ensuring that the non-resident which transacts directly with the HK company has no profit. For all these reasons, Section 20 is ineffective and seldom used in practice.
- There are, however, alternative routes available to the Inland Revenue Department (“IRD”) to challenge transfer pricing in tax avoidance schemes:-
 - Where a HK company transacts with a tax-haven affiliate and diverts profits to the latter, the IRD could directly assess the profits of the tax-haven affiliate to tax under Section 14 if it has no real substance outside HK and all decisions and activities are carried out by its shareholders, directors or representatives in HK.
 - The IRD could deny deductions to a HK taxpayer for excessive payments made to overseas affiliates. This is on the basis that a tax deduction should only be available to the extent that an expense was incurred for the production of assessable profits. Where a payment is excessive, the excess portion would not satisfy the condition of being incurred for the production of assessable profits.
 - The IRD could apply the general anti-avoidance provisions of Section 61 and/or 61A. These provisions permit the IRD to ignore or modify, as appropriate, any transaction which the IRD considers as artificial/fictitious or has been entered into for the sole or dominant purpose of tax avoidance.
- The traditional view is that transfer pricing is not a problem for HK as it is more common for transactions between HK and non-HK companies to give rise to more profits in HK in view of HK’s relatively low tax rate. However, given the global trend of reducing tax rates and the increasing practices of multinationals to channel profits to even lower-tax jurisdictions, transfer pricing is becoming an increasingly important issue to HK. The IRD will likely need to impose more and more transfer pricing adjustments to protect HK’s tax base. Accordingly, the introduction of conventional transfer pricing provisions is justified so that the IRD does not have to rely on general anti-avoidance provisions and general tax provisions that are not tailored for transfer pricing adjustments. Adopting conventional transfer pricing provisions would also have the benefit of making the HK practice consistent with that of its major trading partners.

Transfer Pricing (cont'd)

- In the absence of conventional transfer pricing provisions, double taxation can arise when transfer pricing adjustments are made in another jurisdiction in respect of transactions involving a HK company. For example, suppose that a HK company sells goods to a related party in country A. Also suppose that the tax authority of country A determines that the price at which the sales take place is too high and increases the taxable income of the associate by reducing its cost of sales. In HK, because there is no general requirement that related party transactions be undertaken on arm's length terms, there are no provisions by which a corresponding downward adjustment of the assessable profits of the HK company can be made. Consequently, the group with cross-border transactions involving HK suffers double taxation. As many tax authorities are becoming more active in transfer pricing reviews and adjustments, the lack of a corresponding adjustment mechanism is a disadvantage to HK's position as an international business centre.
- The position is different where a comprehensive double tax treaty ("DTA") exists as all of HK's DTAs contain a clause which provides for corresponding adjustments. However, even in these situations, double taxation could still occur. This is because the DTA clause which provides for corresponding adjustments requires both jurisdictions to agree on the methodology and comparable data used to determine an arm's length price. A failure to agree will likely result in some level of double taxation as there will be no corresponding adjustment or the adjustment will not be in respect of the full amount.

Recommendation

- HK's lack of conventional transfer pricing provisions results in uncertainties and increases the risk of double taxation for businesses.
- We recommend HK to adopt transfer pricing provisions consistent with the international practice. This could be done by enacting specific legislation along the lines of the Organisation for Economic Cooperation and Development ("OECD") guidelines on transfer pricing, or alternatively by the Inland Revenue Department ("IRD") issuing a practice note providing detailed guidance to taxpayers, including the transfer pricing methodologies acceptable to the IRD.

Revenue implication

- This proposal has no immediate revenue implication as the key intention is to provide greater certainty to HK businesses involved in international transactions. In the long run, by making HK better equipped in dealing with transfer pricing adjustments to protect HK's tax base, there should be a positive implication for revenue.

Monitor Implications Arising from the Adoption of International Accounting Standards in HK

Issue

- HK must adopt international accounting standards to maintain its status as a premier international financial centre. However, blindly accepting all accounting standards for tax purposes will not serve the needs of a good tax system.

Discussion

- Assessable profits for tax purposes are generally profits arrived at in accordance with normal accounting principles as adjusted to comply with the requirements of the Inland Revenue Ordinance (“IRO”) and case law principles. The usual starting point in practice is the profits revealed by the commercial accounts. The next step is to add back expenses deducted in arriving at the profit or loss which are not deductible for tax purposes, and receipts which are not included in the profit and loss account but are deemed to be taxable. Adjustments are also required to deduct any profits included in the profit and loss account which are exempt from tax (e.g. dividends, exempt bank interest, capital profits, offshore profits). It is also necessary to disallow any expenditure that is related to such excluded profits or which is statutorily disallowable.
- However, increasingly questions are being raised on the extent of alignment between tax and accounting profits in view of the evolution of accounting principles and the global harmonization of accounting standards.
- International accounting harmonization means a single set of global accounting standards recognized by all international capital markets and market regulators as sufficient for cross-border capital raising without the need for dual financial reporting or reconciliation. Such a set of global standards would allow the international capital markets to assess company performance much more efficiently. International accounting standards (known as International Financial Reporting Standards “IFRS”) are set by an independent body, the International Accounting Standards Board (“IASB”), and they are already widely adopted by the world’s leading capital markets. HK must adopt these standards if it is to maintain its status as a premier international financial centre. And since 2005, HK has adopted and incorporated IFRS into the HK Financial Reporting Standards (“HKFRS”).
- But by embracing global accounting standards, HK is also embracing a vision for financial reporting that is not necessarily suitable for tax reporting.
- Traditionally, accounting measures of income have been based on past transactions recorded at their historic values. It is this model of income measurement that taxation has taken as its starting point. However, the current trend of global accounting standards is moving away from the historical cost of accounting towards fair value accounting. This approach is often referred to as the “balance sheet” approach. This is because the starting point is to establish whether there are assets and liabilities, and then what their values are, with the profit and loss being arrived at as the change in the aggregate value of those assets and liabilities. In contrast, the traditional approach has been to measure the flows of transactions between two points in time. A key difference in the measure of income is that changes in the value of assets and liabilities not evidenced by realization are now included as income whereas traditionally they would be excluded until realization. This means that gains and losses may be recognized earlier than under the traditional approach and that gains and losses may be recognized where none would have been recognized before.

Monitor Implications Arising from the Adoption of International Accounting Standards in HK (cont'd)

- With the principle of fair value accounting, the adoption of international accounting standards would require the recognition in some cases of unrealized profits and losses in audited accounts. Therefore, if these accounts are used as the starting point in calculating assessable profits for Profits Tax and no adjustments are permitted to exclude unrealized items, tax would be levied on unrealized profits.
- This runs contrary to the well established but non-statutory rule that for tax purposes, neither profit nor loss should be anticipated and that tax should only be levied on realized profits. The realization principle is important to tax because to operate fairly and efficiently, a tax system should recognize the ability to pay. Without liquid assets, the taxpayer will have difficulty in paying taxes. Whilst in a perfect market this problem of liquidity might be met by borrowing by the taxpayer against unrealised profits, in practice financing taxes in this way not only creates transaction costs but can also be risky as the value of the security for the borrowing may fall. Although it is arguable that the volatility inherent in fair value accounting reflects the movements in the market and thus should be reflected in the commercial accounts, it is less clear that it is appropriate to base tax on the volatile accounts.
- The objectives of tax and financial reporting are significantly different. The main objective of tax is to raise revenue for the government. On the other hand, the objective of financial reporting is to provide information on a company to existing and potential shareholders and lenders so that they can best predict future cash flows in order to make financial decisions. Another objective is to enable existing shareholders of a company to assess the quality of stewardship exercised by directors. A set of commercial accounts therefore needs to cater to many stakeholders and needs to provide multi-dimensional information relating to the past, the present, as well as to include forward looking figures involving judgement and valuations. Tax, on the other hand, should be based on a period already ended and should be concerned with the profit or loss in that limited period.
- Given the differing objectives of tax and financial reporting there is a need for some separation between the two. This is not to say that tax and financial accounting should operate in isolation from each other but that there should be clear differences based on established principles. In other words, business accounts should be no more than a starting point in assessing tax; blindly accepting all accounting standards for tax purposes will not serve the needs of a good tax system.

Monitor Implications Arising from the Adoption of International Accounting Standards in HK (cont'd)

Recommendation

- We recommend a systematic and timely review of the tax implications of each IFRS (to be adopted in HK as Hong Kong Financial Reporting Standards (“HKFRS”). Since this is an ongoing process, the work should rest with the full-time Tax Policy Unit within Financial Secretary and the Treasury Bureau (“FSTB”). The unit should consider the potential HK tax implications of each IFRS before its adoption in HK, delineate which accounting principles and practices are acceptable for HK tax purposes, and through practice guidance or legislation counteract the inappropriate tax consequences of the new international accounting principles.
- The lack of such a systematic review would amount to HK’s tax policy being decided not by the HK Government but by the International Accounting Standards Board (“IASB”) which sets international accounting standards with no regard to tax issues at a local level.

Revenue implication

- This recommendation is revenue neutral. It is aimed at preserving HK’s tax policy objectives as HK effects a better global integration by the adoption of international accounting standards.

Corporate Tax Rate

Issue

- Comparisons of competitiveness of tax systems often focus on the headline or statutory corporate tax rate. To remain competitive, HK needs to keep a relatively low tax rate.

Discussion

- *HK Corporate Tax Rate since 1997*

Year of Assessment	Incorporated business	Unincorporated business
97/98 (note)	16.5%	15%
98/99	16%	15%
99/00	16%	15%
00/01	16%	15%
01/02	16%	15%
02/03	16%	15%
03/04	17.5%	15.5%
04/05	17.5%	16%
05/06	17.5%	16%
06/07	17.5%	16%
07/08	17.5%	16%
08/09	16.5%	15%

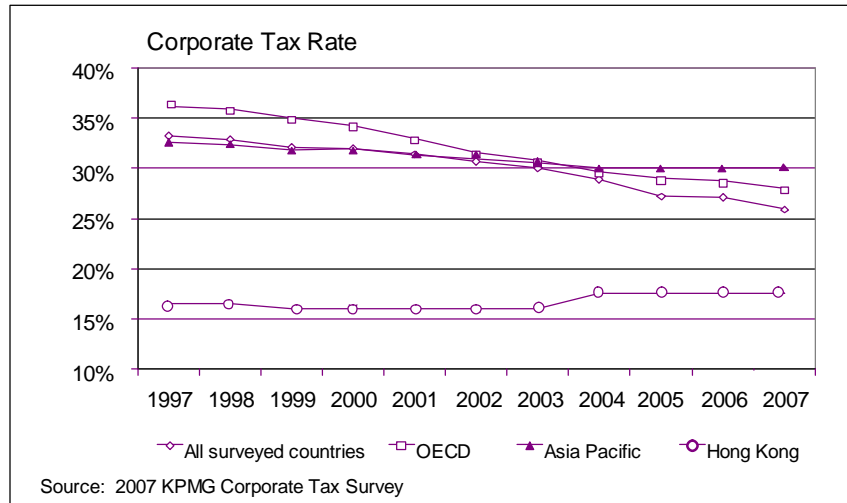
Note:- 10% tax rebate was provided in 1997/98

- The HK Government has focused on maintaining a low corporate tax rate so as to minimise the impact taxation has on businesses in general. In 1998/99, the Government reduced the Profits Tax rate marginally from 16.5 percent to 16 percent for corporations. However, the negative budgetary impact of the Asian economic crisis in 1997 and SARS in 2003 led the Government to increase the Profits Tax rate from 16 percent to 17.5 percent (from 15 percent to 16 percent for unincorporated business) in an attempt to bolster public finances.
- HK's economy has rebounded sharply since early 2004, allowing room for the Chief Executive to promise in his election pledge in 2007 to reduce the Profits Tax rate to 15 percent over his current term of office. As HK's fiscal position has continued to improve, the Chief Executive has also announced in the 2007/08 Policy Address that the rate of Profits Tax will be reduced by 1% in the 2008/09 year of assessment. The reduction was confirmed in the 2008/09 Budget.
- Over the past decade, there has been a consistent trend internationally of lowering the corporate tax rate. The average headline corporate tax rate for the Organisation for Economic Cooperation and Development ("OECD") member countries has reduced from 36 percent to 27.8 percent. Within the Asia Pacific region, the average headline corporate tax rate has reduced from 32.2 percent to 30.1 percent.
- The chart below compares the HK corporate tax rate to the average headline corporate tax rates amongst i) all jurisdictions, ii) OECD members and iii) Asia Pacific jurisdictions covered in a survey. This chart illustrates that while the HK headline corporate tax rate remains relatively low, the gap among the average headline corporate tax rates for these three groups has narrowed, from almost double in 1997 to less than 10 percentage points in some cases in 2007.

Detailed Recommendation

Corporate Tax Rate (cont'd)

- *Headline Corporate Tax Rate comparison*



- Some of HK's close neighbours have made material reductions to their tax rates. For example, Macau's corporate tax rate was reduced from 15% to 12% in 2005, while Singapore and China have reduced their corporate tax rates to 18% and 25% respectively from 2008.
- Although HK's headline or statutory corporate tax rate has remained one of the lowest in the region, its effective tax rate may not be as competitive. In a study released in 2006 by PricewaterhouseCoopers and the World Bank ("Paying taxes : The global picture", 2006), which included a calculation of the actual corporate tax payable as a percentage of the commercial profits of a standard modest-sized company, HK ranked 122 out of 175 economies covered by the survey (with the economy with the lowest effective tax rate being ranked 1).

- Many jurisdictions have used preferential tax treatments and additional tax deductions to lower effective tax rates for specified classes of taxpayers. For example, in connection with the proposed new R&D incentives, the Singapore Minister of Finance said in his 2008-09 Budget Speech:

"A small company that is around the 80th percentile of taxpaying companies, and which spends an additional \$150,000 on R&D, would find its effective tax rate being reduced from around 9% currently, to almost zero. For a medium-sized company, around the 90th percentile of our tax-paying companies, its effective tax rate will come down from about 15% to 10%."

- In addition to a general trend of lowering tax rates, some jurisdictions have adopted lower rates for "small businesses".

Detailed Recommendation

Corporate Tax Rate (cont'd)

Examples of jurisdictions offering lower tax rates to “small businesses”

Belgium	Companies with taxable income of €322,500 or below pay tax under a three-tier progressive system as follows: 24.25% (for the first €25,000), 31% (for the next €65,000) and 34.5% (for the remainder up to €322,500). Companies with taxable income over €322,500 pay tax on their entire taxable income at the basic rate of 33%.
Canada	Lower rates ranging from 14.1% to 18.6% (compared to the effective general rates ranging from 32% to 38.1%) for “Canadian-controlled private corporations” on their first C\$400,000 to C\$500,000 of taxable active business income.
France	SMEs (owned at least 75% by individuals and with a turnover of €7,630,000 or less) are taxed at a reduced rate of 15% on the first €38,120 of profits and at the standard rate of 33.33% on any excess.
Indonesia	A three-tier progressive tax rates system operates as follows: 10% (for taxable income less than IDR 50 million), 15% (for taxable income of between IDR 50 million and IDR 100 million) and 30% (for the remaining amount of taxable income in excess of IDR 100 million).
Luxembourg	Companies with taxable income of €15,000 or less are taxed at 20% for the first €10,000 and at 26% on any excess up to €15,000. The general tax rate for other companies is 27%.
Malaysia	Resident companies with paid-up ordinary share capital of up to RM2.5 million or less at the beginning of a basis period are taxed at 20% on the first RM500,000 of chargeable income, with the remainder taxed at the ordinary rate of 27%.
Singapore	A partial corporate income tax exemption on the first S\$300,000 of income: - 75% of the first S\$10,000 of income and 50% of the next S\$290,000 are exempt from corporate income tax. Income in excess of S\$300,000 is taxed at the standard rate of 18%.
South Korea	A lower rate of 14.3% applies to the first KRW100 million of taxable income, while a higher rate of 27.5% applies to the remainder in excess of KRW100 million.
Taiwan	A three-tier progressive system is in operation where the first TW\$50,000 of taxable income is tax-free with a 15% tax rate for the next TW\$50,000 and a 25% tax rate for any taxable income remaining.
United Kingdom	Profits up to £300,000 are taxed at a small companies’ rate of 19%, with marginal relief up to £1.5 million. Companies with profits of £1.5 million or more pay tax at the full rate of 30%.
United States	Operates a marginal federal corporate income tax system with progressive rates.

Corporate Tax Rate (cont'd)

Recommendation

- Given the international trend of lowering corporate tax rates and the importance of retaining a relatively low headline and effective tax rate, there is room for a reduction in HK's Profits Tax rate.
- However, there is a limit to the reduction because:-
 - Profits Tax remains a major source of the HK Government's revenue. Unlike our competitor jurisdictions, HK has no general consumption tax as an alternative source of revenue. Therefore, HK cannot make up the shortfall from the reduction in corporate tax by increasing indirect taxes such as VAT or GST.
 - HK could fall foul of Controlled Foreign Company ("CFC") rules in investor jurisdictions. CFC rules generally operate to attribute income of a controlled foreign company back to the parent's jurisdiction where the profits would be taxed before an actual distribution. The target of these CFC rules is usually companies located in low tax jurisdictions that do not actively distribute their income and are engaged in passive activities.

As a general rule of thumb, we recommend a headline Profits Tax rate of 15%.

- We recommend the same rate to be adopted for incorporated and unincorporated businesses. The higher rate for companies was introduced in the 1970s as a revenue raising measure; with the current fiscal surplus there is no longer such a requirement.
- To assist small and medium sized enterprises (SMEs), we recommend a lower tax rate of say 10% for businesses with assessable profits of less than \$1 million. Based on 2005/06 revenue collection figures (see table on the right), this measure would benefit approximately 70% of companies paying Profits Tax. Further, the revenue foregone should be limited as corporations with less than \$1 million of assessable profits account for only 3.4% of the total Profits Tax yield.

Distribution of Profits Tax Taxpayers

Profits Tax 2005-06 (Actual revenue)		
Assessable profits	No. of corporations	% of total Profits Tax yield
>\$50M	800 (1.1%)	64.7%
>\$30M to \$50M	500 (0.7%)	5.4%
>\$20M to \$30M	700 (1.0%)	4.4%
>\$10M to \$20M	1 900 (2.7%)	7.4%
>\$7.5M to \$10M	1 100 (1.6%)	2.7%
>\$5M to \$7.5M	2 000 (2.8%)	3.3%
>\$3M to \$5M	3 300 (4.7%)	3.6%
>\$2M to \$3M	3 300 (4.7%)	2.3%
>\$1M to \$2M	7 000 (10.0%)	2.8%
\$1 to \$1M	49 600 (70.7%)	3.4%

Source: Information Pack for the Financial Secretary's Consultations on the 2008/09 Budget

Revenue implication

- A reduction of the Profits Tax rate of 1.5% (from the prevailing rate of 16.5% to the recommended rate of 15%) is estimated to cost approximately \$6.6 billion per annum based on the 2007/08 projected revenue figures.
- 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 the 05/06 figures).

Tax Loss Relief

Issue

- The tax loss provisions should be improved to enhance the competitiveness of HK's tax system.

Discussion

- Under current tax provisions, where a tax loss is incurred by a corporation, it can be carried forward indefinitely and set off against the corporation's future assessable profits until fully utilised (subject to anti-tax avoidance provisions). However, in contrast to many other jurisdictions, tax losses cannot be carried back to offset against taxable profits in prior years or transferred between group companies (commonly known as group relief).
- The HK loss utilisation rules work well where companies operate separate businesses under the same legal entity. However, these days it is less common for enterprises to organise their businesses under a single entity. Corporations are usually organised along lines of business operated through separate legal entities. This may be in order to limit the liability and risk of their investments or to reflect the structure of their businesses. Even though the business of the parent company may be legally separated from those of its subsidiaries, the group is commonly managed and controlled as a consolidated economic unit.
- It is generally accepted that a good tax system is one that incorporates neutrality and equity among different forms of commerce. Taxpayers in similar situations conducting similar transactions should be subject to similar levels of taxation. In the absence of any tax loss carry-back or group loss relief, the current tax loss regime in HK could give rise to an inequitable tax result. For example, a loss-making enterprise which derived profits and paid tax in the earlier years can never obtain a tax refund and will remain in a tax paying position overall even though it is in an overall loss position during its lifetime. Further, a corporate group consisting of profit-making and loss-making companies may suffer a higher overall tax burden and higher effective tax rate than would be the case had the businesses been carried out by a single company.
- In the absence of a tax loss carry-back or group loss relief mechanism, corporate groups in HK are more likely to:-
 - suffer a higher tax burden and higher effective tax rates
 - pay tax even though they are loss making as a group
 - have less favourable cash flow positions
 - suffer higher legal, economic and capital risks in undertaking new business in HK
 - be discouraged from expanding or investing in HK, especially for projects which involve higher risks, heavier upfront investments and/or longer pay-back periods
 - engage in more complex intra-group transactions
- Many developed economies now allow tax losses to be carried back and offer some form of group relief mechanism to taxpayers, either by way of group consolidation, group loss transfer, consortium relief or a combination thereof. The following table highlights the features of the tax loss carry-back and group loss relief regimes in a number of selected jurisdictions.

Detailed Recommendation

Tax Loss Relief (cont'd)

Jurisdiction	Tax loss carry-back	Group relief
Austria	Not available	Group consolidation
Australia	Not available	Group consolidation
Canada	3 years	Not available
Cyprus	Not available	Loss transfer
Denmark	Not available	Group consolidation
Finland	Not available	Loss transfer ¹
France	3 years	Group consolidation
Germany	1 year	Group consolidation
Ireland	1 year	Loss transfer, consortium relief ³
Italy	Not available	Group consolidation
Japan	1 year	Group consolidation
Luxembourg	Not available	Group consolidation
Malaysia	Not available	Loss transfer
Netherlands	1 year	Group consolidation
New Zealand	Not available	Dual system ²
Norway	Not available	Loss transfer ¹
Portugal	Not available	Group consolidation
Singapore	1 year	Loss transfer
Spain	Not available	Group consolidation
Sweden	Not available	Loss transfer ¹
United Kingdom	1 year	Loss transfer, consortium relief ³
United States	2 years	Group consolidation

Notes:

¹ The loss transfer regimes operated in Finland, Norway and Sweden are commonly known as group contribution regime. It allows profits (instead of losses) to be transferred within a corporate group.

² New Zealand offers both group consolidation and loss transfer mechanisms to taxpayers on an elective basis.

³ Consortium relief is an extension of group loss transfer regime that allows tax losses to be transferred between the consortium entity and its consortium members.

Tax Loss Relief (cont'd)

- A group consolidation regime is a comprehensive system for taxing corporate groups. Broadly, corporate group entities are treated as a single economic unit and the taxable income and loss of member entities are considered together in order to determine the group's overall tax position.
- A group loss transfer regime is generally speaking simpler than a consolidation regime. It allows unutilised tax losses of one group company to be transferred to and set off against the taxable income of another company within the same corporate group. Transfer rules are relatively straightforward and easier to administer. Typically, a loss transfer regime would require only amendments to existing laws (rather than a new body of law), more flexible joining requirements (by percentage of direct or indirect ownership) and less administration and compliance costs. Accordingly, the loss transfer regime is likely to fit better into HK's current tax system as compared to the group consolidation regime. Countries such as Cyprus, Ireland, Malaysia, New Zealand, Singapore, and the United Kingdom ("UK") currently operate group loss transfer regimes.

Recommendation

- We recommend the introduction of a group loss transfer system in HK. Taking account of HK's listing rules requiring an open market in the securities for which listing is sought (this will normally mean that at least 25% of the total issued capital must at all times be held by the public so that an entity may only own up to a 75% interest), we recommend that a HK group loss transfer regime be based on a shareholding threshold requirement set at below 75%. Many groups hold interests in HK companies through interposed non-resident entities. That being the case, we recommend allowing a group to trace through (i.e. allow indirect holding to be taken into account) non-resident entities in order to test its shareholding level in a HK company for group loss transfer purposes.
- We recommend the introduction of a tax loss carry-back regime so that tax losses in the current year can be carried back to offset assessable profits in an earlier year resulting in a refund of the tax paid in the earlier year. We recommend the carry-back period to be tied to the standard time-bar provisions so that the number of years for which a tax loss can be carried back would be six years given the current six year rule for finalisation of tax affairs.

Revenue implication

- The recommended changes should have no long-term impact on government revenue as the current tax loss regime already allows losses to be carried forward. A loss of revenue only arises if the company does not recover from its current losses and subsequently fails.

Stamp Duty Exemption for Unquoted Shares and Instruments

Issue

- Abolishing the stamp duty on unquoted shares and instruments would encourage the use of HK incorporated companies.

Discussion

- A transfer of HK stock involves the execution of a contract note (commonly referred to as a bought and sold note) and an instrument of transfer (also known as a deed of transfer or a transfer deed) which will give rise to the following stamp duty respectively:-
 - An ad valorem duty at the rate of 0.2% (0.1% each on the bought note and sold note) on the consideration or value of the stock bought and sold;
 - A fixed duty of HK\$5.
- Many tax-free jurisdictions do not impose any stamp duty. Hence companies incorporated in these tax-free jurisdictions (the most commonly used jurisdiction is the British Virgin Island (“BVI”)) are often used to conduct business in HK or for investment holding. Investors could transfer the effective ownership of their HK investments by transferring the stock of the BVI companies. As such, HK stamp duty could be avoided legitimately. If stamp duties on transfers of unquoted shares and instruments are abolished, unquoted stock in HK can be bought and sold more flexibly and efficiently without the need to incorporate or interpose BVI companies.
- Many developed economies do not impose a stamp duty or tax on the transfer of stock (indicated as “None” in the table on the right). As globalisation and inter-city competition intensifies, the abolition of the stamp duty on transfers of unquoted shares and instruments should strengthen the competitiveness of HK’s tax system in the global arena.

Jurisdiction	Rate for stock transactions
Australia	None
Belgium	0.17% with a maximum of EUR500
Canada	None
Denmark	None
Estonia	None
Finland	Nil for stock traded on stock exchange; 1.6% otherwise
France	0.003% up to EUR153,000 and 0.015% thereafter subject to a maximum of EUR610
Germany	None
Italy	Nil for stock traded on stock exchange; otherwise 0.009% to 0.14% depending on the types of assets
Japan	None
Korea	0.15% for stock traded on KSE, 0.3% for stock traded on KOSDAQ and 0.5% for unquoted shares
Latvia	None
Lithuania	None
Netherlands	None
Portugal	None
Singapore	0.2 for every SGD100 or part thereof
Spain	None
Sweden	None
Switzerland	0.15%
United Kingdom	0.5%
United States	None

Stamp Duty Exemption for Unquoted Shares and Instruments (cont'd)

- Although the scope, rate, time limit and penalties of stamp duties are the same for both quoted and unquoted stock, the paperwork involved in stamping unquoted stock is substantially higher than that of quoted stock. This is because the *ad valorem* stamp duty is charged based on the consideration or value of the stock bought and sold. If the Stamp Office considers the consideration to be lower than the market value of the stock, the *ad valorem* stamp duty will be assessed based on the market value of the stock on the date of transfer. As quoted stock is traded in a recognised free market, the consideration is generally accepted as the market value of the stock. But for unquoted stock, there is no recognised market from which the market stock value could be attained. Therefore, the Stamp Office would require additional documents to ascertain the market value of unquoted stock.
- If the intra-group relief is applied for a transfer of unquoted stock, further documents are required to be submitted. The intra-group relief provides an exemption for an instrument effecting the transfer of HK stock between associated companies. Companies are associated if one is the beneficial owner of not less than 90% of the issued share capital of another or a third corporate body is the beneficial owner of not less than 90% of the issued share capital of each company. In order to be valid, an application for this exemption is required to be made within 30 days after the execution of the instrument.
- If the transferee and transferor cease to be associated companies by reason of a change in the percentage of the issued share capital of the transferee in the beneficial ownership of the transferor or a third corporate body within two years after the date on which the contract note was required to have been made and executed, the relief will be clawed back.
- If stamp duties on a transfer of unquoted shares and instruments are abolished, both the investors and the Stamp Office can save time, costs and effort in complying with and administering the stamping procedures. In particular, they will no longer be required to compile or review extensive paperwork in order to:-
 - Justify the market value of the unquoted stock;
 - Apply for or consider the intra-group relief;
 - Monitor the intra-group relief even after it has been granted.

Stamp Duty Exemption for Unquoted Shares and Instruments (cont' d)

Recommendation

- We recommend the abolition of stamp duty on unquoted shares and instruments to:-
 - Increase the use of HK incorporated companies
 - Reduce the administrative burden for stamping in HK

Revenue implication

- The stamp duty collection from contract notes of unquoted stock is consistently and significantly lower than that from quoted stock. In the fiscal year 2006/07, the stamp duty collection from contract notes of unquoted and quoted stock amounted to \$1.36 billion and \$13.6 billion respectively. For the fiscal years 2000/01 to 2006/07, the stamp duty collected on contract notes of unquoted stock accounted for:
 - Not more than 11% of the total stamp duty collected from all contract notes
 - Not more than 6% of the total stamp duty collection
 - Not more than 1% of the total tax collected

Tax Deductions

Issue

- The competitiveness of HK's tax system would be enhanced by improving tax deductions on expenditures for intellectual property ("IP"), research & development ("R&D") and manufacturing plant and machinery

Discussion

R&D tax deductions

- Tax relief for R&D expenditures that is currently provided includes:-
 - outright deductions for payments made to research institutions approved by the Commissioner of Inland Revenue;
 - outright deductions for all expenditures (including capital expenditures on plant and machinery) on eligible R&D activities, other than acquisition and improvement costs of land and buildings; and
 - taxable proceeds from the disposal of rights in R&D are capped at an amount equal to the prior year deductions claimed by the taxpayer on the disposed rights.
- If the expenditure is made or incurred solely in HK, there is no requirement to apportion tax deductions, even if part of the profits arises outside HK and is not subject to Profits Tax. The rules are so set to encourage local research.
- Most developed jurisdictions provide comprehensive R&D tax relief by way of tax deferral¹, bonus tax deductions², tax credits³, full or partial tax exemptions⁴, or a combination thereof. Table 1 provides a summary of the R&D tax relief available in HK and in selected key competitor jurisdictions⁵.

Notes:

¹ Tax deferral generally involves the use of accelerated depreciation to work out the capital allowance deductions for costs of plant and machinery and the provision of temporary tax exemption of a gain realised from the disposal of a capital item. For example, Australia allows the assessable gain from the sale of a plant or machinery used in R&D activities to be deferred if the plant or machinery is sold to another member of the same wholly-owned corporate group.

² Bonus tax deductions refer to deductions allowed in excess of 100% of the R&D expenditure made or incurred by a taxpayer. Government's approval may be required to access some of these bonus tax deductions.

³ Tax credits/rebates are generally calculated by multiplying the eligible R&D expenditure by a statutory rate. The credits/rebates are to be set-off against the taxpayer's tax payable for the relevant assessment year.

⁴ For instance, South Korea exempts all assessable profits of an enterprise that carries out government approved R&D activities in a prescribed economic zone.

⁵ The selected jurisdictions are (i) Singapore, South Korea and Japan, which are usually considered as key competitors to HK in the region; and (ii) the US, the UK, Canada and Australia, which are well-developed countries.

Detailed Recommendation

Tax Deductions (cont'd)

Table 1: Summary of mainstream R&D tax concessions provided by selected key competitor jurisdictions

Description of R&D tax concession	Hong Kong	Singapore	South Korea	Japan	USA	UK	Canada	Australia
Outright deductions for onshore R&D expenditure	√	√			√	√	√	√
Extension of tax relief to offshore R&D activities performed	√	√ (if they relate to a R&D project primarily conducted onshore)					√ (if they relate to a R&D project primarily conducted onshore)	√ (if they relate to a R&D project primarily conducted onshore)
Accelerated depreciation of R&D plant & machinery			√	√				
Bonus deductions (i.e. > 100% deductions) for R&D expenditure		√ (up to 200%) ^(b)				√ (125% to 150%)		√ (125% to 175%)
Bonus deductions for government approved R&D expenditure		√ (up to an additional 100% deduction at government's discretion))	√ (at government's discretion)					√ (at government's discretion)
R&D tax credits for R&D expenditure				√	√		√	
Tax rebates for unutilised R&D deductions/tax credits to SMEs		(c)			√	√	√	√
Other industry/region specific tax exemptions or incentive schemes^(a)		√	√	√				√

Notes:

(a) Tax exemptions and other tax incentives are provided to taxpayers that carry out industry specific R&D activities and R&D activities in prescribed economic zones.

(b) On 15 February 2008, the Singapore Minister of Finance announced in his Budget Speech 2008 that a minimum 150% tax deduction will be allowed to taxpayers that incur expenditure to carry out eligible R&D activities in Singapore for the years of assessment 2009 to 2013. The maximum rate of tax deduction allowed would depend on whether the taxpayer is also eligible for industry specific and/or government approved R&D expenditure bonus deductions.

(c) 2008 Singapore Budget Speech proposed tax refunds for qualifying start-ups for unutilised R&D tax deductions (convert up to S\$225,000 into cash grants of S\$20,250).

Tax Deductions (cont'd)

- Compared to key competitor jurisdictions, the R&D tax relief available in HK is less generous. In particular:-
 - Most countries examined provide bonus R&D tax deductions and/or tax credits. The value of bonus tax deductions provided by competitor jurisdictions ranges from 125% (e.g. Australia⁶ and the UK⁷) to 200% (e.g. Singapore⁸) of the R&D expenditure. The value of tax credits provided ranges from 10% (e.g. Japan) to 35% (e.g. Canada) of the R&D expenditure. HK does not currently provide similar tax relief to induce R&D activities;
 - Unutilised R&D tax deductions and tax credits are rebatable to SMEs in some countries (e.g. Australia provides tax rebates for unutilised R&D tax deductions to SMEs with an annual turnover of less than A\$5,000,000). HK does not currently provide any tax rebate for unutilised R&D tax deductions. Unutilised tax deductions (i.e. tax losses) are carried forward indefinitely until the taxpayer derives sufficient assessable profits to offset against these deductions; and
 - Asian countries favour the use of industry and region specific tax exemptions to supplement general R&D tax deductions that are available to all taxpayers.

Intellectual property (“IP”) tax deductions

- Tax relief for IP expenditures currently available in HK includes:-
 - outright deductions for registration costs of trademarks, patent rights and other designs provided the relevant IP is used in the production of the taxpayer’s assessable profits.
 - outright deductions for purchase costs of patent rights and industrial know-how purchased from an unassociated party if the right is for use in HK and the expenditure is incurred in the production of the taxpayer’s assessable profits. Where the right is used partly in HK and partly elsewhere, only that part of the cost which is attributable to the use in HK is deductible.
 - if the patent right or right to know-how is disposed of, the proceeds of sale are to be brought in as a trading receipt and, therefore, chargeable to Profits Tax. There is no statutory cap to limit the assessable disposal proceeds as is the case for R&D rights.

Notes:

⁶ The maximum bonus tax deduction allowed in Australia is 175% of the eligible R&D expenditure.

⁷ SMEs are eligible for an additional 25% bonus tax deduction (i.e. effectively 150% of the eligible R&D expenditure).

⁸ In addition to a bonus tax deduction of 200% on the R&D expenditure, Singapore also provides bonus tax deductions for expenditure on certain government approved R&D activities.

Detailed Recommendation

Tax Deductions (cont'd)

- The intellectual property (“IP”) tax deductions currently provided are deficient in the following respects:-
 - The deductions are available only for a limited range of IP. No deductions are available for other intangible items such as commercial know-how (e.g. trademarks, brandnames, etc) and purchased goodwill.
 - Expenditures on “excluded” intangible items are effectively treated as non-deductible capital expenditures (e.g. no deductions or capital allowances are available for purchased trademarks, brandnames, or designs etc.). This gives rise to an anomaly whereby the profits produced by a taxpayer from the usage of these intangible items are assessed, but deductions are denied for the corresponding costs. This is an inequitable outcome as the costs of these intangible items represent real economic costs to the enterprise and should be deducted from the enterprise’s assessable profits. This represents a strong disincentive prohibiting enterprises from performing IP enhancement activities in HK.
 - The entire proceeds from the disposal of IP are fully taxable without a cap. This is inconsistent with the HK tax system under which capital gains are non-taxable.
- Table 2 provides a summary of income taxation rules applicable to IPs and purchased goodwill in selected jurisdictions.

Table 2: Summary of income taxation rules applicable to IP and purchased goodwill in selected key competitor jurisdictions

Description of IP/intangible items	Outright deduction	Amortisation	No deduction, no amortisation
Patent rights	- Singapore ¹ - Hong Kong	- The US - The UK - Canada - Australia - South Korea - Japan - Singapore ¹	
Rights to know-how	- Hong Kong ²		
Trademarks			- Hong Kong
Brandnames			
Licence rights			
Purchased goodwill		- The US - The UK - Canada - South Korea - Japan	- Singapore - Australia - Hong Kong

Notes: ¹ Deductions are only available to costs relating to the registration of patent rights in Singapore. All other costs relating to IP rights are amortised.

² Deductions are only available to costs relating to the acquisition of rights to industrial know-how.

Tax Deductions (cont'd)

- Most jurisdictions examined provide tax relief for purchase costs on intellectual property (“IP”) rights, either in the form of outright deductions (in Singapore) or amortisation. The scope of tax relief for IP rights in HK is comparatively limited as it only covers patent rights and rights to know-how acquired from third parties.

Manufacturing plant & machinery tax deductions

- Tax relief for manufacturing plant & machinery currently available includes:-
 - 100% outright deduction (except where the plant & machinery is under a lease); or
 - Depreciation allowances (initial allowance at 60% in the year the expenditure is incurred plus annual allowance at applicable rate of 10%, 20% or 30% on the tax written down value), but the allowances are denied where the plant & machinery is subject to a lease and is used outside HK.

“Lease” is given a broad definition such that plant & machinery provided free of charge by HK taxpayers to processing units constitutes a lease.
- Since the 1980s, many HK manufacturers have relocated their manufacturing operations to the Mainland. The HK manufacturers are often required to provide the Mainland processing units with plant & machinery for use, although the legal title remains with the HK manufacturers. Given the broad definition of “lease”, no tax deductions are available for the expenditure on such plant & machinery. As a concession, for contract processing cases, the Inland Revenue Department (“IRD”) would allow 50% of the depreciation allowances (not the 100% outright deductions). However, this concession is not granted to import processing cases even though under the current practice 100% of profits generated from an import processing arrangement are usually treated as taxable (profits from contract processing are usually treated as 50% taxable). This means HK taxpayers engaged in import processing would not obtain any tax relief for their expenditure incurred on the plant & machinery used in their Mainland processing units.

Tax Deductions (cont'd)

Recommendation

Research & development ("R&D") tax deductions

- We recommend HK to provide bonus tax deductions for R&D expenditures. This would encourage businesses to engage in R&D projects and put HK on a level playing field with its key competitor jurisdictions.
- To be competitive and to keep the rules simple, bonus tax deductions should ideally be provided to all R&D expenditures and at a rate within the range of 150% to 200%.

Intellectual property ("IP") tax deductions

- To increase HK's competitiveness from a tax perspective, the range of purchased IP eligible for deductions should be extended to include trademarks, brandnames, designs and other similar IP.
- Where granting an outright deduction for the purchase costs of the "extended" IPs is considered inappropriate, alternatively, amortisation over a number of years (say 5 years as in Singapore) could be considered.
- Further, there should be a cap to limit the assessable disposal proceeds from the sale of IP rights to the amount which has been allowed as deductions. This proposal is justified on the following grounds:-
 - HK does not impose tax on capital gains. As such, it would be unreasonable to tax the full disposal proceeds on a capital item (i.e. the IP right); and
 - The current treatment of IP is inconsistent with that applicable to R&D rights. Given their similar nature, IP rights and R&D rights should be treated in the same manner.

Manufacturing plant & machinery

- Under current rules and practice, HK taxpayers engaged in processing trade have been put in an unfavourable situation -- contract processing cases are only entitled to depreciation allowances, giving rise to a timing difference in their tax relief entitlements; import processing cases are in an even more disadvantageous position since the HK taxpayers cannot obtain any relief for their expenditure incurred on plant and machinery which is used to generate profits that are 100% assessable to Profits Tax. As the amount involved is usually very significant, the impact to HK taxpayers could be huge even for contract processing cases where it would only involve a timing difference in capital allowance entitlements.
- To address this issue, we recommend allowing 100% outright tax deductions for plant & machinery expenditures incurred for processing trade. This could be effected by amending Section 16G of the Inland Revenue Ordinance ("IRO") such that the plant and machinery provided to Mainland processing units by HK taxpayers engaged in processing trade do not fall within the definition of "excluded fixed assets".

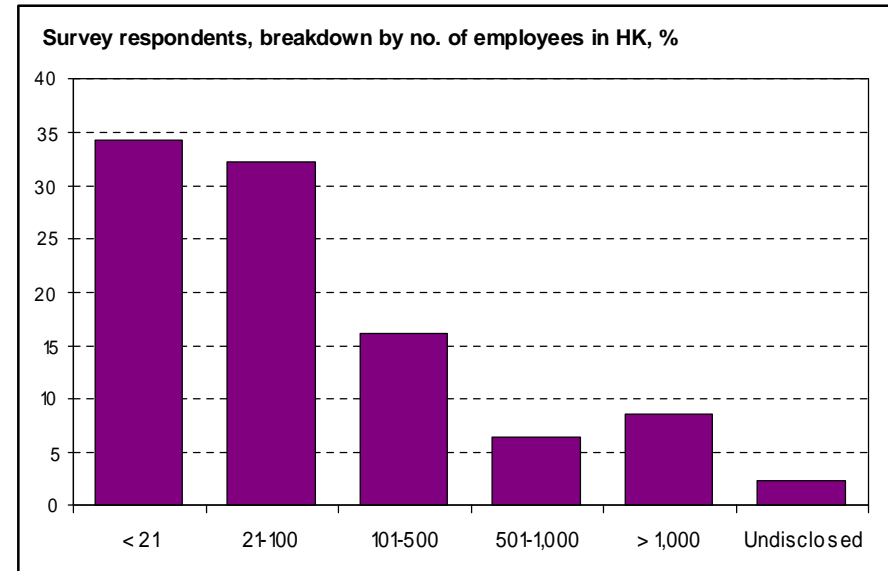
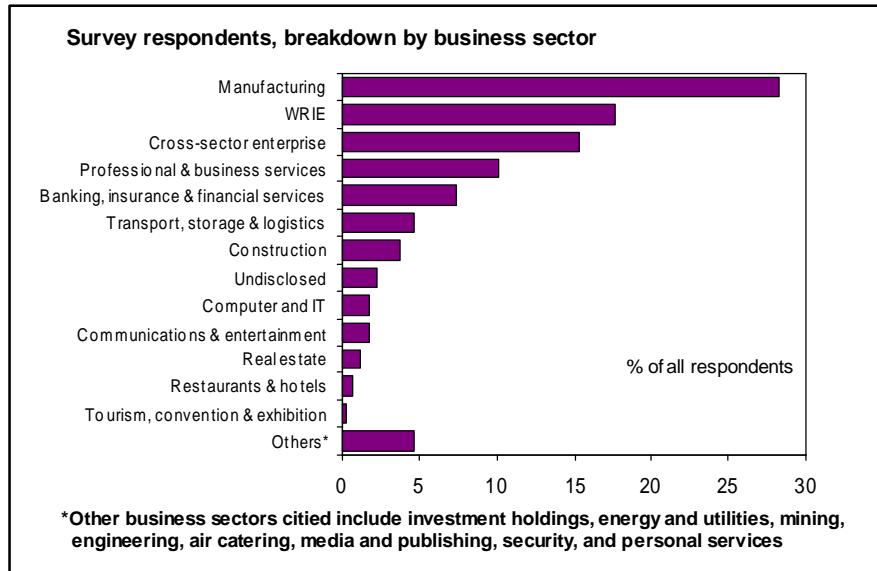
Revenue implication

- Since the recommendations are to provide more tax deductions to Profits Tax taxpayers, their implementation would reduce the Government's tax revenue. However, as there are no published statistics on the relevant expenditure, this Study Group is unable to estimate the revenue implication.

Appendix

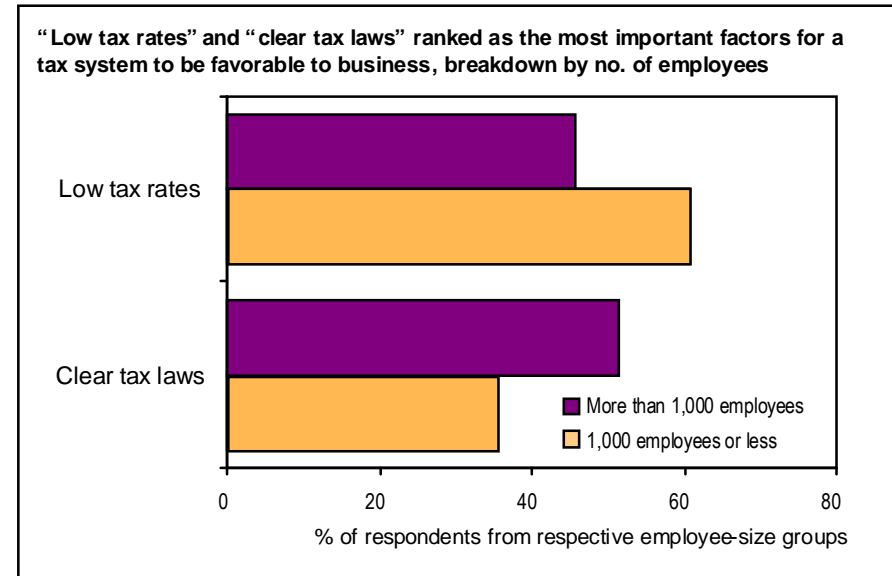
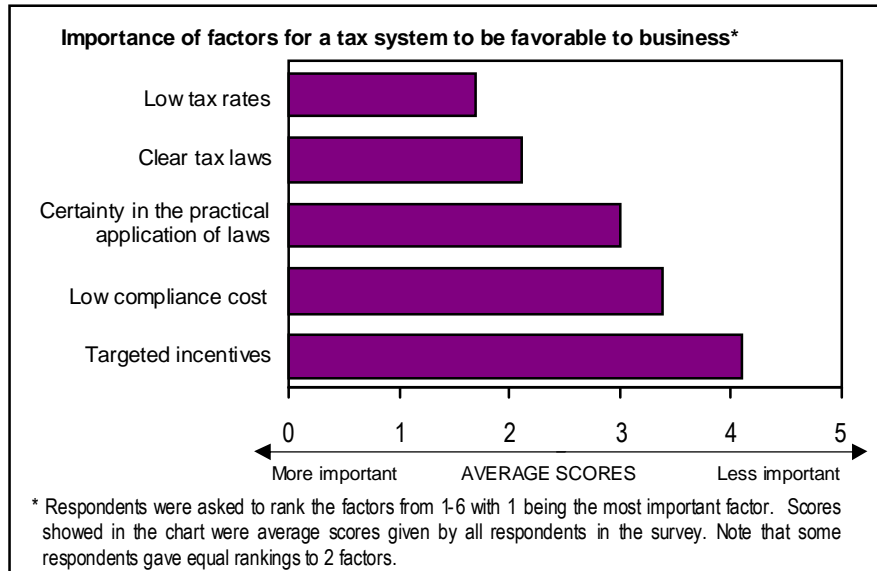
Details of Business Survey Results

Profile of Respondents



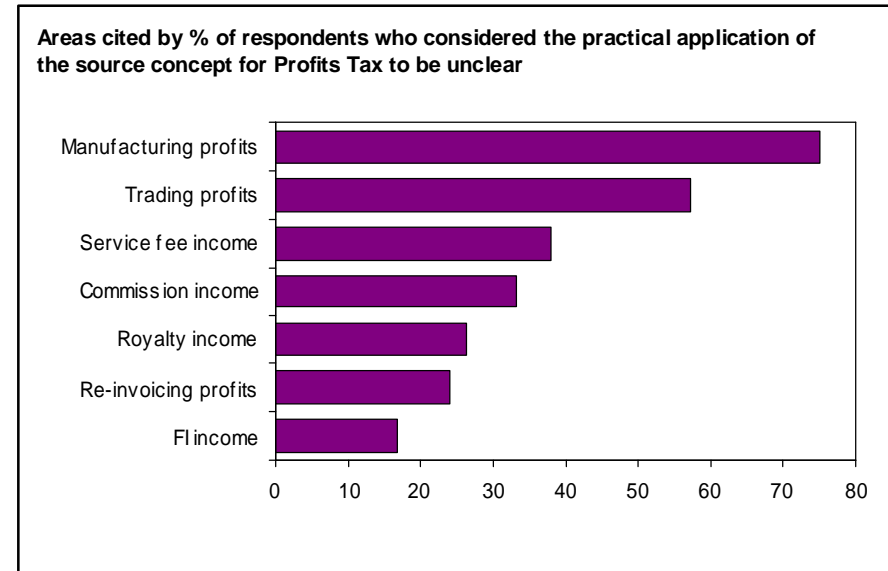
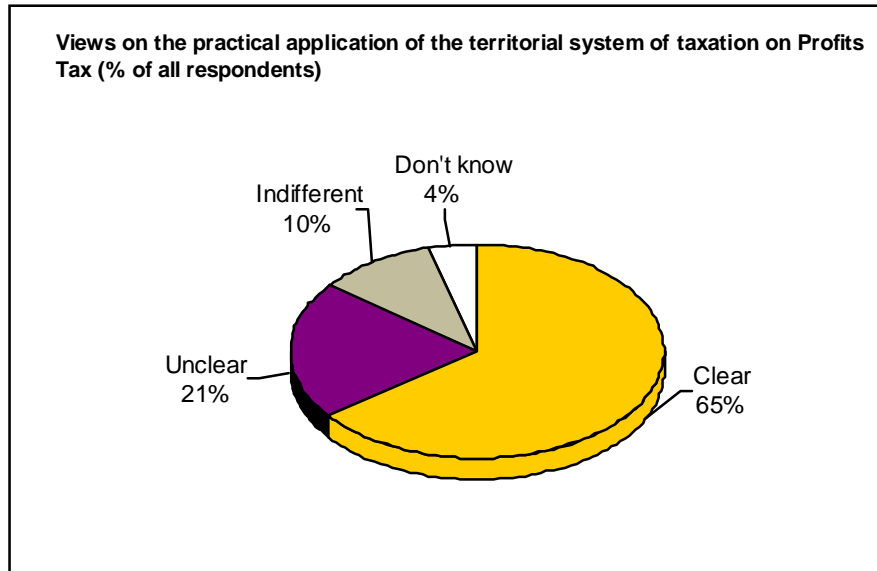
- 404 responses were received out of the 12,039 questionnaires distributed mainly via HK's four trade associations/chambers of commerce, namely, the Chinese General Chamber of Commerce, the Chinese Manufacturers Association of Hong Kong, the Federation of Hong Kong Industries, the Hong Kong General Chamber of Commerce.
- Considering the estimated 50% overlapping of the recipients, the response rate is estimated at 6-7%.
- The manufacturing sector returned the highest number of responses (28%), followed by the wholesale retail, import and export sector (WRIE, 18%), companies engaged in more than one form of business activities (15%), and professional & business services sector (10%).
- Two-thirds of the respondents were from companies with no more than 100 employees in HK. Those with 101-500 employees accounted for 16% and those with over 1,000 employees in HK accounted for 9% of the respondents. This is reflective of HK's business sector with 99% of number of companies being SMEs and 68% of employees working in SMEs.

Ranking of Important Factors



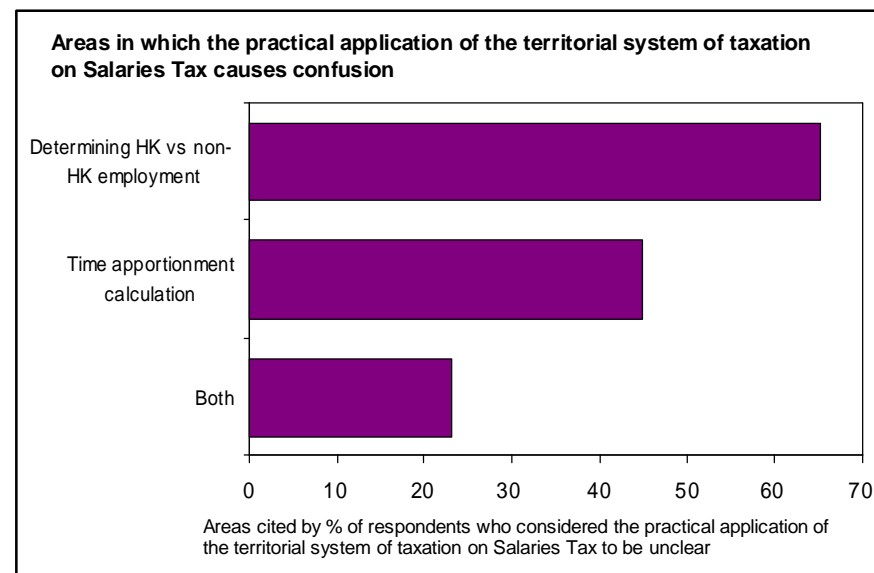
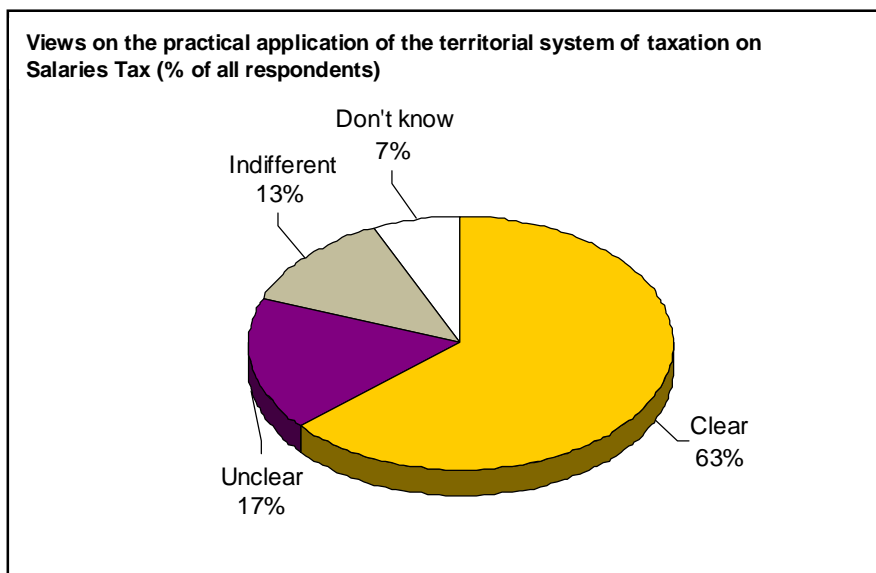
- Respondents were asked to rank the key factors for a tax system to be favourable to business. Survey results showed “low tax rates” to be the most important factor, with 59% of all the respondents giving it the highest ranking. This was followed by “clear tax laws” (36%), “certainty in the practical 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.
- Factors outside of those enumerated in the survey questionnaires but were cited by respondents as important for a tax system to be favourable to business include: comprehensive double tax treaty networks (“DTA”), government’s fiscal policy, simplicity of tax structure, as well as the efficiency of Inland Revenue Department (“IRD”) officers in handling tax cases. In some cases, these factors received high rankings from the respondents.

Practical Application of the Source Concept for “Profits Tax”



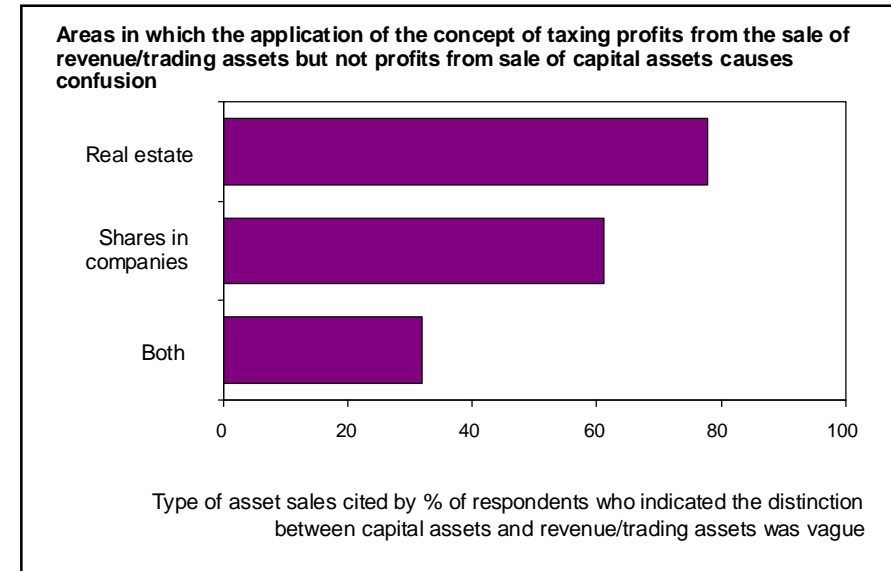
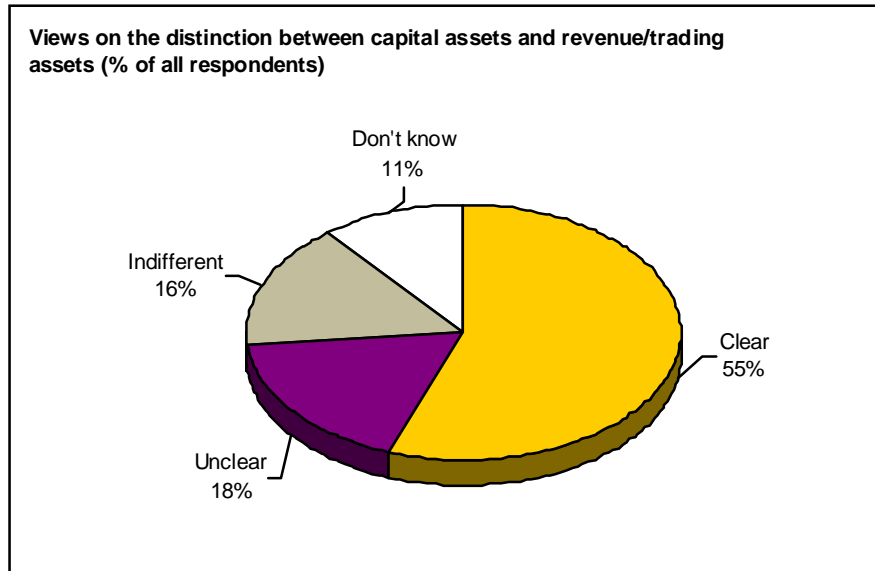
- HK's Profits Tax operates a territorial system of taxation so that only profits derived from HK are subject to tax. 65% of the survey respondents found the practical application of the source concept for Profits Tax to be clear, 21% regarded it to be unclear.
- This concept appeared to be more confusing to the larger companies than their smaller counterparts. 30% of the respondents with more than 1,000 employees said they found the practical application of this concept to be unclear, while only 20% of the respondents with 1,000 or less employees found it confusing.
- By business sectors, among the 84 respondents who regarded the practical application of this concept to be unclear, those engaged in manufacturing accounted for the largest percentage (37%), followed by those engaged in more than one form of business activities (13%).
- 75% of the respondents who regarded the practical application of this concept to be unclear cited the treatment of “manufacturing profits” as an area where the application of the concept caused confusion, while 57% of them cited “trading profits” and 38% cited “service fee income”. 14% of them cited areas outside of those enumerated in the survey questionnaires as causes of confusion. These areas include the treatment of offshore income and income derived from web-based business / e-commerce, as well as the definition of a company’s “head and centre of management”.

Practical Application of the Source Concept for “Salaries Tax”



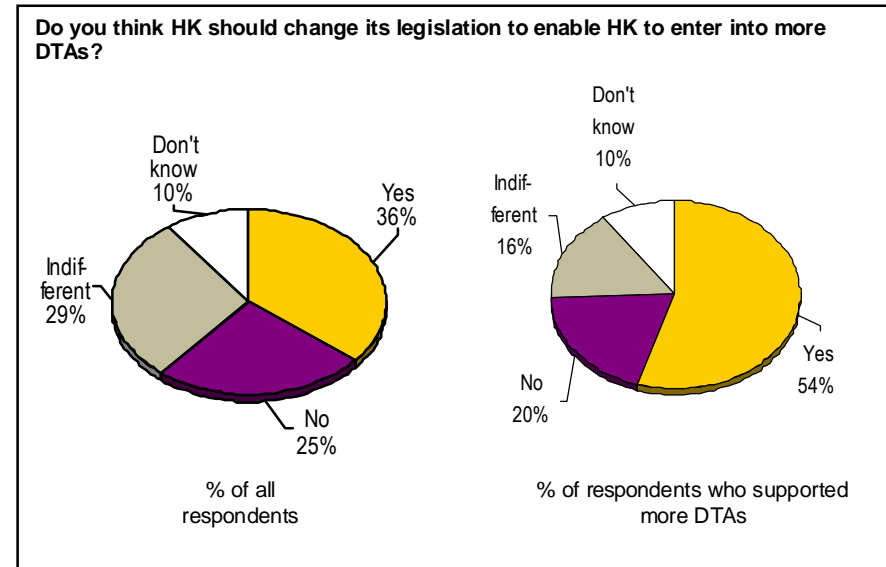
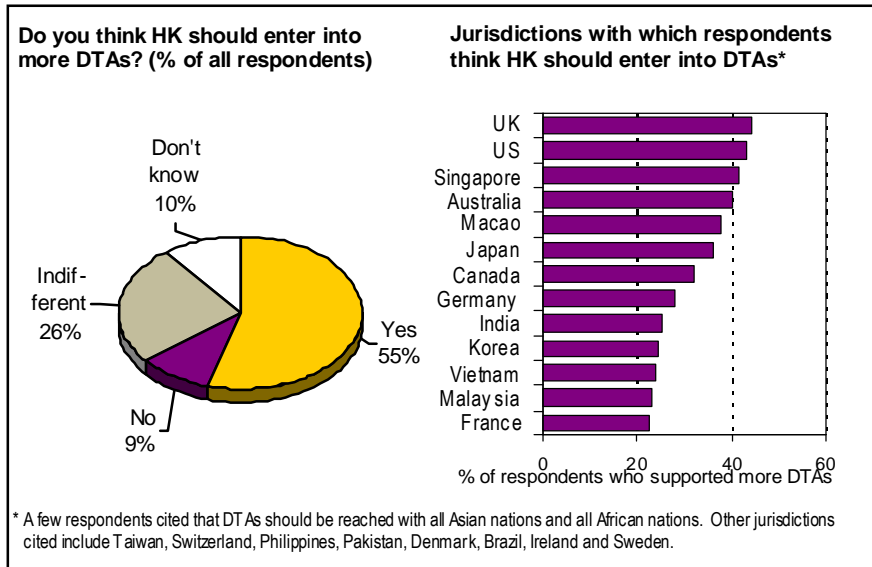
- HK’s Salaries Tax also operates on a territorial system so that only income arising from a HK employment and income attributable to services performed in HK from a non-HK employment are subject to tax. While 63% of all respondents regarded the practical application of this concept to be clear, 17% found it to be unclear.
- Again, a higher percentage of the larger companies found the practical application of the source concept for Salaries Tax to be more confusing, compared to their smaller counterparts. 26% of the respondents with more than 1,000 employees said they found the practical application of this concept to be unclear, while only 16% of the respondents with 1,000 or less employees found it confusing.
- Among the 69 respondents who regarded the practical application of this concept to be unclear, 65% cited the “determination of HK versus non-HK employment” as an area where the practical application of the concept caused confusion, while 45% cited “time apportionment calculation”. A notable 23% cited both as areas that caused confusion.
- One of the respondents cited in particular that in the determination of HK versus non-HK employment, the vague definition of “head and centre of management” is a major cause of confusion. Under Inland Revenue Department (“IRD”) “totality of facts” approach, the question of where a company’s “head and centre of management” is located will be considered in determining HK versus non-HK employment.

Distinction between Capital Assets and Revenue/Trading Assets



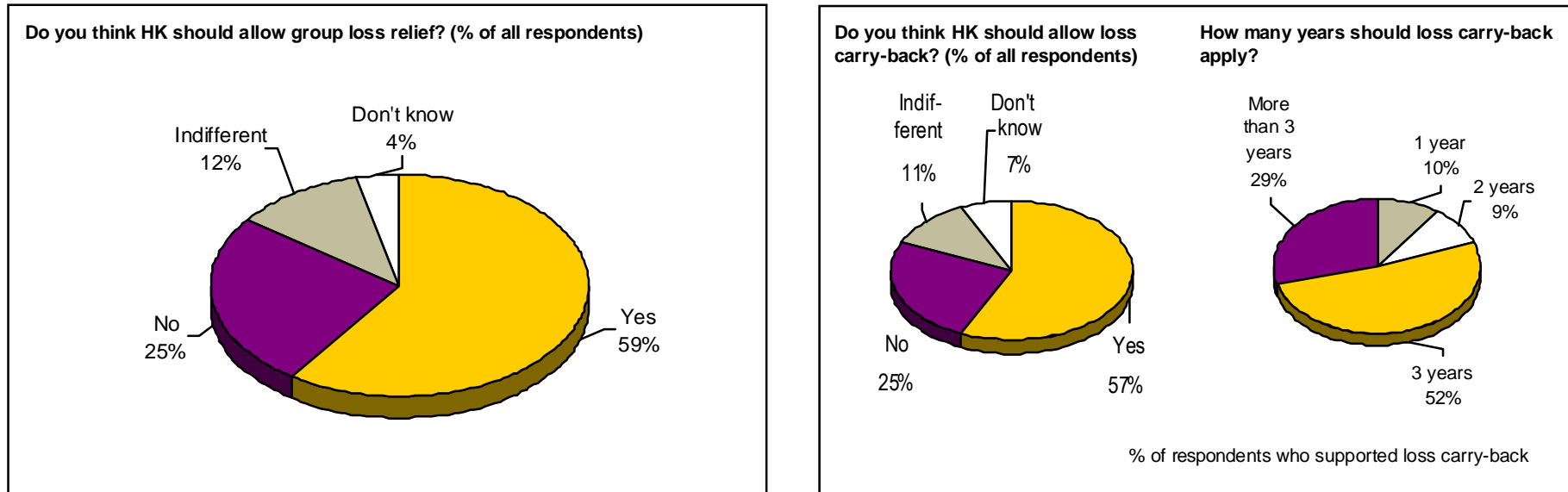
- HK does not tax profits derived from the sale of capital assets. However, profits derived from revenue/trading assets are taxable. When asked whether the distinction between capital assets and revenue/trading assets was clear, 55% of the survey respondents answered yes while 18% thought otherwise. 27% of them answered “indifferent” or “don’t know”.
- As with the trend seen in respondents’ views on the clarity of the practical application of the source concept on Profits Tax and Salaries Tax, a higher percentage of the companies with more than 1,000 employees (28%) found the distinction between capital assets and revenue/trading assets to be vague, compared to their smaller counterparts with 1,000 or less employees (18%).
- Among the 72 responses which indicated the distinction between capital assets and revenue/trading assets was vague, a substantial 78% cited the “sale of real estate assets” as an area in which the application of the concept of taxing profits from the sale of revenue/trading assets but not profits from sale of capital assets caused confusion, while 61% cited the “sale of shares in companies”. A significant 32% cited both as areas that caused confusion.
- 11% of the respondents who indicated the distinction between capital assets and revenue/trading assets was vague cited the “sale of other assets” as causing confusion, including the “transfer of assets within group of companies”, “transfer of trademark”, “sale of art pieces”. The “subjective assessment of Inland Revenue Department (“IRD”) officials in distinguishing between capital assets and revenue/trading assets” was also mentioned as an area causing confusion in one of the survey responses.

HK to Enter into More Double Tax Treaties



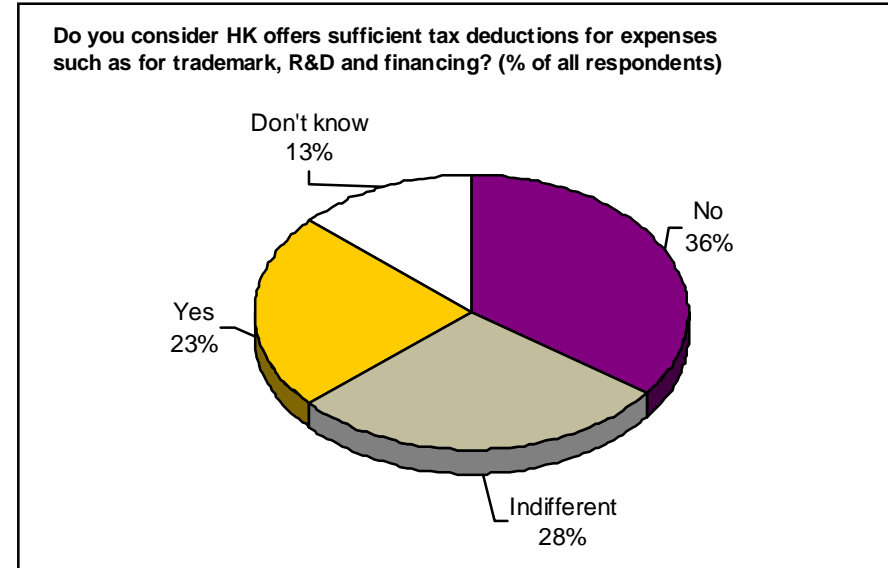
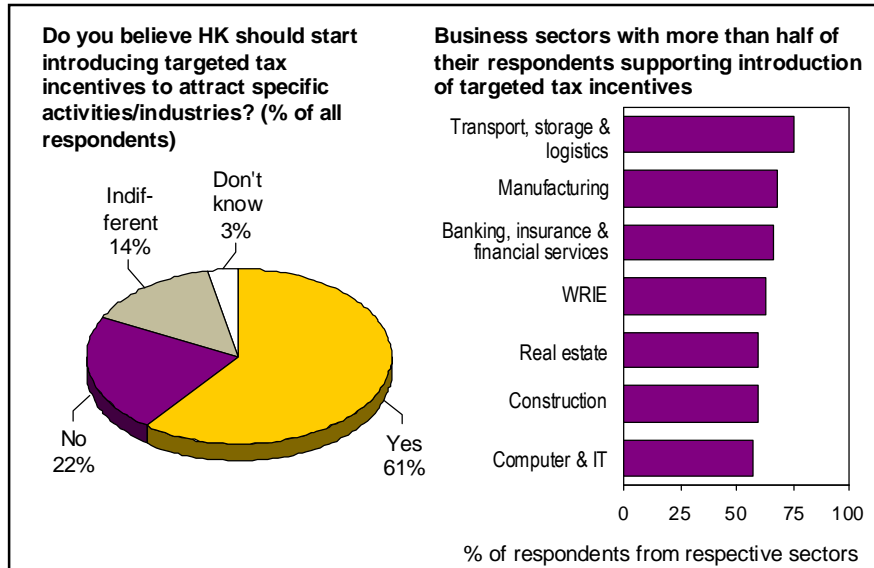
- At present, HK only has 4 comprehensive double tax treaties (“DTAs”) with Belgium, Thailand, Mainland China and Luxembourg.
- When asked whether HK should enter into more DTAs with other jurisdictions, 55% said yes, while only 9% thought otherwise.
- 25% of those respondents who supported more DTAs did not specify any jurisdiction when asked which ones HK should approach. Among those who had views, UK, US, Singapore, Australia and Macao were cited by most as jurisdictions with which HK should enter into a DTA.
- On the issue of exchange of information (“EoI”), the survey respondents did not seem to have a strong opinion on the need for a change in HK’s legislation to enable HK to enter into more DTAs, with 39% of the respondents answered “indifferent” or “don’t know”, 36% answered “yes”, while another 25% believed HK should not change its legislation. Among those who favoured more DTAs, however, more than half (54%) supported a change in legislation to enable HK to enter into more DTAs.

Group Loss Relief and Loss Carry-back



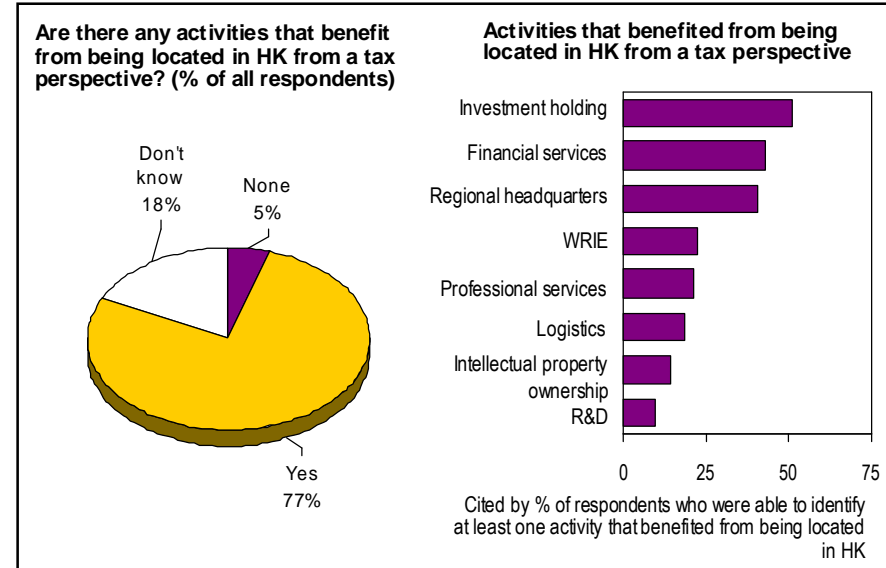
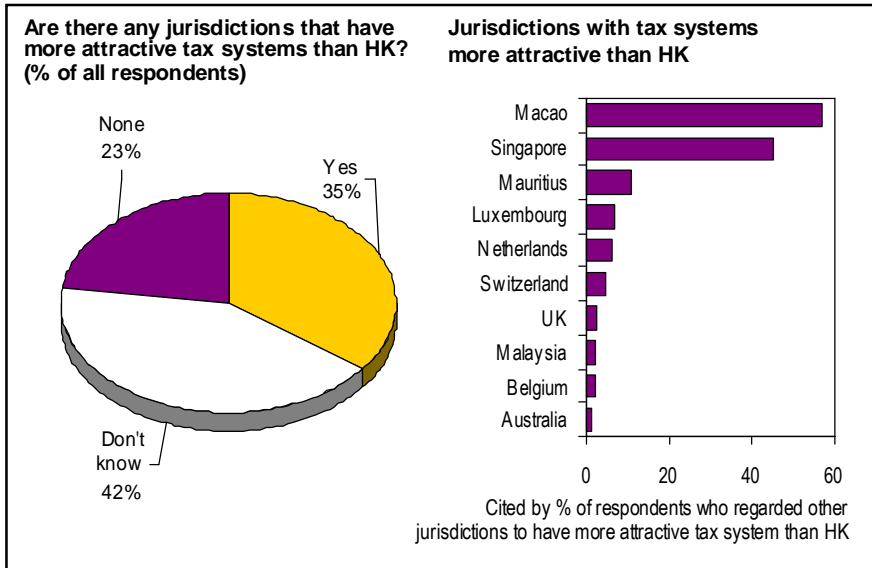
- At present, a tax loss incurred by a company can be carried forward indefinitely and set off against the same company's future assessable profits until fully utilised. However, tax losses cannot be carried back or transferred between group companies.
- When asked about whether HK should allow group loss relief so that tax losses of a group company can be used to set off against assessable profits of another company in the same group, a substantial 59% of the survey respondents supported the idea.
- Meanwhile, a similar percentage of the survey respondents (57%) agreed that HK should allow loss carry-back so that tax losses can be set off against assessable profits of prior years resulting in tax refunds. 52% of these respondents thought the loss carry-back should apply for a 3-year period, while 29% thought it should extend beyond 3 years.
- Among the respondents who supported the extension of loss carry-back beyond 3 years, most preferred a 5-year period (10% of respondents who supported loss carry-back), followed by 7-year (6%). 2% even thought the carry-back should apply for as many years as needed to fully offset the loss.

Targeted Tax Incentives and Tax Deductions



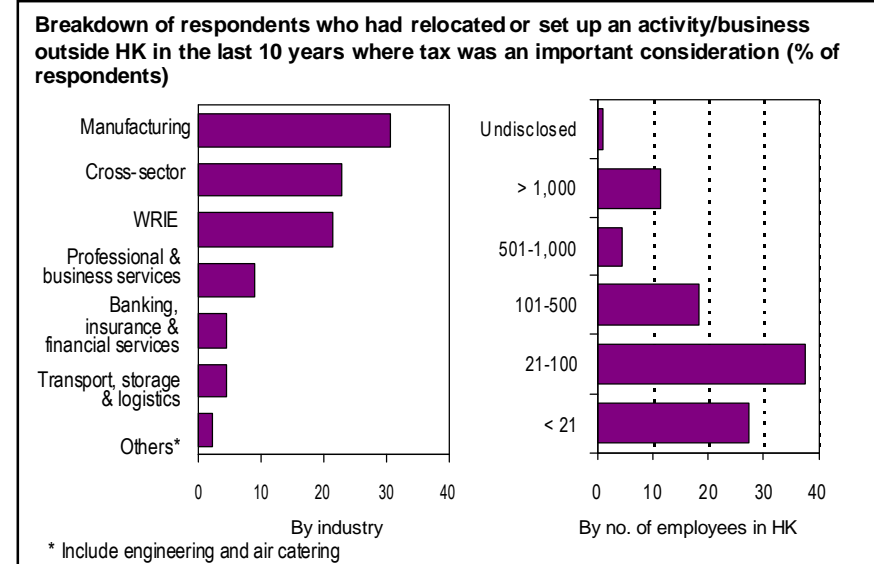
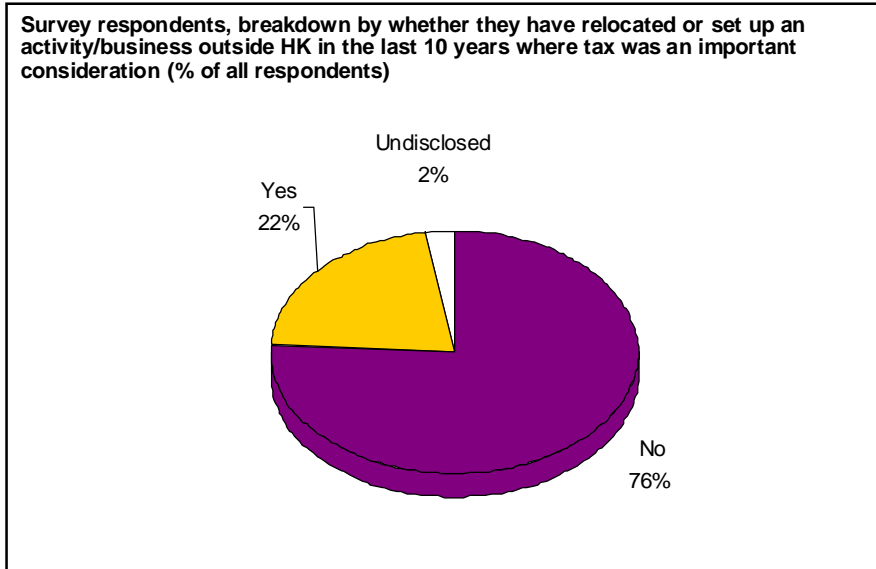
- More than half of the respondents (61%) believed HK should start introducing targeted tax incentives to attract specific activities/industries, while only 22% countered this view. This is in contrast to the ranking of important factors for a tax system to be favourable to business where only 4% of the respondents gave the top ranking to “targeted incentives”.
- Among the business sectors, “transport, storage and logistics” had the strongest opinion on the need for tax incentives, (75% of their respondents). This was followed by “manufacturing”, “banking, insurance and financial services”, Wholesale and retail, import and export trade (“WRIE”), “real estate” and “construction”, all of which had 60% of their respondents supporting the introduction of tax incentives.
- Unlike the strong opinion they had on the need for targeted tax incentives, the survey respondents appeared to be less sure on whether they wanted more tax deductions. When asked whether they thought HK offered enough tax deductions for expenses such as for trademark, R&D and financing, 41% of the respondents answered “indifferent” or “don’t know”, while another 23% believed HK already offered enough tax deductions for these expenses.
- Companies engaged in more than one form of business had the strongest opinion on the need for more tax deductions, with 45% of their respondents considering the currently available deductions to be insufficient.

Attractiveness of HK's Tax System Relative to Other Jurisdictions



- No strong opinion among the respondents on the attractiveness of HK's tax system relative to other jurisdictions. When asked which jurisdiction has a more attractive tax system than HK, 23% said "none" and another 42% said they "don't know". Only 35% regarded other jurisdictions as having a more attractive tax system than HK. Among them, Macao was cited by most (57%) followed by Singapore (45%).
- Jurisdictions not listed in the survey questionnaire but were cited by respondents as having a more attractive tax system than HK include offshore tax havens such as the British Virgin Islands ("BVI"), the Cayman Island, Isle of Man, Mainland China which gives preferential tax treatment to manufacturers, and Qatar, UAE where no profits/Salaries Tax is levied.
- There seemed to be a stronger consensus among the respondents that HK still had an edge in attracting a host of activities to HK from a tax perspective. 77% identified at least one activity that benefited from being located in HK relative to another jurisdiction. Among the activities cited, "investment holding" was seen by most (51%) as the activity that benefited from being located in HK, followed by "financial services" (43%) and "regional headquarters" (41%).

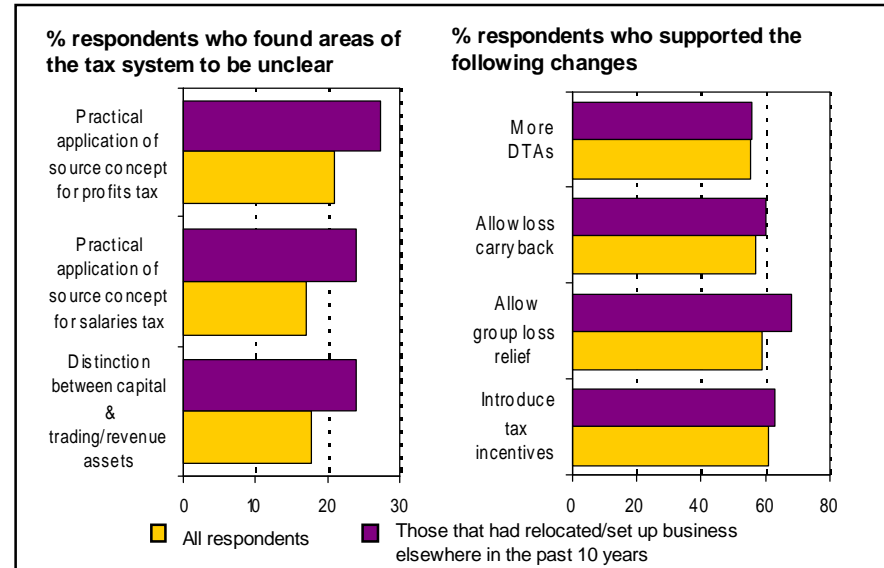
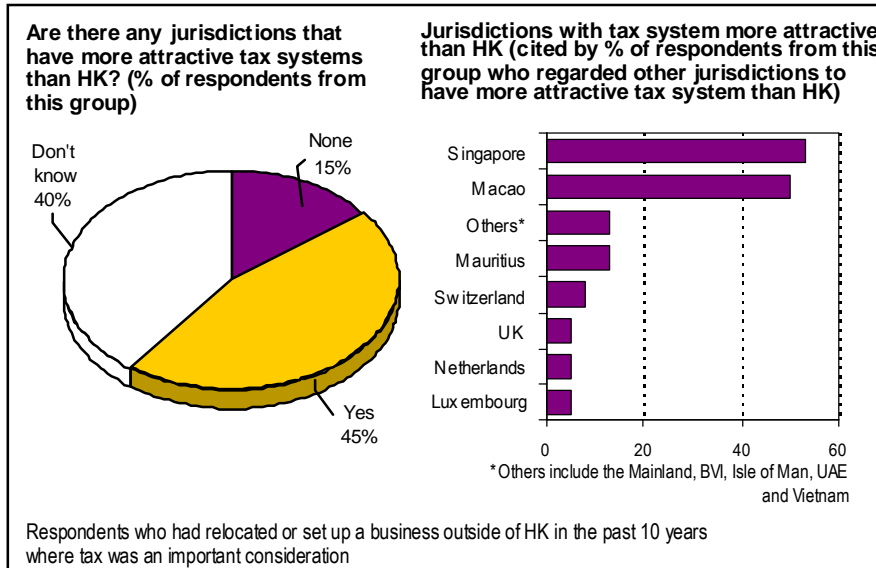
Locating Business outside HK due to Tax Considerations



- Of the survey respondents, 22% indicated they had relocated or set up an activity/business outside HK in the past 10 years where tax was an important consideration. Among them, 31% were engaged in “manufacturing”, 23% in activities involving more than one business sector and 22% in Wholesale and retail, import and export trade (“WRIE”).
- In terms of business scale, 11% of the respondents which had relocated or set up another business elsewhere in the past 10 years were large companies with more than 1,000 employees in HK, 5% were companies with between 500-1,000 employees and the remainder 84% employed less than 500 people.
- 23 out of the 88 respondents who indicated they had relocated or set up an activity/business outside HK in the past 10 years disclosed where they relocated or set up the new business. 14 relocated or set up another business in China to enjoy the preferential tax treatment offered by the Mainland on manufacturing enterprises (tax exempt on the first 2 years and lower tax rate on the 3rd-5th years); 4 set up in Macao, 2 in Dubai, 2 in British Virgin Islands (“BVI”), 1 in Singapore and 1 in UK.
- Views of those who have relocated or set up another business outside HK in the past 10 years on the key factors for a tax system to be favourable to business was consistent with the general surveyed sample, with “low tax rate” deemed as most important, followed by “clear tax laws” and “certainty in the practical application of the laws”.

Appendix: Business Survey Results

45% of Those Relocated Found Other Jurisdictions as Having a More Attractive Tax System than HK



- Among the respondents who had relocated or set up a business outside HK in the past 10 years where tax was an important consideration, there seemed to be a stronger opinion on the attractiveness of HK's tax system relative to other jurisdictions. 45% of these respondents found other jurisdictions as having a more attractive tax system, compared to only 35% for the general surveyed sample. Among the jurisdictions cited by this group of respondents, Singapore was seen by most to have a more attractive tax system, closely followed by Macao. In the general surveyed sample, Singapore was second to Macao.
- Compared with the general surveyed sample, a higher percentage of the respondents who had relocated or set up another business activity elsewhere in the past 10 years indicated the practical application of the source concept for profits and Salaries Tax, as well as the distinction between capital assets and trading/revenue assets to be unclear.
- A higher percentage of the respondents from this group also thought HK should introduce targeted tax incentives, allow group loss relief & loss carry-back, and enter into more double tax treaties ("DTAs"). However, compared with the general surveyed sample, a lower percentage of respondents from this group supported a change in legislation to accommodate exchange of information ("EoI") obligations to enable HK to enter into more DTAs.

Glossary

Glossary

Under **contract processing**, legal title of the imported raw materials remains with the HK company while the PRC factory charges a processing fee for the processing services.

The Inland Revenue Department (IRD) publishes a series of **Departmental Interpretation and Practice Notes (“DIPNs”)** setting out the Department’s interpretation and practices in relation to the tax laws.

A **double tax treaty (“DTA”)** is a bilateral agreement between two jurisdictions primarily to deal with the issue of double taxation.

An **exchange of information (“Eol”)** clause in a DTA sets out the terms on which the contracting parties may pass information to each other.

Group consolidation regime is a comprehensive system for taxing corporate groups. Broadly, corporate group entities are treated as a single economic unit and the taxable income and loss of member entities are considered together in order to determine the group’s overall tax position.

Group loss transfer regime allows unutilised tax losses of one group company to be transferred to and set off against the taxable income of another company within the same corporate group.

HK Financial Reporting Standards (“HKFRS”) adopts and incorporates the International Financial Reporting Standards (“IFRS”).

In **import processing** arrangements, legal title of the imported raw materials is transferred from the HK company to the PRC factory and the legal documents indicate a sale of the raw materials. On completion of processing, the PRC factory will sell the finished goods back to the HK company.

Intellectual property (“IP”) refers to property rights in creations of the mind, such as inventions, industrial designs, literary and artistic works, symbols, and names and images

International Financial Reporting Standards (“IFRS”) are set by an independent body, the International Accounting Standards Board (IASB), and they are already widely adopted by the world’s leading capital markets.

Loss carry-back allows tax losses in the current year to be carried back to offset assessable profits in an earlier year resulting in a refund of the tax paid in the earlier year.

A **“participation exemption”** style regime would be a blanket exemption from HK Profits Tax that could be applied in relation to the disposal of shares provided that certain conditions are fulfilled.

Glossary (cont'd)

Reinvoicing refer to arrangements wherein a HK company, as a member of a group and pursuant to group directive, carries out restricted administrative activities (which do not include the acceptance or issue of sale or purchase orders in or from HK) relating to trading transactions and “books” the profits in HK.

Royalty income arises from the acquisition or self-creation of intellectual property rights and the subsequent exploitation of those rights through licensing.

HK Profits Tax operates a **source concept** so that only profits arising or derived from HK, from a trade, business or profession carried on in HK, are liable to Profits Tax.

Time-bar period refers to the period of time within which the IRD can raise assessments. Currently, the IRD can raise assessments at any time within six years from the end of the year of assessment.

Transfer price is the value at which transactions are conducted amongst group companies.