Measures to Improve the Competitiveness of Hong Kong Taxation System in the Aftermath of the Recent Crisis

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Abstract

This paper addresses key tax issues and suggests measures to improve the competitiveness of the Hong Kong taxation system. With the enactment of new legislation, Hong Kong is now able to adopt the latest internationally agreed standard of exchange of information by concluding comprehensive double taxation agreements with its trading partners. The expanded treaty network provides added clarity and certainty to the allocation of taxing rights and the tax treatment for international transactions. To broaden the current narrow tax base, we suggest the following measures: introduce a land-related taxation, modify the scope of charge in profits tax, promulgate detailed statutory source-of-profits rules, and implement a mini capital gains tax. By so doing, the Hong Kong government revenue will be less susceptible to economic cycles, and tax efficiency will be enhanced as most controversial tax dispute areas will have been removed.

Keywords: Exchange of information, Comprehensive double taxation agreements, Tax base, Territorial source, Capital gains tax

1. Introduction

This paper addresses key tax issues and suggests measures to improve the competitiveness of the Hong Kong taxation system in the aftermath of the 2007-2009 economic crisis. With the enactment of new legislation in 2010, Hong Kong is now able to adopt the latest internationally agreed standard of exchange of information by concluding comprehensive double taxation agreements (CDTAs) with its trading partners. The expanded treaty network in Hong Kong provides added clarity and certainty to the allocation of taxing rights and the tax treatment for international transactions. To broaden the current narrow tax base, we suggest the following measures: introduce a land-related taxation, modify the scope of charge in profits tax, promulgate detailed statutory source-of-profits rules, and implement a mini capital gains tax. By so doing, the Hong Kong government revenue will be less susceptible to economic cycles, and tax efficiency will be enhanced as most controversial tax dispute areas will have been removed. The following sections discuss the rationale for our observations and suggestions.

2. Expand Treaty Network

Double taxation arises when the same item of income or profit is subject to tax in more than one tax jurisdictions because these jurisdictions overlap. Hong Kong residents generally do not suffer from double taxation. Under the source basis of taxation, income/profit sourced in Hong Kong is subject to tax, and that derived from a source outside Hong Kong is generally not taxed. In addition, non-Hong Kong residents operating businesses in Hong Kong do not generally suffer from double taxation problems. There are two reasons for this. First, many jurisdictions that tax their residents on a worldwide basis often provide their residents operating businesses in Hong Kong with unilateral tax credit relief for any Hong Kong tax paid on income/profit derived from Hong Kong. Second, the Hong Kong Inland Revenue Department (IRD) allows a deduction for foreign tax paid on a turnover basis in respect of an income that is also subject to tax in Hong Kong. There are, however, merits for Hong Kong to

conclude CDTAs with its trading partners. A CDTA provides certainty to investors on the taxing rights of the contracting parties, helps investors to better assess their potential tax liabilities on economic activities and provides an added incentive for non-resident companies to do business in Hong Kong and for Hong Kong companies to do business overseas (Note 1).

Since the handover of sovereignty in 1997, Hong Kong has signed CDTAs with Belgium in 2003, Thailand in 2005, mainland China in 2006 (Note 2), Luxembourg in 2007 and Vietnam in 2008. Compared with Singapore, Japan and Thailand, which have entered into more than 50 tax treaties each, the Hong Kong treaty network is extremely limited. More importantly, all these five pre-2010 CDTAs have only adopted the restrictive exchange of information (EoI) clause that is based on the 1995 Organization for Economic Co-operation and Development (OECD) standard. It has been argued that the pre-2010 CDTA negotiation processes with other jurisdictions have been delayed mainly because Hong Kong does not adopt the more liberal 2004 OECD EoI clause (Note 3). With the passing of the Inland Revenue (Amendment) Ordinance 2010 and the Inland Revenue (Disclosure of Information) Rules in March 2010, the major negotiation hurdle of adopting a more liberal EoI clause has been resolved. Since then, Hong Kong has proceeded quickly to expand and update its treaty network as swiftly as possible, with a total of seventeen CDTAs concluded (2 CDTAs and 13 CDTAs are newly signed in 2011 and 2010 respectively, and 2 existing CDTAs are upgraded to new standard) at the time of writing. All these seventeen CDTAs have adopted the 2004 OECD model EoI article, with certain modifications providing additional safeguards against abuse of the article. Not only will it promote more inbound and outbound investments, an expanded tax treaty network in Hong Kong will enhance the existing tax system in terms of clarity, certainty and consistency for strengthening its competitive edge.

3. Broaden Tax Base

Hong Kong has a narrow tax base. It is a source-based jurisdiction where only Hong Kong source income/profit is subject to tax. It does not impose taxes on capital gains and dividends. It has no goods and services tax (GST) or value added tax (VAT). The main source of government revenue is from profits tax, salaries tax, stamp duty, land selling and reserve investment. In addition, the International Monetary Fund (IMF) has stated that "Hong Kong SAR has one of the lowest overall tax burdens in the world and its tax base is remarkably narrow by any standard. Indeed, it is the only territory in the Asian and Pacific region that does not have some form of a broad-based tax on consumption" (Advisory Committee, 2001).

We agree that the Hong Kong tax base is too narrow and volatile, and it must be broadened so that Hong Kong government revenue is less susceptible to economic cycles. Although the GST may be a good broad-based tax to broaden the Hong Kong tax base in the long run, we suggest the introduction of land-related taxation during the transitional period. We consider that the land-related taxation is equivalent to a broad-based tax because there has been a heavy reliance by the Hong Kong government on revenue producing through land sales and related transactions (Note 4). In addition, a land-related taxation can help to control the somewhat overheated immovable property market in Hong Kong.

3.1 Modify the Scope of Charge in Profits Tax

The tax structure of Hong Kong is relatively straightforward, and there are three distinct and separate headings under which tax is levied: property tax, salaries tax and profits tax. Profits tax is charged on every person who is carrying on a trade, profession or business in Hong Kong in respect of his assessable profits *arising in or derived from Hong Kong* from such trade, profession or business [section 14(1) of the Inland Revenue Ordinance (IRO)]. Hence, the fact that a taxpayer has carried on business in Hong Kong does not automatically mean that the profits from the business were 'profits arising in or derived from Hong Kong'. The source of profits is not always identical to the place where the business is carried on. In general, there is no distinction between resident and non-resident persons for Hong Kong tax purposes.

If a person can arrange his business operations outside Hong Kong, it is possible that the profit is sourced outside Hong Kong and is exempt from Hong Kong profits tax. Whether a profit is sourced in or outside Hong Kong is a question of facts. Each case is determined on its own merits and different rules are applicable to different types of business.

3.1.1 Profits 'Arising in or Derived from Hong Kong'

The only statutory definition of 'profits arising in or derived from Hong Kong' is in section 2(1) of the IRO. It states that 'profits arising in or derived from Hong Kong' includes all profits from business transacted in Hong Kong, whether directly or through an agent. Determining the source of profits has been one of the most contentious issues in Hong Kong because source is an easy concept to understand, but difficult to apply in practice. There are a growing number of disputes in this area, and the source of profits is largely ascertained in accordance with case law

principles. The broad guiding principle for determining the source of a taxpayer's profit is that 'one looks to see what the taxpayer has done to earn the profit in question and where he has done it'. This principle originated in the decisions of the Privy Council in *Hang Seng Bank* (1990) and was expanded in the *TVBI* (1992) to mean that 'one was to ascertain what were the operations which produced the relevant profits and where those operations took place'. However, it is not always easy to apply the broad guiding principle in solving disputes between taxpayers and the IRD. It appears that subsequent cases (e.g. *Orion Caribbean* (1997) and *ING Baring* (2007) have looked increasingly to a wider range of activities or even the whole operations of a taxpayer's business to identify the source of the taxpayer's profits. The question of profit source remains contentious and uncertain.

3.1.2 Principles on Which Locality of Profits Is Determined

After the first version of Departmental Interpretation and Practice Note No. 21 (DIPN 21) was released in 1992, the IRD revised its practice note in 1996 and 1998. The 2009 version was the fourth revision to incorporate the legal principles established in court cases handed down since 1998. Compared to the 1998 version, the DIPN 21 (Revised 2009) suggests that the IRD is taking a more strict and restrictive approach when determining the source of profits (RSM Nelson Wheeler Tax Advisory Limited, 2010). In addition, the IRD's interpretation of the legal principles established in the recent court cases seems to be somewhat selective and imbalanced (PricewaterhouseCoopers, 2010a). As the DIPN 21 (Revised 2009) only provides a guideline and has no legal binding effect, the source of profits will inevitably continue to be a major area of uncertainty to taxpayers (PricewaterhouseCoopers, 2010a).

3.1.3 "Residence" Basis of Taxation v. Detailed Statutory Source Rules

To minimise the disputes on source of profits, the Hong Kong profits tax regime can be changed from territorial taxation to taxation of profits from all sources by persons carrying on a trade, profession or business in Hong Kong. This is similar to adopt "residence" as the basis of taxing profits from all sources. If such a "residence" basis of taxation is adopted in Hong Kong, a unilateral tax relief can be made available to exclude the profits attributable to an overseas permanent establishment of a Hong Kong resident company from the charge of tax. However, the "residence" basis of taxation may overly complicate Hong Kong's renowned simple and efficient tax system and make Hong Kong less competitive and attractive internationally. Since no tax system is purely "source" or "residence" based, we suggest that the unclear or arbitrary problems on the current source rules may be better addressed by enacting detailed statutory source rules.

4. Capital Gains Tax

Capital gains tax is levied on the profit or gain made from the disposal or sale of a capital asset. Unlike most other countries, Hong Kong does not impose a capital gains tax.

4.1 Trading or Not

Profits tax is charged on every person who is carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong from such trade, profession or business. *Profits arising from the sale of capital assets* are excluded from the charge (section 14(1) of the IRO). The terms 'capital' and 'capital asset' are not defined in the IRO. However, there is a significant body of case law concerned with whether a taxpayer's profits are exempt from profits tax. If a person can prove to the satisfaction of a tax assessor that he does not carry on a trade or business in Hong Kong, or the gain made from the sale of an asset is of a capital nature rather than a trading nature, such income is exempt from Hong Kong profits tax.

4.2 Revenue versus Capital Receipts

Profits tax is usually levied only on 'revenue profits' and not income of a capital nature. As a general rule, the commonly accepted accounting principles would be applied in drawing a distinction between revenue and capital receipts, but in many cases it is an extremely thin line and there are no hard and fast rules. Whether an asset is a capital asset is a question of facts and the six badges of trade are often employed for the determination of a capital asset or a trading stock. Among Hong Kong tax disputes, trading-versus-investment cases are common and are regularly the subject of appeal cases. Two typical instances in which these disputes occur involve the buying and selling of shares and immovable property.

The Commissioner of Inland Revenue (CIR) does apply the badges of trade to determine whether a person trades in shares and immovable property. Yet, in the case of *individuals* buying and selling shares, the benchmarks concerning the level of organisation, system and frequency of transactions are so high that a finding for a person who has carried on a trade (or business) is rare (Note 5). One of the reasons the IRD has not aggressively sought to tax share trading gains is the impact of revenue losses when the markets turn.

4.3 Mini Capital Gains Tax

Due to the recovery and booming of the shares and immovable property markets in Hong Kong, we can expect the

argument on trading-versus-investment cases to intensify as it is still one of the problematic issues in Hong Kong revenue law. To maintain an efficient tax system and broaden its tax base, the Hong Kong profits tax charge could be amended to include capital receipts as taxable income. Alternatively, Hong Kong could implement a separate capital gains tax at a relatively low rate (say 10%) that covers all taxpayers. However, the capital gains tax might overly complicate or make less attractive Hong Kong's simple taxation system. To this end, we suggest that a mini capital gains tax which targets at short swing sales of key items of property (such as residential immovable property). The mini capital gains tax compares well with the Special Stamp Duty on resale of residential immovable property which was proposed by the Financial Secretary in November 2010. This will contribute to income re-distribution, narrow the gap between the rich and the poor and lessen the bubble effect in the markets of key property items in Hong Kong.

5. Conclusion

The expanded treaty network in Hong Kong provides added clarity and certainty to the allocation of taxing rights and the tax treatment for international transactions (PricewaterhouseCoopers, 2010b). Specifically, the treaty network with major economies would help reduce tax burdens on individuals and enterprises, and would eliminate uncertainties over tax liabilities (Inland Revenue Department, 2010). Together with Hong Kong's existing competitive edge (e.g., being one of the freest economies in the world, having a quality workforce and respected legal system, and its proximity to mainland China), Hong Kong will become an attractive gateway for foreign investors in the contracting states with which Hong Kong has concluded CDTAs because they may take advantage of the available treaty benefits (PricewaterhouseCoopers, 2010b). The expanded treaty network improves the business environment and facilitates flows of investment and individuals between Hong Kong and other economies, which in turn enhances the Hong Kong's position as an international business and financial centre (Inland Revenue Department, 2010).

It is generally agreed that the Hong Kong tax base is too narrow and volatile, and it must be broadened. Our suggestions are to introduce a land-related taxation, to enact detailed statutory source of profits rules, and to introduce a mini capital gains tax. By so doing, the Hong Kong government revenue will be less susceptible to economic cycles, and tax efficiency will be enhanced as some controversial tax dispute areas will have been removed.

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Notes

Note 1. Adapted from Hong Kong IRD's discussion of double taxation. Available at: http://www.ird.gov.hk/eng/pol/dta.htm (Accessed on 2 March 2012).

Note 2. A "mini" CDTA between Hong Kong and mainland China was signed in 1998. The scope of the 2006 CDTA is wider than that of 1998 and covers passive income such as dividends, interest, royalties and capital gains.

Note 3. For discussion on the reasons for Hong Kong's failure to meet the OECD's February 2010 deadline to substantially implement a liberalised tax information exchange regime, see Pheny, M. and Wong, P. W. Y. (2010), 'Why was Hong Kong unable to substantially implement tax information exchange in time?', *International Tax Journal*, 36(5), September – October, pages 71 -80.

Note 4. See the work of Cullen, R. and Krever, T. (2005), Taxation and Democracy in Hong Kong, Civic Exchange. Also the work of Littlewood, M. (2010), Taxation Without Representation: The History of Hong Kong's Troublingly Successfully Tax System, Hong Kong University Press, Hong Kong.

Note 5. See, for example, *Lee Yee Shing v CIR* (2008) 3HKLRD 51; FACV 14/2007 (January 2008) and *CIR v Chang Liang-jen* (1977) 1 HKTC 975 where the purchase and sale of many parcels of shares over a period of several years was held not to be trading but rather speculative (or gambling) transactions (in *Lee Yee Shing*) or turning over an investment portfolio (in *Chang*).