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11 August 2005

Clerk to LegCo Panel on Financial Affairs
Legislative Council
3/F, Citibank Tower
3 Garden Road
Central
Hong Kong
(Attn : Ms Connie Szeto)

Dear Ms Szeto,

Review of the Inland Revenue Ordinance (IRO)

I refer to the referrals by the FA Panel in May on the captioned subject and would like to provide in the attached the Administration's response to the views stated therein.

The submissions in question raise specific matters that either advocate tax relief, or concern the interpretation of the Inland Revenue Ordinance (IRO), the administrative practices of the Inland Revenue Department (IRD), or the consultation mechanism on taxation matters.

We have, in conjunction with IRD, reviewed these issues. As for the tax relief proposals, we will review these with the Financial Secretary in preparing next year's Budget. As for the issues that involve the interpretation of the IRO and IRD's administrative practices, JLCT and IRD are working together (mostly at the sub-committee level) to conduct in-depth reviews on these as appropriate. We believe that most of such issues have been or could be dealt with through the issuance of new (or the revision and/or updating of existing) Departmental Interpretation and Practice Notes (DIPNs). We will continue the co-operative efforts of the Administration and JLCT on these issues. Separately, on the consultation mechanism for taxation matters, the Administration has stated its position to the Legislative Council in an earlier motion debate that, while we do not consider it appropriate to set up a new, statutory committee on

taxation matters, we will continue to expand our liaison and consultation network with the objective of ensuring that we accurately and adequately gauge the views of various sectors, as well as the wider community, on taxation matters. Lastly, deputations have raised certain issues but no details are given. IRD will approach these organisations to better understand the problems that the concerned parties are encountering with a view to finding satisfactory solutions.

We have forwarded the submissions to JLCT together with explanations on the rationale for the policies and practices concerned. We will keep the FA Panel informed of any substantial comments from JLCT.

Your sincerely,

(Original signed)

(M M Glass)

for Secretary for Financial Services and the Treasury

Specific issues raised in the submissions

A. Issues also raised in Hon Tam Heung-man's letter of 28 October 2004 to FA Panel

	Issues and comments raised	Administration's views
1.	<p>The quantum of administrative penalty under section 82A is somewhat arbitrary. (Aaron Wong)</p> <p>Application of the penalty policy under section 82A could be improved. (HKICPA)</p>	<ul style="list-style-type: none"> ◆ IRD's penalty policy is transparent and well publicized. The quantum of penalty is subject to appeal.
2.	<p>Implementation of section 61A should be improved. (HKICPA)</p>	<ul style="list-style-type: none"> ◆ Section 61A itself stipulates an objective way of invoking the section. Seven objective matters have to be considered. ◆ IRD has issued guidelines and DIPN on its views on the implementation of the section ◆ Taxpayers can apply for advance ruling in respect of the application of section 61A to contemplated transactions. Indeed, the application of section 61A is frequently an issue on which ruling is sought.
3.	<p>Introduce loss-carry back provisions. (HKICPA)</p>	<ul style="list-style-type: none"> ◆ Carry forward of tax losses for an indefinite period already allowed ◆ The proposal would have significant impact on tax revenue collection and on the balance of the Government's fiscal accounts.

		<ul style="list-style-type: none"> ◆ This is a tax relief proposal which will be considered by the Financial Secretary in the annual Budget exercise.
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B. Tax relief/new tax proposals

	Issues and comments raised	Administration's views
4.	Exempt income from all corporate bonds (British Chamber)	<ul style="list-style-type: none"> ◆ These are tax relief proposals which will be considered by the Financial Secretary in the annual Budget exercise.
5.	Clarify/Relax deductibility restrictions on interest paid to overseas associates (section 16 of the IRO) (British Chamber)	<ul style="list-style-type: none"> ◆ Same as above.
6.	Decrease personal allowances (British Chamber)	<ul style="list-style-type: none"> ◆ Same as above.
7.	Increase deductions for home loan interest (British Chamber)	<ul style="list-style-type: none"> ◆ Same as above.
8.	Write off for more tourism industry related refurbishments (British Chamber)	<ul style="list-style-type: none"> ◆ Same as above.
9.	Introduce Group Tax Loss Relief (British Chamber, HKICPA and Deverall)	<ul style="list-style-type: none"> ◆ Same as above.

	Issues and comments raised	Administration's views
10.	Give incentives for Global Trading Operations (British Chamber)	◆ Same as above.
11.	Give tax incentives for high value add industries, e.g. E-business, R&D (British Chamber)	◆ Same as above.
12.	Relax ability to claim partnership losses (British Chamber)	◆ Same as above.
13.	Introduce Polluter Pays taxes. (British Chamber)	◆ This is a proposal for new tax which will be considered by the Financial Secretary in the annual Budget exercise.

C. Issues involving interpretation of the Inland Revenue Ordinance and IRD's administrative practices

	Issues and comments raised	Administration's views
14.	Clarify source of profits rules. (HKICPA and Deverall) There should be a statutory definition of source. (British Chamber) Want to see source rules codified. (TIHK) The Hong Kong tax ordinances are drafted in such a way either	◆ The territorial source of profits is a hard, practical matter of fact and there are bound to be disputes, especially in this age of ever changing business environment. ◆ The IRD has all along adopted the operation test as upheld in case law. ◆ Case law has ruled that apportionment is permissible under certain

	Issues and comments raised	Administration's views
	<p>the profit is arising in or derived from Hong Kong offering no room for apportionment. (Dickson Wong)</p> <p>Clarify 50% exemption for manufacturing subcontracted to PRC (exemption not in the IRO but given in practice), and to which structures this will apply. (British Chamber and HKICPA)</p>	<p>circumstances.</p> <ul style="list-style-type: none"> ◆ IRD is reviewing DIPN No. 21 on “Locality of Profits” with a view to providing more guidelines for taxpayers and practitioners. ◆ The industry will be consulted on the revised DIPN in due course.
15.	<p>The concept of “onshore” and “offshore” is now quite obscure. Recent case decisions seem to import the concept of “central management and control”. If such concept is applied and extended then Hong Kong companies will be taxed on “worldwide” income. (Dickson Wong)</p>	<ul style="list-style-type: none"> ◆ The territorial source of a profit is a practical, hard matter of fact that frequently gives rise to controversy. ◆ The concept of “central management and control” is relevant in determining whether a person is a non-resident. ◆ This is nothing to do with taxing “worldwide” income. Hong Kong taxes only profits derived from Hong Kong.
16.	<p>Clarify foreign employment rules. (British Chamber and HKICPA)</p>	<ul style="list-style-type: none"> ◆ According to case law, the location of an employment has to be decided by considering the totality of facts. ◆ IRD generally considers a number of factors in determining the charge to salaries tax, as explained in DIPN No. 10. ◆ IRD is reviewing the DIPN in the light of recent experience and Board of Review decisions.

	Issues and comments raised	Administration's views
		<ul style="list-style-type: none"> ◆ The industry will be consulted on the revised DIPN in due course.
17.	Salaries tax liabilities of employees seconded to work in PRC. (British Chamber and Deverall)	<ul style="list-style-type: none"> ◆ When the Arrangement with the Mainland was concluded in 1998, IRD issued DIPN No. 32 in June 1998 to explain the Arrangement. Two information pamphlets on the subject, including one entitled "Guide for Personal Services" were also published in October 1998. Another information pamphlet that addresses the particular subject of "Hong Kong residents working across the Mainland border" and reflects the issues agreed with the Mainland as of December 2003 was also released on the IRD website. The pamphlet has been revised in July 2005 and updated on the IRD website and reprinted.
18.	Definitions of a capital gain/other items exempt from tax (section 26A of the IRO). (British Chamber)	<ul style="list-style-type: none"> ◆ There is a wealth of decided cases on the issue of capital gains. ◆ Income exempt under section 26A is clearly defined thereunder. There has so far been no significant dispute.
19.	The wording of section 14(1) should be expanded to cover "profits of a capital nature". (Deverall)	<ul style="list-style-type: none"> ◆ Profits of a capital nature are always accepted as not taxable. There has never been any dispute.
20.	Clarify treatment of Agents of overseas persons (sections 20A and 20AA of the IRO). (British Chamber)	<ul style="list-style-type: none"> ◆ Revised DIPNs (No. 17 on "The taxation of persons chargeable to profits tax on behalf of non-residents" and No. 30 on "Profits Tax: Section 20AA Persons not treated as agents") have been issued (in

	Issues and comments raised	Administration's views
		January 2005 and August 1998 respectively) to specifically address these issues.
21.	Clarify taxation of trusts. (British Chamber and Deverall)	<ul style="list-style-type: none"> ◆ Case law has established the principle that in a trading trust the trustee is liable to profits tax. Only in cases where the trustee is simply a nominee of the beneficiary will the beneficiary be charged to profits tax in respect of the profits made by the trust business. The law in this regard has been settled and there seems to be little lingering doubt on the person liable.
22.	Clarify tax on the exercise of stock options. (British Chamber and Deverall)	<ul style="list-style-type: none"> ◆ Revised DIPN No. 38 “Employee share option benefits”, which was issued recently in March 2005, clarifies this point.
23.	Application of the Secan case, i.e. when is expenditure deductible (British Chamber), measurement of profits and timing of assessment of income (HKICPA and Deverall).	<ul style="list-style-type: none"> ◆ Secan has clarified the law regarding the importance of accounting practices on computation of taxable profits. ◆ On timing of deduction of expenses, DIPN No. 40 has been issued on prepaid revenue expenses. ◆ On measurement of profits and timing of assessment, HKICPA has seen and been consulted on the draft DIPN No. 39 on financial instruments in which the IRD has explained its stance on these issues and its views on the relevance of the Secan case.

	Issues and comments raised	Administration's views
24.	<p>Clarify calculations on Depreciation Allowances. (British Chamber)</p>	<ul style="list-style-type: none"> ◆ Revised DIPN No. 7 “Machinery and plant – depreciation allowances” was issued in August 2002. ◆ DIPN No. 2 on industrial building and commercial building allowances will be updated. ◆ The industry will be consulted on the revised DIPN in due course.
25.	<p>Re-write the part on double taxation relief under the IRO and streamline all related provisions in the IRO concerning foreign tax suffered. (TIHK)</p> <p>Deduction for foreign taxes where no credit is available, is too limited. (British Chamber)</p>	<ul style="list-style-type: none"> ◆ At present, double taxation (“DT”) relief is available where DT arrangements with other territories are concluded and in force. Relief is either by way of exempting income that has been taxed overseas or by allowing a tax credit. Those provisions are fair and adequate by international standard and are clear. ◆ The IRO does not provide for unilateral relief. Given that HK only imposes taxes on income sourced in HK, the chance of double taxation of foreign income is small. ◆ Internationally recognised taxation principle is the source country has the right to tax and relief is to be granted by the home country. If a person has been taxed in his home country on income that is sourced and thus taxed in HK, there is no reason for HK to grant relief.

	Issues and comments raised	Administration's views
		<ul style="list-style-type: none"> ◆ Exclusion of salaries income taxed elsewhere (s.8(1A)(c)) and deduction of certain overseas tax paid as expenses (s.16(1)) are other forms of relief. ◆ HKSARG is actively negotiating with major trading/investment partners on comprehensive agreement on avoidance of double taxation.
26.	Clarify the operation of section 50(5) on tax credit. (Deverall)	<ul style="list-style-type: none"> ◆ DIPN No. 32 has set out clearly the computation of tax credit.
27.	Improve Advance Tax Ruling processes. (British Chamber)'	<ul style="list-style-type: none"> ◆ DIPN No. 31 sets out details of the procedures. ◆ Some advance ruling cases of common interest have been uploaded on IRD's website.
28.	<p>Power of field audit/investigation used inappropriately under "Assess First, Audit Later"(AFAL). (Aaron Wong)</p> <p>Re-opening of prior year assessments and the application of the AFAL procedure. (HKICPA)</p>	<ul style="list-style-type: none"> ◆ Assessors have the duty to make sure that taxpayers are assessed at the proper amounts and are thus empowered under the law to review and, if necessary, to raise additional assessments within 6 years after the relevant year of assessment. This is so even before the AFAL system. ◆ IRD has clear guidelines and procedures for cases where additional assessments have to be raised because of change of opinion of the Assessor.

	Issues and comments raised	Administration's views
		<ul style="list-style-type: none"> ◆ Assessments issued by Assessors are subject to objection and appeal by taxpayers. Within certain limits, taxpayers can also re-open back year assessments (section 70A of the IRO).
29.	<p>Clarify assessment process (section 59) – whether the new AFAL approach is legal. The practice of allowing protective and additional assessments to be raised by the IRD within 6 years after the year of assessment is a cynical approach to tax collection. The time limit is much longer than those in other countries and should be reduced to say 5 years. (British Chamber)</p>	<ul style="list-style-type: none"> ◆ The IRD had obtained a legal opinion which confirmed that there is legal basis to adopt the AFAL approach. The legal authority can be found in section 59(2)(a) of the IRO which provides that where a person has furnished a return under section 51, the assessor may “accept the return and make an assessment accordingly”. ◆ The time limit of 6 years for raising original and additional assessments is prescribed under section 60 the IRO, not an administrative practice. This provision is necessary to protect public revenue. See also the Administration's views under item 28 above.
30.	<p>Publication of the assessor's manual. (HKICPA)</p>	<ul style="list-style-type: none"> ◆ This issue has been discussed with the HKICPA on various occasions and at LegCo in the context of a question on 5 January 2005. ◆ As explained before, the IRD considers that the Assessor's Manual should not be of much reference value to taxpayers or their representatives. Besides, it contains some reference to taxpayers'

	Issues and comments raised	Administration's views
		information such as reference to CIR's determinations and unreported Board of Review decisions in which taxpayers can be identified.
31.	Efforts to promote compliance by taxpayers should be enhanced. (Aaron Wong)	◆ Efforts have continuously been made to enhance compliance by taxpayers and their representatives. These include, but are not limited to, posting of advertisement in the media, publication of information through various means (paper and electronic), provision of enquiry services, conduct of seminars, holding of annual meetings with tax practitioners, etc.
32.	Simplify calculation of Salaries Taxation liabilities. Very few understand the basis for the current calculations. (British Chamber)	◆ IRD has adopted a new design for the 2004-05 salaries tax and personal assessment demand notes. The computation of tax liability is clearly explained in the new design.
33.	Clarify Transfer Pricing rules. (British Chamber and Deverall) The Government should consider whether a set of more detailed transfer pricing rules should be created which can be easily and consistently be applied. (TIHK)	◆ The IRD has explained its stance of adopting the arm's length principle. That said, the Administration welcomes views on how to make the rules more clear.

D. Other issues

	Issues and comments raised	Administration's views
34.	<p>Need to re-create a "Review Board". (British Chamber)</p> <p>Create a formal committee with a clear mandate, resources, and expertise and time to deal with the more fundamental and macro issues of the IRO. (TIHK)</p> <p>Consider that the review of the IRO conducted by the Government on a continuous basis through gathering views from various consultative channels helps serve the purposes of ensuring the IRO to be up-to-date; as such, the need for a comprehensive review is not of top priority as long as "issue specific" reviews are conducted as and when needs arise. (ACCA)</p> <p>Create a forum for the views of the professional bodies and public to be heard. (TIHK)</p> <p>The JLCT does not have a written constitution or terms of reference. It is merely an ad hoc advisory body of tax specialists and hence insufficiently representative to "police" a regular review of the IRO. It has no power or obligations to perform such a vital function. (British Chamber)</p>	<ul style="list-style-type: none"> ◆ As explained during the motion debate on 11 May 2005, it is the Administration's established practice to communicate and work closely with various sectors to see how best we can make improvements. ◆ The Administration will continue to keep various tax items under constant review and gauge views from all sectors of the public through various channels. In its annual budget exercises, the Administration will also continue to conduct extensive consultations with various sectors of the community. ◆ We will also continue to explore ways to expand the existing consultation channels and to gather views from all sectors of the community in order to improve the formulation and implementation of taxation policies. The Administration welcomes proposals and suggestions. ◆ The Administration is also receptive to suggestions to expand JLCT's membership and would discuss this issue with JLCT.

	Issues and comments raised	Administration's views
	<p>Recommend that composition of JLCT be expanded to accommodate more and different views. (ACCA)</p>	
35.	<p>Consider introducing PAYE. (British Chamber)</p> <p>No need to require taxpayers to make payment only after receiving a notice of assessment. (Aaron Wong)</p> <p>Provisional tax system is confusing (misunderstood as prepayment of tax) and should be abolished. (Aaron Wong)</p>	<p>◆ The existing assessment and collection arrangements are working efficiently and effectively. The cost of collection is also relatively low. We do not see need for a major overhaul of the arrangements.</p>
36.	<p>Simplify Personal Assessment. (British Chamber)</p>	<p>◆ More detailed views and proposals are welcome.</p>
37.	<p>Consider renumbering the articles [sections of the IRO] as a start. (British Chamber)</p> <p>Revamp the IRO into a piece of legislation which is consistently drafted and logically set out. (TIHK)</p> <p>Simplify the language used in the IRO which is difficult in many parts even for the experience tax practitioners. (TIHK)</p>	<p>◆ Tax practitioners are familiar with the current arrangement. That said, detailed and specific proposals are welcome.</p>

Deputations:

The British Chamber of Commerce in Hong Kong (“British Chamber”)

The Association of Chartered Certified Public Accountants, Hong Kong Branch (“ACCA”)

The Taxation Institute of Hong Kong (“TIHK”)

The Hong Kong Institute of Certified Public Accountants (“HKICPA”)

Mr. Lloyd Deverall (“Deverall”)

Mr. Dickson Wong

Mr. Aaron Wong