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**FINANCIAL SERVICES AND  
THE TREASURY BUREAU  
(The Treasury Branch)**

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21 January 2006

Miss Salumi Chan  
Clerk to Panel  
LegCo Panel on Financial Affairs  
Legislative Council Building  
8 Jackson Road  
Central  
Hong Kong

Dear Miss Chan,

**Review of the Inland Revenue Ordinance (IRO)**

In our letter dated 11 August 2005, we advised that the tax relief proposals raised by the deputations would be considered by the Financial Secretary when he prepares the coming Budget. We also undertook to keep the Panel on Financial Affairs informed of any substantial comments from the Joint Liaison Committee on Taxation (JLCT) on the issue of IRO review. And for issues that involve the interpretation of the IRO and the Inland Revenue Department (IRD)'s administrative practices, we advised that JLCT and IRD would continue to work together to conduct in-depth reviews as appropriate. As for certain issues raised by some deputations in insufficient detail, we indicated that IRD would approach these deputations in order to better understand the issues involved.

On the first part, the Financial Secretary is currently in the process of preparing the Budget and will thoroughly consider their suggestions.

On the second part, JLCT indicated to us that it believes that the basic structure of the IRO has served Hong Kong well and is capable of doing so for many years to come. The IRO has enabled Hong Kong to maintain a relatively simple tax system which is the envy of many other jurisdictions. JLCT is concerned that conducting a full-blown general review is an invitation to invite proposals that would have the effect of complicating Hong Kong's taxation system rather than simplifying it. For example, it is inevitable that such a review would prompt calls for a wider basis for taxation including the taxation of offshore income, capital gains, dividends and other passive investment income. Its view, therefore, is that no general review of the IRO needs to be conducted. We agree with JLCT that an overall review of the IRO would not be necessary or productive.

As for the review of specific issues, IRD has continued its close cooperation with JLCT, which has provided its views on the issues raised in the letters from Hon Mandy Tam and Mr Lloyd Deverall. It is of the view that some of the suggestions, including those on group loss relief and offsetting of partnership losses, are worth consideration. Others either require further in-depth examination, should not require any changes or are not priority issues. JLCT is of the view that there is merit in having a relatively wide-ranging review of specific issues relating to Hong Kong's existing taxation system. It believes that there are facets of the IRO and tax administration that could be improved so as to strengthen Hong Kong's tax system for the future, and an example concerns group loss relief, which is increasingly becoming a major issue of concern to the business community, according to JLCT. JLCT also pointed out that there was a perception within the business community that IRD had a tendency to change its assessing practices, suggesting that attention could also be given to issues that relate to the administrative aspects of the tax system.

JLCT has offered to work with the Administration on reviews on specific issues, both on tax policy and administration that are of major concern to the business community. In this relation, JLCT recognises that if it is to take on an active role in reviewing a wide range of specific issues, it might be required to rethink its membership criteria in order to

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be regarded as being more “representative” of the tax-paying community.  
Submissions from JLCT are enclosed (see *Annex A*).

The Administration has taken note of JLCT’s views. Though we do not share JLCT’s perception of IRD’s tendency to change its assessing practices, we will work with JLCT to undertake reviews on specific tax administration issues to improve on our tax regulations and assessing practices, with a view to further enhancing the competitiveness of Hong Kong’s tax system and administration. We also welcome JLCT’s plan to widen its representation.

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To sum up, we will continue to consider tax relief proposals regularly in the context of the annual Budget exercise. We will also continue to listen to the views of the public on taxation-related matters. We will maintain a dialogue with the industry, in particular the JLCT, and interested parties, and follow the above approach to review taxation-related issues systematically. In this regard, we have updated the table summarising the Administration’s response to the specific issues raised by deputations (see *Annex B*) taking into account the above developments and the results of IRD’s follow-up enquiries to certain deputations on the details of their proposals, for Members’ reference.

We would like to take this opportunity to thank the Panel, Hon Mandy Tam and other deputations for their views offered in respect of our taxation regime.

Yours sincerely,

( M M Glass )

for Secretary for Financial Services and the Treasury

Encls.

c.c. Chairman of JLCT (Fax no. 2842 0529)

Commissioner of Inland Revenue (Fax no: 2877 1082)

## JOINT LIAISON COMMITTEE ON TAXATION

CONSTITUENT MEMBERS: THE AMERICAN CHAMBER OF COMMERCE  
THE GENERAL CHAMBER OF COMMERCE  
THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS  
THE INTERNATIONAL FISCAL ASSOCIATION - HONG KONG BRANCH  
THE LAW SOCIETY OF HONG KONG  
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13 September 2005

Mr Martin Glass  
Assistant Secretary for Financial Services and the Treasury  
Financial Services and the Treasury Bureau  
(The Treasury Branch)  
Central Government Offices  
Lower Albert Road  
Hong Kong

Dear Martin,

**Re: Review of the Inland Revenue Ordinance**

I refer to your letter dated 2 February 2005 in which you briefed the JLCT on the Administration's position concerning the desirability of a comprehensive review being conducted of the Inland Revenue Ordinance ("IRO").

You also enclosed a copy of a letter from Mandy Tam Heung-Man to the LegCo Panel on Financial Affairs dated 28 October 2004 setting out her proposals to allow for the carrying back of tax losses, allowing double deduction of expenses for companies employing new staff members, computing commercial building and industrial building allowances by reference to the purchase price of the property rather than the cost of construction, and allowing separate assessment on husbands and wives under personal assessments.

The JLCT has since considered Ms. Tam's proposals for a comprehensive review to be conducted of the IRO, as well as her specific proposals. In this letter, we wish to relay our comments on the issue of a comprehensive review. We will write to you separately with our comments on Ms. Tam's specific proposals.

### Need for Comprehensive Review of IRO

The view of the JLCT is that no *general* review of the IRO needs to be conducted. We believe that the basic structure of the IRO has served Hong Kong well and is capable of doing so for many years to come. It has enabled Hong Kong to maintain a relatively simple tax system which is the envy of many other countries.

Although there have been previous Inland Revenue Review Committees established in Hong Kong, their terms of reference were generally quite limited and they did not conduct what could be regarded as a *general* or "from scratch" review of Hong Kong's tax system. We are concerned that conducting a full-blown general review is an invitation to invite proposals that would have the effect of complicating Hong Kong's taxation system rather than simplifying it. For example, it is inevitable that such a review would prompt calls for a wider basis for taxation including the taxation of offshore income, capital gains, dividends and other passive investment income. Although such wide forms of taxation have become the norm in other countries, Hong Kong has been blessed by being able to function without such forms of taxation.

That being said, we do believe that there is merit in having a relatively wide-ranging review of *specific* issues relating to Hong Kong's existing taxation system. In saying this, we do not suggest that Ms. Tam's specific proposals are necessarily those in respect of which reform could be considered, not that they are the only issues that require review. We believe that there are facets of the Inland Revenue Ordinance and tax administration that could be improved so as to strengthen Hong Kong's tax system for the future.

Before proceeding, we would offer a general observation that the Administration has not been, in our view, aggressive in its pursuit of taxation reform over the years. There is a perception in many quarters that the Administration has tended to react negatively to suggestions for specific tax reforms without taking into account the importance of regular reviews of technical rules and assessing practices as a means of keeping Hong Kong's tax system relevant to economic and business developments. Such a regular review of specific issues would in our view have helped to avoid the development of frustration in some quarters that ultimately has resulted in the more recent demands for a general review, as evidenced by the support that Ms. Tam's proposals have obtained. We believe that, were the Administration more flexible in considering and implementing suggestions for tax reform in specific areas on a regular basis, wide-ranging demands for a general review of Hong Kong's tax system would be less likely to curry support. A simple example (and this is only an example) concerns group loss relief which is increasingly becoming a major issue of concern to the business community.

The perceived lack of certainty in Hong Kong's taxation system is another issue that is key to the business community, yet the importance of this appears to be underrated by the Administration. It has caused concern within the business community, especially among foreign investors. A widely held perception is that the IRD – whether rightly or wrongly – has frequently changed its practices in a number of matters (eg, source of profits), but this in itself is not the main complaint our members hear. The business community can tolerate changes on a prospective basis where such changes can be budgeted for. However, the IRD's tendency is to apply its new practices to the last 6 years (as indeed it is legally entitled to do). This has resulted in hefty and unanticipated tax bills and tax disputes, and has led to companies moving operations out of Hong Kong (eg, to Macau or Europe where more favourable tax treatment is available).

Businesses require a reasonable degree of certainty with respect to their tax affairs. Until recently, Hong Kong's tax system has provided relatively predictable results, but there is a general perception that this is no longer the case. Of course, the Administration might disagree with this view, but it cannot deny that such a perception prevails in the business

community and among tax advisers. Such perceptions are often more important than the reality. It is important that steps be taken to correct such perceptions.

Thus, in identifying specific issues that deserve review, regard could be had not only to legislative issues but also issues that relate to the administrative aspects of the tax system, including the IRD's assessing practices.

Over time, new issues will emerge that will cause concern and will need to be addressed early on before disputes arise. For example, one nascent issue concerns the lack of tax amortization for capital expenditure (other than expenditure on tangible items such as plant and machinery and on buildings, as well as other isolated cases). This means that a taxpayer can be taxed on its gross income without being permitted to amortize the real costs of carrying on its business or otherwise to deduct them as expenses. The unfairness of the depreciation rules has been accentuated by the IRD recently asserting more frequently that expenditures that previously were permitted as deductions outright are really on capital account and therefore do not qualify for any tax benefit whatsoever. In view of the fact that, following the *Secan* case, there is a gradual convergence of taxation and accounting principles, we can foresee that such a situation will not be tolerated by the business community in the long term, yet unless the Administration takes the lead we would not expect this issue to be resolved without many disputes and angst. Hong Kong's tax system would be more "user-friendly" if such specific issues could be addressed and resolved early on. The fact that such issues exist emphasizes that Hong Kong's tax system is "behind the times" and that some review of specific tax issues is called for.

It is no answer to say that issues can be decided by the courts. Taxpayers do not relish litigation, which is very expensive and has an uncertain outcome. Court decisions apply to the facts of a specific case and do not provide certainty for other taxpayers whose facts invariably differ. Importantly, the courts cannot address fundamental policy issues (eg, the lack of group loss relief in Hong Kong). It is of course dangerous in any event to allow courts to dictate tax policy. Often, this can create worse problems that either cause more discontent or require legislative intervention to undo. As a practical matter, it cannot be denied that the IRD's assessing policies have an important role to play in shaping tax policy in Hong Kong, and can be adapted to meet the legitimate concerns of the taxpayer community in many cases.

In light of these observations, we believe that it would be very helpful to review specific issues relating to Hong Kong's tax system, and to monitor new issues as and when they arise. Such a review should deal with both technical tax rules and, where appropriate, the IRD's assessing procedures.

We believe that such a review should be conducted outside the Administration, but we are not convinced that a formal statutory body needs to be established for this purpose. It would be sufficient if the Administration participated in the review process in good faith in an attempt to understand what are the legitimate concerns of the IRD's users, to listen to the concerns of the IRD's users, and strove to implement changes from time to time (whether at a legislative or administrative level) to ensure that Hong Kong's tax system retains the correct balance between providing certainty and fairness to taxpayers. Needless to say, maximizing tax revenue should not be the driver for the Administration's participation in this process (and nor do we suggest that it would be). The common goal of all parties should be to achieve a

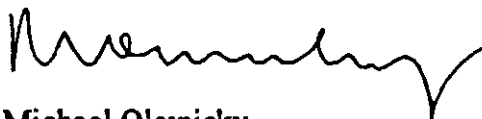
good, effective, certain, fair and balanced tax system for Hong Kong that is acceptable to all concerned.

If the Administration agrees, we offer the services of the JLCT (or of a specially constituted sub-committee of the JLCT) to act in this role. We appreciate that this might require the JLCT to rethink its membership criteria in order that it (or the sub-committee) can be regarded as being more "representative" of the tax-paying community. The Administration, on the other hand, would need to commit to provide the JLCT with more resources to undertake such a role. One attraction of the sub-committee proposal is that this would enable the JLCT itself to continue to act in a "technical" role, whereas the sub-committee could have greater input vis a vis policy-related matters.

\* \* \*

We hope you find our comments above useful. If you have any questions, please call me at 2846 1716.

Yours sincerely,



Michael Olesnicky,  
Chairman,  
for and on behalf of  
The Joint Liaison Committee on Taxation

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## JOINT LIAISON COMMITTEE ON TAXATION

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THE GENERAL CHAMBER OF COMMERCE  
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13 September 2005

Mr Martin Glass  
Assistant Secretary for Financial Services and the Treasury  
Financial Services and the Treasury Bureau  
(The Treasury Branch)  
Central Government Offices  
Lower Albert Road  
Hong Kong

Dear Martin,

**Re: Review of specific facets of the Inland Revenue Ordinance**

I refer to your letter dated 2 February 2005 with which you enclosed a copy of a letter from Mandy Tam Heung-Man to the LegCo Panel on Financial Affairs dated 28 October 2004 setting out her proposals to allow for the carrying back of tax losses, allowing double deduction of expenses for companies employing new staff members, computing commercial building and industrial building allowances by reference to the purchase price of the property rather than the cost of construction, and allowing separate assessment on husbands and wives under personal assessments. Also attached to that letter was an undated letter from Mr. Lloyd Deverall in which he suggested further tax issues that could usefully be reviewed.

The JLCT has since considered Ms. Tam's and Mr. Deverall's specific proposals. We wish to relay to you our comments, as follows.

**Ms. Tam's specific proposals**

**a. Penalty regime under section 82A**

Ms. Tam suggested that too much discretion is provided to the IRD in calculating penalty tax. She suggested that more precise rules, if enshrined in legislation, would be desirable and would result in fewer taxation appeals.



We note that the IRD has a formal penalty policy which is publicly available on its website. These guidelines have given reasonable certainty to taxpayers and their advisors as to how penalties will be calculated. The experience of our members is that the Commissioner has been quite consistent in her application of these guidelines. We therefore query to what extent enshrining these (or other) guidelines in legislation would give more certainty.

We also note that, although there are inevitably appeals to the Board of Review against penalty assessments (what appear to be in only a small percentage of cases, we understand in the 2-4% range), such disputes would be expected to arise even if the penalty guidelines were enshrined in legislation. We also note that most of these appeals tend to be dismissed by the Board of Review. This suggests that the penalty guidelines are applied appropriately.

In summary, we believe that the IRD's penalty policy is reasonably transparent and consistently applied. We do not see any reason to provide for legislation. We suggest that there are other issues that deserve more pressing attention.

**b. Sections 61 & 61A**

Ms. Tam suggested that the anti-avoidance provisions in sections 61 & 61A are applied widely to commercial transactions. Her suggestion is that these provisions are antiquated and should be abolished, and that specific anti-avoidance provisions be introduced to deal with particular types of tax avoidance. Her preference is to leave the issue of tax avoidance to the courts to decide.

The issue of whether general anti-avoidance rules in tax legislation are desirable has given rise to debate in other countries. Even in Australia, which has very wide general anti-avoidance provisions (on which Hong Kong's section 61A is modeled), the principles remain unclear even though there have been many court cases dealing with the interpretation of these provisions. There is no inherently right or wrong answer. In the US, the authorities tend to legislate specifically against particular schemes, but this has led to a huge amount of legislation. Such an approach would be inconsistent with Hong Kong's desire to have a relatively simple system.

On balance, the JLCT favours general anti-avoidance rules in a statutory format. The experience of some of our members suggests that the IRD tends to be aggressive in applying these anti-avoidance provisions, especially in simple source cases. This is despite the IRD's assurances that such provisions would not be applied in such circumstances. To this extent, Ms. Tam's concerns are legitimate. If wide powers are to be given to the IRD, there is a concomitant obligation on the part of the IRD to apply these provisions sparingly and not across the board. Regretfully, it appears that some Assistant Commissioners do apply these provisions to transactions which one would not easily characterize as being of a tax avoidance nature. It is not appropriate, eg, to apply such rules merely because a taxpayer could have performed a transaction in the manner that would have resulted in more tax being levied.

Some degree of artificiality should be a precursor to the application of these provisions.

The courts have tended to support the IRD's application of the anti-avoidance provisions, and we have reviewed statistics in this regard. However, there are many other instances where the IRD has applied anti-avoidance provisions in which taxpayers have simply decided that they do not wish to pursue the matter on litigation, and so these statistics do not present a full picture.

Perhaps one compromise is to retain a statutory rule but limit its *content* in order to scale down its potential application. However, we would not support out-right abolition of general anti-avoidance rules.

We do not believe that the best solution to tax avoidance is simply to leave this matter to the courts to decide. One reason is that court decisions are inevitably decided *ex post facto*, and therefore do not give taxpayers certainty. Indeed, court decisions are often surprising and unpredictable. More importantly, the issue of how to attack tax avoidance is a fundamental issue of tax policy. Such policy issues are not best left to the courts to decide. We note that courts in common law countries have been dealing with common law doctrines of tax avoidance for over thirty years. No certainty has arisen; decisions have changed the scope of the common law rule quite often during the course of the development of the rule, to the extent that a lot of uncertainties exist with the judge-made principles.

**c. Carrying back of tax losses**

The issue of carrying back of tax losses is linked with the more general issue of group loss relief. From a general policy perspective, both matters raise the same issues. We therefore do not distinguish between them in our discussion below.

We do appreciate that introduction of group loss relief in Hong Kong would be an expensive proposition to the government (by one estimate, this would result in a loss of revenue equal to approximately 2.5% of profits tax collections for a single year). However, this fact serves to highlight the real cost that the lack of group loss relief imposes on the business community. Whatever the actual costs, the lack of group loss relief puts them on the business community. This situation has been tolerated until now. However, there has recently been growing demand for group loss relief to be introduced (or, at the very least, a system of carry back of losses in order to ensure the matching of profits with past years' losses).

The need for some type of loss relief has become exacerbated by recent legal developments, particularly the *Secan* case. We also note that this was previously less of an issue because the IRD had in the past been reasonably tolerant about arrangements to shift profits between related companies (eg, through management fees arrangements). However, such arrangements are increasingly being challenged by the IRD, and so the demand for group loss relief has increased.

We accept that there are many tax avoidance implications that need to be addressed with a group loss relief system. The fact is that all sophisticated tax regimes offer some type of group loss relief, and they address this avoidance issue through appropriate rules. Group loss relief need not be particularly complicated. For example, a simple "loss transfer regime" would be simpler to administer than a full tax consolidation regime.

What is important is to get the policy right in the first place. Group loss relief could be seen as part of the trade-off for introducing a goods and services tax in Hong Kong.

**d. Double deduction of expenses for companies employing new staff members**

Ms. Tam suggested that a double deduction be permitted for wages of new staff, in order to encourage companies to employ more people.

We respectfully disagree with such an approach. One of the most attractive features of Hong Kong's tax system, which helps to ensure its relative simplicity, is the fact that it is not used by government in order to achieve ulterior social objectives. In other words, the Inland Revenue Ordinance focuses on technical tax matters. Although it is obviously desirable to encourage full employment in Hong Kong, there are other mechanisms by which this could be achieved, without utilizing the tax system for this purpose. For example, government could simply give cash grants to employers to compensate them for the cost of new employees. Experience overseas dictates that any incentives conferred by tax legislation are susceptible to exploitation and schemes in order to achieve artificial benefits that do not in fact fulfill the social objective behind such provisions. This in turn distorts the tax system in an inefficient manner.

We do not believe that the tax system should be utilized for this purpose.

**e. The IRD could increase penalties to enhance correct filings**

There is no right or wrong answer to this, and we do not offer a comment.

**f. Commercial building and industrial building allowance**

Ms. Tam suggested that the CBA and IBA should be computed on a "cost of purchase" basis instead of a "cost of construction" basis.

We are not aware that the current rules have caused dissatisfaction or difficulties, so the issue is not a pressing one. That being said, Ms. Tam's proposal does have the advantage of simplicity and therefore deserves further consideration. However, one difficulty we foresee is that it is difficult to determine what is the cost of purchasing a building (particularly a second-hand building) as opposed to the cost of buying the underlying land. This is one reason, we suspect, why the tax rules tend to focus on the cost of

construction rather than the cost of purchase. We fear that closer examination will reveal that our fear is insurmountable and that Ms. Tam's proposal is unworkable.

**g. Sales of properties by non-residents**

We offer no comment on this proposal. To a large measure, a decision would need to be based on how significant tax evasion is in this context, because this needs to be balanced against the inconvenience of requiring clearances to be obtained in all cases.

**h. Personal assessment**

Ms. Tam suggested that tax should be computed on a personal assessment basis unless the taxpayer affirmatively elects for non-personal assessment. This is in contrast with the current position where an election for personal assessment must be made.

We see no compelling reason to introduce this change. Both proposals have advantages and disadvantages. We believe there are more pressing issues that need to be addressed.

**Mr. Deverall's specific comments**

**i. Introduction of group loss relief**

Our comments on this proposal are the same as set out above in dealing with Ms. Tam's proposal to permit the carrying back of tax losses (item c. above). The issues are similar.

**j. Offsetting of partnership losses**

Mr. Deverall expressed concern that the losses of a partner in a partnership cannot be set off against its share of profits in a separate partnership. He suggested that s.19C(5) of the IRO be amended to permit such setting off.

In principle, we agree that this proposal has merit. The current position does indeed seem odd. It appears to us that the reason why a taxpayer's partnership losses cannot be set off against the taxpayer's profits from another partnership is due to a drafting glitch rather than any overt policy.

**k. Exemption for capital profits**

Mr. Deverall has identified a technical lacuna in the IRO. Although many people assume that Hong Kong does not tax capital gains, the exemption in s.14 of the IRO only extends to a limited range of capital profits, namely, "profits arising from the sale of capital assets". This lacuna has caused concern although, in practice, the IRD has generally recognized that *all* capital profits are tax-free, whether they fall within the strict wording of the exemption or not.

This is a point of growing concern because, with recent wide-spread changes in accounting standards, there is a fear that such practice might change. Amending the legislation as suggested by Mr. Deverall would be welcomed as a means of providing certainty in respect of what is generally regarded as a fundamental aspect of Hong Kong's tax system.

**l. Transfer pricing**

We agree that s.20(2) is badly drafted and is inappropriate to serve as a basis for a transfer pricing regime in Hong Kong.

The more fundamental issue in this regard is whether Hong Kong should adopt a more formal transfer pricing regime. We offer no comment on this issue at this stage, because this is a complex area that deserves extensive review. However, we definitely agree that this is an issue that must be reviewed more closely.

We would ask you to note that transfer pricing regimes are an integral feature of all sophisticated tax regimes worldwide. Such rules have an important role to play in allocating income and profits between various jurisdictions in situations involving cross-border business activities. This in turn avoids double taxation, which is an obvious point of concern for international businesses. We also note that Hong Kong's entry into comprehensive double tax treaties will inevitably put pressure on Hong Kong to deal with transfer pricing issues in a more systematic manner consistently with global transfer pricing standards (which, to work efficiently, must be applied consistently by taxation authorities around the world).

We agree this issue deserves review.

**m. Taxation of trusts**

We share Mr. Deverall's view that the rules relating to the taxation of trusts are confusing and ambiguous, although as a practical matter they have rarely given rise to concern. Some clarity would be useful from a technical viewpoint, but this is not a high priority compared to other issues.

**n. Taxation of stock options**

The JLCT has generally taken the position that tax rules should be set out in legislation rather than in practice notes that have no binding force. The old maxim "that it is better to be taxed by legislation than untaxed by concession" applies in this regard. This is a consequence of the rule of law.

That being said, on a practical level, we appreciate that it is often impractical to legislate minutiae to deal with unforeseen circumstances, or to set out comprehensive rules. Thus, practice notes in our view do have a useful role to play, at least pending legislative changes.

In the case of the specific issue raised by Mr. Deverall in this context, we agree with him on general principle, but we do not think that the situation cries out for urgent change. There are other priorities. We point out that addressing Mr. Deverall's concern about the role of practice notes would require many other legislative changes to be made, because his example (dealing with stock options) is only one instance where practice notes serve to modify or ameliorate relatively strict legislative rules.

**o. Source of trading profits**

The JLCT does have concern that Hong Kong appears to be gradually departing from the stricter source rules that were applied in the past. We are in the process of making comments to the Commissioner about the practice note that deals with the issue of source of profits.

The issue of source of profits has given rise to many tax disputes. The application of the source rules has probably been the biggest cause of frustration with Hong Kong's tax system over recent years, particularly among foreign investors in Hong Kong. Also, it appears to us that there is potential to modify Hong Kong's source rules in a manner that would attract more foreign investors to base their operations in Hong Kong.

There is no right or wrong answer to many of these issues which are inevitably complex. Suffice it to say that we agree that this is an issue that deserves thorough review.

**p. Source of salaries income**

We agree that many of the rules and practices dealing with the source of salaries income are confusing and irrational. This is an area that deserves thorough review.

**q. Deduction of excess foreign taxes**

We agree that the IRD's practice in this regard is contrary to the plain wording of s.50(2) of the IRO and deserves explanation. This is an administrative matter that does not require legislative reform.

The Administration might consider there is a policy issue here as to whether such a deduction ought to be permitted in the first place, but any change would require legislative change. We offer no further comment on this issue.

**r. Taxation of unrealized profits**

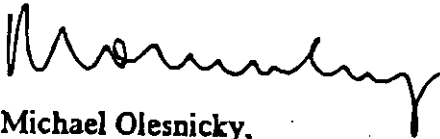
There is in our view no inherently right or wrong answer to the issue whether unrealized profits should be taxed, or whether taxation should be deferred until such profits are actually realized. This is, however, a recent point that has caused a lot of controversy, and it therefore does deserve to be reviewed. There are many issues involved here, such as fairness to taxpayers and the

impact of accounting treatment on tax liability. The latter issue raises even more wide-ranging points that need to be separately reviewed.

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We hope you find our comments above useful. If you have any questions, please call me at 2846 1716.

Yours sincerely,



Michael Olesnicky,  
Chairman,  
for and on behalf of  
The Joint Liaison Committee on Taxation

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## 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"> <li>◆ IRD's penalty policy is transparent and well publicized. The quantum of penalty is subject to appeal.</li> </ul>
2.	<p>Implementation of section 61A should be improved. (HKICPA)</p>	<ul style="list-style-type: none"> <li>◆ Section 61A itself stipulates an objective way of invoking the section. Seven objective matters have to be considered.</li> <li>◆ IRD has issued guidelines and DIPN on its views on the implementation of the section</li> <li>◆ 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.</li> </ul>
3.	<p>Introduce loss-carry back provisions. (HKICPA)</p>	<ul style="list-style-type: none"> <li>◆ Carry forward of tax losses for an indefinite period already allowed.</li> <li>◆ The proposal would have significant impact on tax revenue collection and on the balance of the Government's fiscal accounts.</li> </ul>



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

	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

	<b>Issues and comments raised</b>	<b>Administration's views</b>
	<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"> <li>◆ IRD is reviewing DIPN No. 21 on “Locality of Profits” with a view to providing more guidelines for taxpayers and practitioners.</li> <li>◆ The industry will be consulted on the revised DIPN in due course.</li> </ul>
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"> <li>◆ The territorial source of a profit is a practical, hard matter of fact that frequently gives rise to controversy.</li> <li>◆ The concept of “central management and control” is relevant in determining whether a person is a non-resident.</li> <li>◆ This is nothing to do with taxing “worldwide” income. Hong Kong taxes only profits derived from Hong Kong.</li> </ul>
16.	<p>Clarify foreign employment rules. (British Chamber and HKICPA)</p>	<ul style="list-style-type: none"> <li>◆ According to case law, the location of an employment has to be decided by considering the totality of facts.</li> <li>◆ IRD generally considers a number of factors in determining the charge to salaries tax, as explained in DIPN No. 10.</li> <li>◆ IRD is reviewing the DIPN in the light of recent experience and Board of Review decisions.</li> </ul>

	<b>Issues and comments raised</b>	<b>Administration's views</b>
		<ul style="list-style-type: none"> <li>◆ The industry will be consulted on the revised DIPN in due course.</li> </ul>
17.	Salaries tax liabilities of employees seconded to work in PRC. (British Chamber and Deverall)	<ul style="list-style-type: none"> <li>◆ 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.</li> </ul>
18.	Definitions of a capital gain/other items exempt from tax (section 26A of the IRO). (British Chamber)	<ul style="list-style-type: none"> <li>◆ There is a wealth of decided cases on the issue of capital gains.</li> <li>◆ Income exempt under section 26A is clearly defined thereunder. There has so far been no significant dispute.</li> </ul>
19.	The wording of section 14(1) should be expanded to cover "profits of a capital nature". (Deverall)	<ul style="list-style-type: none"> <li>◆ Profits of a capital nature are always accepted as not taxable. There has never been any dispute.</li> </ul>
20.	Clarify treatment of Agents of overseas persons (sections 20A and 20AA of the IRO). (British Chamber)	<ul style="list-style-type: none"> <li>◆ 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</li> </ul>

	<b>Issues and comments raised</b>	<b>Administration's views</b>
		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"> <li>◆ 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.</li> </ul>
22.	Clarify tax on the exercise of stock options. (British Chamber and Deverall)	<ul style="list-style-type: none"> <li>◆ Revised DIPN No. 38 "Employee share option benefits", which was issued recently in March 2005, clarifies this point.</li> </ul>
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"> <li>◆ Secan has clarified the law regarding the importance of accounting practices on computation of taxable profits.</li> <li>◆ On timing of deduction of expenses, DIPN No. 40 has been issued on prepaid revenue expenses.</li> <li>◆ On measurement of profits and timing of assessment, HKICPA has seen and been consulted on the draft DIPN No. 42 on financial instruments in which the IRD has explained its stance on these issues and its views on the relevance of the Secan case. The DIPN was issued in November 2005.</li> </ul>

	<b>Issues and comments raised</b>	<b>Administration's views</b>
24.	<p>Clarify calculations on Depreciation Allowances. (British Chamber)</p>	<ul style="list-style-type: none"> <li>◆ Revised DIPN No. 7 “Machinery and plant – depreciation allowances” was issued in August 2002.</li> <li>◆ DIPN No. 2 on industrial building and commercial building allowances will be updated.</li> <li>◆ The industry will be consulted on the revised DIPN in due course.</li> </ul>
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"> <li>◆ 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.</li> <li>◆ 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.</li> <li>◆ 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.</li> </ul>

	<b>Issues and comments raised</b>	<b>Administration's views</b>
		<ul style="list-style-type: none"> <li>◆ 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.</li>   <li>◆ HKSARG is actively negotiating with major trading/investment partners on comprehensive agreement on avoidance of double taxation.</li> </ul>
26.	Clarify the operation of section 50(5) on tax credit. (Deverall)	◆ 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"> <li>◆ DIPN No. 31 sets out details of the procedures.</li>   <li>◆ Some advance ruling cases of common interest have been uploaded on IRD's website.</li> </ul>
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"> <li>◆ 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.</li>   <li>◆ IRD has clear guidelines and procedures for cases where additional assessments have to be raised because of change of opinion of the</li> </ul>

	<b>Issues and comments raised</b>	<b>Administration's views</b>
		<p>Assessor.</p> <ul style="list-style-type: none"> <li>◆ 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).</li> </ul>
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"> <li>◆ 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”.</li> <li>◆ 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.</li> </ul>
30.	<p>Publication of the assessor's manual. (HKICPA)</p>	<ul style="list-style-type: none"> <li>◆ This issue has been discussed with the HKICPA on various occasions and at LegCo in the context of a question on 5 January 2005.</li> <li>◆ As explained before, the IRD considers that the Assessor's Manual should not be of much reference value to taxpayers or their</li> </ul>



	<b>Issues and comments raised</b>	<b>Administration's views</b>
		<p>representatives. Besides, it contains some reference to taxpayers' information such as reference to CIR's determinations and unreported Board of Review decisions in which taxpayers can be identified.</p>
31.	<p>Efforts to promote compliance by taxpayers should be enhanced. (Aaron Wong)</p>	<p>◆ 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.</p>
32.	<p>Simplify calculation of Salaries Taxation liabilities. Very few understand the basis for the current calculations. (British Chamber)</p>	<p>◆ 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.</p>
33.	<p>Clarify Transfer Pricing rules. (British Chamber and Deverall)</p> <p>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)</p>	<p>◆ 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.</p>

## 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"> <li>◆ 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.</li> <li>◆ 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.</li> <li>◆ 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.</li> <li>◆ JLCT recognises that if it is to take on an active role in reviewing a wide-range of specific issues, it might be required to rethink its membership criteria in order that it can be regarded as being more "representative" of the tax-paying community. We welcome JLCT's plan to widen its representation.</li> </ul>

	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>◆ There is a lot of anecdotal evidence to suggest that the Personal Assessment system is not well understood. While the main aim of Personal Assessment is to enable personal allowances to be set off against business or property income if there is no salary income; or the ability to offset current year business losses against salary or property income, the Individual Tax Return Form itself does not clarify these matters. It is even more confusing for spouses who may not be aware that they can claim under Personal Assessment to use the business losses of their spouse in some circumstances.</p>	<p>◆ The “Guide to Tax Return – Individuals” explains that electing Personal Assessment may reduce a taxpayer’s tax liability. However, given that there are various situations under which Personal Assessment may benefit a taxpayer, it is not possible to set out all the details in the return form or guidance notes. The IRD has an updated DIPN No. 18: Assessment of Individuals under Salaries Tax and Personal Assessment in January 2005. Taxpayers may also refer to the pamphlet: A Brief Guide to Personal Assessment, or refer to IRD’s website, which contains worked examples to illustrate how Personal Assessment may reduce a taxpayer’s liability, election mechanism, frequently asked questions and answers thereto, etc. Taxpayers can also compute their tax liabilities under Personal</p>

	Issues and comments raised	Administration's views
	<ul style="list-style-type: none"> <li>◆ A more comprehensive approach to giving loss relief for losses arising from business, and the possibility of offsetting a personal allowance against any form of taxable income in Hong Kong would be a better route to follow.</li> </ul>	<p>Assessment by using the program provided by the IRD on its website. From July 2005 onwards, IRD has adopted a new design for Personal Assessment demand notes, which enhances the clarity of computations of tax liabilities under Personal Assessment.</p> <ul style="list-style-type: none"> <li>◆ The existing Personal Assessment regime provides adequate relief for personal allowances and business losses against a taxpayer's other income.</li> </ul>
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>	<ul style="list-style-type: none"> <li>◆ Tax practitioners are familiar with the current arrangement. That said, detailed and specific proposals are welcome.</li> </ul>

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