

Hong Kong Revenue Law Its Content, Origins and Destiny

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Table of Contents

- 1.0 INTRODUCTION
 - 1.1 Overview
 - 1.2 A Change of Epoch
- 2.0 BACKGROUND
- 3.0 THE HONG KONG REVENUE LAW REGIME
 - 3.1 Introduction
 - 3.2 Sources of Revenue
 - 3.3 Profits Tax
 - 3.4 Salaries Tax
 - 3.5 Property Tax

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- 3.6 Anti-Avoidance Provisions
- 3.7 Estate Duty
- 3.8 Stamp Duty
- 3.9 Summary

4.0 SOME FACTORS WHICH HAVE SHAPED THE REGIME

5.0 CHALLENGES AND POSSIBLE REFORMS

6.0 WIDER FACTORS SHAPING CHANGE

7.0 THE IMPACT OF THE CHANGE OF SOVEREIGNTY

8.0 LESSONS TO BE DRAWN FROM THE HONG KONG TAX EXPERIENCE

A Table of Major Abbreviations

| | |
|-------|---|
| BORO | Bill of Rights Ordinance |
| CGT | Capital Gains Tax |
| DIPN | Departmental Interpretation and Practice Note |
| DTA | Double Tax Agreement |
| EDO | Estate Duty Ordinance |
| EXCO | Executive Council |
| FWT | Final Withholding Tax |
| HKSAR | Hong Kong Special Administrative Region |
| IRD | Inland Revenue Department |

| | |
|-----------|---------------------------------|
| IRO | Inland Revenue Ordinance |
| LEGCO | Legislative Council |
| PRC | People's Republic of China |
| PROVLEGCO | Provisional Legislative Council |
| SDO | Stamp Duty Ordinance |
| UK | United Kingdom |
| USA | United States America |
| VAT | Value Added Tax |

1.0 INTRODUCTION

1.1 Overview

This paper looks at the operation of the Hong Kong Revenue Law system in some detail. It also aims to place that review in political, economic and social contexts. The purposes of this examination are as follows:

To review the development of the Revenue Law regime in Hong Kong;

To understand the current major features of the regime;

To understand some of the factors which have shaped the development of this regime;

To consider the challenges facing the regime;

To consider areas of potential change and development in the Hong Kong Revenue Law regime;

To try and understand some of the factors shaping future change and development; and

To review the impact of the change of sovereignty, on July 1, 1997, on the regime.

The next Part of this paper provides some general background to inform the following discussion which addresses the range of topics listed above. The paper concludes with some commentary on the relevance of the Hong Kong taxation experience for other jurisdictions. It looks at the general lessons, if any, which may be drawn from that experience and it also looks at the more particular lessons which Hong Kong can offer in terms of crafting regimes for business taxation. The paper argues that there are significant limits on any general lessons which may be drawn from Hong Kong. That is, Hong Kong presents a special case in many ways. Bearing this reservation in mind, however, we can refer to the Hong Kong tax experience to frame some useful comparative insights. Those insights may have greater policy-making relevance in advanced jurisdictions like Japan which do not have near totally comprehensive State welfare regimes.

The Hong Kong system for taxing business is generally approved of by businesses operating in Hong Kong. This is not especially surprising as the system is, comparatively speaking, “business-friendly”. Once again, the Hong Kong system cannot really provide a model for emulation due to special circumstances but it can serve as one kind of “benchmark” in the debate over systems for taxing business profits.

1.2 A Change of Epoch

The World has not previously seen the equal of Hong Kong’s recent change of sovereignty. Many former colonies have gained independence in the past. And many colonies have passed between sovereigns as a result of imperial power-plays. Hong Kong, however, falls into neither of these categories. This extraordinary city-state was, on July 1, 1997, returned from whence it came, to China, but to a China far different to that from which it departed over 150 years beforehand. In 1841, when Britain secured Hong Kong island using gun-boat diplomacy, China was entering the final years of the

brooding, corrupt Qing dynasty. In 1997, Communist China, though still politically authoritarian, is a market oriented economic powerhouse grasping for modernity. Moreover, Hong Kong was returned not as a bedraggled colonial outpost but as glittering prize; lock, stock and shining skyscrapers. On July 1, 1997, the British Territory of Hong Kong became the Hong Kong Special Administrative Region (HKSAR) of the People's Republic of China (PRC).²

2.0 BACKGROUND

The British acquired Hong Kong Island in 1841 at the conclusion of the First Opium War with a China ruled by the Qing or Manchu Dynasty. Before that degraded dynasty collapsed in 1911, Britain had acquired the Kowloon Peninsula in 1860 at the end of the Second Opium War and the New Territories in 1898. The New Territories, unlike the other two components of the British Colony of Hong Kong, were acquired under a 99 year Term Treaty. Hong Kong Island and the Kowloon Peninsula had been acquired in perpetuity, although all subsequent Chinese governments, whether Imperial, Republican or Communist, denied the legality of the various Treaties governing the acquisition of Hong Kong by the British.

As the 99 year Term Treaty covering the New Territories drew within 20 years of completion in the mid-1970s, active consideration commenced on the future of the British Territory of Hong Kong in London, Hong Kong and Beijing. Within Hong Kong, an important practical problem was forcing the issue. As Hong Kong had expanded both economically and in terms of population after the

² In this article I have use the terms Hong Kong and HKSAR interchangeably. When referring to China, usually I am doing so in the sense of China *separate* from rather than *including* Hong Kong. Where the meaning is the latter meaning, it will be obvious from the context. I have used the terms, China, PRC, PRC Government, PRC Mainland and Mainland interchangeably when referring to China in the first (*separate*) sense just noted.

Second World War, the Hong Kong Government had met the huge demand for housing, in part, by building a range new cities in the New Territories. These residential, commercial and manufacturing municipalities grew to house some 2 million people, whilst Hong Kong itself had grown to around 6 million people. The pressures to develop them still further remained as strong as ever but developers and the Hong Kong Government were both confronted with the problem of ensuring secure land tenure for developments beyond the Term Treaty expiry year of 1997.

Although Hong Kong had, by this time, come to be known and referred to as the Territory of Hong Kong rather than as the Colony of Hong Kong, it retained a colonial style of government. The government existed outside of the legislature and was entirely appointed (either directly from Westminster or by the Governor of Hong Kong). It was known as the Executive Council (EXCO). The Legislative Council (LEGCO) was made up of appointed members and members elected by “functional constituencies” with very limited franchises and ex-officio members (such as the Governor). This position remains little changed until 1991 and then, more dramatically, 1995. These changes are described further below.

When the British first raised the issue of the future of Hong Kong with China’s new Paramount Leader (and distinguished political survivor) Deng Xiao Ping in the late 1970s, they had hopes of striking a deal to allow for some sort of British management of the Territory of Hong Kong. The British hopes in this regard were, perhaps, heightened by the refusal of the PRC to accept the hand-back of Macau from the Portuguese Government in the wake of the overthrow of the Salazar-Caetano regime in Portugal in 1974. Deng, however, was ready with his own plan to deal with Hong Kong, the “One Country - Two Systems” model, originally crafted with the “renegade” (in PRC eyes) Province of Taiwan in mind. This model saw zero role for any continuing British sovereign or managerial presence but, rather, an incorporation of the vastly different Hong Kong political-economy, without change, within the PRC as the HKSAR. The Deng model was ultimately accepted by the British in the early 1980s.

In the course of the change of sovereignty over Hong Kong, there have been a number of difficulties which have been encountered. Two of these have been quite significant, one more so than the other. The very lowest point in the change-over process occurred on June 4, 1989, when the new Premier Li Peng, at the behest of Paramount Leader Deng, authorized the use of military force to crush the pro-democracy movement which had been protesting in vast numbers in Tiananmen Square in Beijing throughout most of the Spring of 1989. The bloody outcome of this decision is a matter of notorious record. The British response was to take a series of steps to help repair the deeply shattered confidence of the people within Hong Kong. A giant new airport project was commenced, British passports were promised to certain civil servants, a Hong Kong Bill of Rights Ordinance (BORO) was enacted and moves towards a democratic system of governance were promised. It was the move towards increased democracy which was to trigger the second most significant low point during the handover process.

The first step towards greater democracy occurred in 1991. In the elections for LEGCO in that year, somewhat less than one third of LEGCO members were directly elected for the first time. The group collectively referred to as Hong Kong Democrats, for the most part led by Martin Lee, swept the polls. These elections were conducted in accordance with the development of Hong Kong democracy envisaged in the Joint Declaration of Government of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong (Joint Declaration) and the Basic Law of the Hong Special Administrative Region of the People's Republic of China (Basic Law). The Joint Declaration sets out the original formal agreement over Hong Kong between the two sovereign powers concluded in 1984. The Basic Law, which was finalized in 1990, is the mini-Constitution governing the HKSAR.³

Subsequently, in 1992, the recently arrived, last British Governor of Hong Kong, Christopher Patten, announced that various measures

³ The best work on the constituent documents governing the HKSAR is the recently published work by Professor Yash Ghai (Ghai, Yash, Hong Kong's New Constitutional Order (Hong Kong University Press, Hong Kong, 1997) (now in a second edition).

would be taken to enhance Hong Kong democracy still further in the 1995 LEGCO elections. China's reaction to this announcement was extremely hostile. As events transpired, the Patten proposals were implemented in the teeth of PRC resistance. The PRC maintained that the 1995 LEGCO was not constituted in accordance with either the Joint Declaration or the Basic Law. The better view is that the 1995 LEGCO did not breach the letter of either instrument in any significant way but the PRC may have had a point when they argued that the spirit of the two instruments had been violated to some degree.

In any event, the British refused to back down and China disbanded to the 1995 LEGCO on July 1, 1997. In its place there appeared a Provisional LEGCO (PROVLEGCO) which the PRC had established formally some months earlier. Until July 1, 1997, the PROVLEGCO sat in Shenzhen, just across the border in the then entirely separate, Mainland. The PROVLEGCO passed a range of bills during the Spring of 1997, which were subsequently ratified at its first sitting in Hong Kong during the small hours of July 1, 1997. The new Chief Executive Officer (CEO) of the HKSAR (who replaced the Governor as Head of Government on July 1, 1997), Mr Tung Chee-hwa, announced that the elections for a fresh LEGCO, with a make-up based on the 1991 LEGCO, would be held in May 1998.

The PRC had promised, when the BORO was introduced in 1991, that it would be repealed come July 1, 1997. In fact, the BORO was not repealed by the PROVLEGCO but only amended. Most commentators believe that the amendments are more symbolic than substantive.⁴

⁴ See, for example, Ghai, Yash, *The Continuity of Laws and Legal Rights and Obligations in the SAR* (1997) 27 Hong Kong Law Journal, 136; and Wesley-Smith, Peter, *The SAR Constitution: Law or Politics?* (1997) Hong Kong Law Journal, 125.

3.0 THE HONG KONG REVENUE LAW REGIME⁵

3.1 Introduction

This Part reviews the basic features of the Hong Kong Revenue Law regime. It also notes the range of sources of government income in Hong Kong arising other than through taxation or taxation like imposts.

Broadly, the Hong Kong fiscal system is characterized by the following features:

A narrow taxation base (no Value Added Tax (VAT) and no Capital Gains Tax (CGT));

Low taxation rates;

Previous heavy reliance on land-related taxes;

Simple and relatively stable taxation laws;

Retention of Death and Gift Duties in the system;

Retention of Stamp Duties in the system;

Practically no use of Double Taxation Agreements (DTAs);

Nil government borrowing;

Infrequent deficit budgeting; and

Massive accumulated fiscal reserves.

The pattern is one of low expenditure, low taxes, fiscal prudence and relative fiscal stability.

The main taxes examined in this article are:

Profits tax (business tax); and

Salaries tax.

Some attention is also paid to property tax and to estate duties and stamp duties.

Certain preliminary points need to be noted. First, notwithstanding the incorporation of Hong Kong into the PRC on July 1, 1997, the HKSAR remains an entirely separate tax

⁵ The principal commentaries on Hong Kong Revenue Law include: Willoughby, Peter and Halkyard, Andrew, Encyclopedia of Hong Kong Taxation (in 4 Volumes) (Butterworths, Hong Kong, 1993); Ernst & Young, Taxation in Hong Kong (1998/99) (Longman, Hong Kong, 1998); and Flux, David, Hong Kong Taxation: Law and Practice (1998/99) (Chinese University Press, Hong Kong, 1998).

jurisdiction from the Mainland PRC. The Basic Law stipulates that this shall be so and, indeed, guarantees that this separation must apply. The Basic Law provides that, not only is Hong Kong's relatively simple, low tax regime to be maintained but it prohibits the Central Government of the PRC in Beijing from either, imposing any taxes in the HKSAR or from sharing in any revenues collected in the HKSAR. Secondly, the HKSAR retains an old British, schedular system for imposing income taxes. That is, unlike other advanced Common Law jurisdictions (including, now, Britain) the HKSAR does not impose a single tax on income. Rather, it imposes separate taxes on different sorts of income. Income which does not fall within a category in the schedule is, generally speaking, not subject to tax at all. Thus income from interest earned, except in special cases, is not subject to tax as the general provisions in the Inland Revenue Ordinance (IRO) imposing tax on interest income have been suspended for some years. Currently, income from business profits, income from salaries and wages and income from property are all subject to taxation under separate Parts of the IRO. Until quite recently, each taxpayer filed entirely separate returns if they earned income subject to tax under more than one heading. Nowadays, such taxpayers must complete a single return, although the income remains subject to taxation under the separate headings.

The fiscal year in Hong Kong runs from April 1 until the following March 31. Hong Kong does not use a "pay-as-you-earn" tax collection system for any taxes under the IRO. The collection system which applies in the case of each of the taxes discussed below is that, in the first income year for a taxpayer, an assessment is issued after the first tax return plus an assessment is issued at the same time for provisional tax for the next following year. Provisional tax is based on the tax payable in the year just assessed.

3.2 Sources of Revenue

Apart from taxation, the HKSAR Government raised revenue from a variety of sources. These include a variety of fees and duties such as excise duties, betting duties, utility charges, vehicle-related imposts and incorporation and related charges. These sources can

generate in excess of 30% of total revenue.

At their peak in the mid-1970s, land transaction revenues accounted for over 30% of government income. Hong Kong has a most unusual real property structure. Partly as a result of the historical acquisition process explained above, partly due to policy choices and partly due to British land tenure practices, virtually all land in the HKSAR is leasehold. Moreover, the holder of the freehold, the government, has maintained a policy of limited release of land. This has driven up the price of land dramatically and the government, as the vendor of the leaseholds, has reaped the financial rewards. Also, as the land is leasehold, any change of existing usage requires governmental agreement. To obtain any such agreement, leaseholders have to pay a further premium. The result is that government is able to share in most growth in the economic benefits from land. One significant aspect of this policy is that it has substantially reduced the need for successive Hong Kong Governments to rely on other forms of taxation during the first decades following the Second World War. It has, in other words, helped underpin Hong Kong's fundamental, simple, low tax structure. It is a curious twist of political practice, that it has been in Hong Kong that land-related taxation has been most effectively employed. This is because such taxation policies have, historically, been developed by left wing, tax policy analysts,⁶ yet their implementation has been most striking in Hong Kong, for the most part, a bastion of free market customs.

The Hong Kong experience has also highlighted the drawbacks of such a heavy reliance on land-related taxation. One of these is that the purchase of a home has been placed beyond the reach of the majority of the Hong Kong population. The Government's

⁶ The most well known theorist advocating land-based taxation was Henry George, an American economist and social reformer. He and his followers argued for the imposition of a single tax on the unimproved value of land to replace all other taxes. The dogmatic approach of the "Henry George League" (whose offices may still to be found in various cities around the World) set them against many other social reformers. For a good discussion of the heated debates over "Georgist" policies see, Smith, Julie P., Taxing Popularity: The Story of Taxation (Federalism Research Centre, Australian National University, Canberra, 1993) 18-24.

answer has been to construct public housing on a massive scale. Over 50% of Hong Kong citizen occupy public housing. Public rental housing is almost always crowded and is usually noisy but it is often well-located and rents are usually around 10% of earnings or less. Another problem is that this artificial scarcity has encouraged speculation and fast rising (and falling) residential (and commercial) property markets. A final significant drawback is that the policy has major cost implications for all levels of commerce. Office space is exceptionally expensive in Hong Kong as is retail space. The high (and often rising) rentals are, in turn, factored into the pricing of goods and services in Hong Kong (thus creating a de facto goods and services tax or VAT). This has affected Hong Kong's competitiveness as a regional centre, as an entropot to China and as a tourist destination. Overall, however, one has to concede that the policy has been tolerably effective in distributing the benefits of rising land prices across the entire community.

The Hong Kong Government is now less reliant on direct land transaction revenues than before but they are still significant. The balance of revenue comes largely from income-type taxes and estate and stamp duties to which we can now turn our attention.

3.3 Profits Tax

Profits tax is the most important tax imposed by the IRO. It is, nowadays, the most significant single revenue source in Hong Kong. It currently applies at a flat rate of 16% in the case of corporations and a flat rate of 15% for individuals. Profits tax is imposed by Part IV of the IRO. Section 14 of the IRO says that every person carrying on a trade, profession or business in Hong Kong who is in receipt of assessable profits arising in or derived from Hong Kong from any such trade, profession or business is liable to pay profits tax.

The crucial issue with respect to profits tax is source. That is, section 14 makes it clear that only profits with a source in Hong Kong are subject to Hong Kong profits tax. This feature of Hong Kong tax law provides a part of the explanation for why Hong Kong is such a popular location for regional banking, financial and related services. This rule also helps explain why the question of source has

been the subject of more serious litigation than any other issue in Hong Kong tax law. Because source is so central, the issue of residency generally is not important, unlike in, for example, Australia, where residency is a crucial concept.

The leading case on source remains *Commissioner of Inland Revenue v Hang Seng Bank Limited*⁷ (*Hang Seng Bank* case) from 1991. In that case, the Commissioner of Inland Revenue (Commissioner) lost at all levels including, most importantly, in the Privy Council in London.⁸ The *Hang Seng Bank* case concerned the taxability of profits related to trading in certificates of deposit by the *Hang Seng Bank*, outside of Hong Kong in jurisdictions where the bank did not maintain separate business operations. Despite the fact that certain general decision making with respect to the trading had occurred in Hong Kong, the Privy Council held that the transactions which had given rise to the profits had occurred *outside* Hong Kong. Thus, their source was not in Hong Kong and the resulting profits did not fall to be taxed under section 14 of the IRO. The Privy Council said that the broad guiding principles to be applied when considering questions of source were:

No universal rule will cover all cases;

One must look to see what the taxpayer has done to earn the profits and where the taxpayer has done it; thus

One must ascertain the transactions which produced the relevant profits and where they took place.

The decision makes it clear that it is not appropriate to apply and sort of “management or control” test of the sort typically used to determine “residency” in jurisdictions such as Australia. That is, the test for source is far more narrow than is the test for residency. The source test is transaction related. It is not determined by reference to where the ultimate controlling power of a taxpayer lies. The case also makes it clear that it is not necessary for a Hong Kong taxpayer

⁷ (1991) 1 Appeal Cases, 306; (1991) 3 Hong Kong Tax Cases, 351.

⁸ Until June 30, 1997, the Privy Council remained the final court of appeal for Hong Kong. The Privy Council has now been replaced by the Hong Kong based, Court of Final Appeal.

to maintain a permanent offshore establishment to take advantage of the source rule.

The issue of source remains controversial. There have been a number of cases since the *Hang Seng Bank* case, including a rather confusing Privy Council decision a year later in 1992, in *Commissioner of Inland Revenue v HK-TVB International*⁹ (*TVB* case). The *TVB* case concerned the sale of certain rights to broadcast films and television programs overseas. The Privy Council on this occasion found that, despite the overseas sales, the source of the profits remained in Hong Kong. The reasoning is widely believed to be incomplete in this case and it generally has been confined to its facts.

The most recent cases on source include one decision from the Court of Appeal handed down in late December, 1996, *Commissioner of Inland Revenue v Magna Industrial Company Limited*¹⁰ (*Magna Industrial* case) and what will be one of the last decisions on Hong Kong revenue law from the Privy Council, decided on June 23, 1997, *Commissioner of Inland Revenue v Orion Caribbean Limited (in voluntary liquidation)*¹¹ (*OCL* case). The *Magna Industrial* case endorses the spirit of strictly interpreting the meaning of source in section 14 so as to limit the reach of the section. The Hong Kong source of any profits needs to be clear before section 14 can operate. The Court of Appeal thought that the profit making activities of the taxpayer in the *Magna Industrial* case came rather close to so qualifying but, in the final analysis, they failed to do so. In the *OCL* case, the Privy Council did little to help erase the confusion created by the *TVB* case but they did endorse, once more, the “hard practical matter of fact” test from the *Hang Seng Bank* case. The taxpayer in the *OCL* case had attempted to rely on a particular example given in the *Hang Seng Bank* case. This was a fragile basis for claiming an offshore source for the profits involved, especially as the agent (so found) of *OCL* completed virtually all the profit making activities for *OCL* and did so in Hong

⁹ (1992) 1 Hong Kong Revenue Cases, 100, 535.

¹⁰ (1997) 5 Hong Kong Revenue Cases, 100, 765.

¹¹ [1997] Simon's Tax Cases, 923.

Kong. Once the Privy Council had dismissed the relevance of the example in deciding the taxability of OCL, the facts fairly much spoke for themselves; the activities generating the profits had mostly taken place in Hong Kong so the profits clearly had a Hong Kong source. It is fair to say that the subsequent case law has not yet altered the position of the *Hang Seng Bank* case as the leading authority on the issue of source.

Clearly, distinguishing when profits have a Hong Kong source and when they do not, in the case of a Hong Kong based taxpayer, will continue to give rise to argument. One rather “raw” way of understanding the distinction is to bear in mind the basic levels of a typical company’s behavior. At the top of the company, one finds high level, macro decision-making by the board of directors. At the shop floor (or trading interface), on the other hand, company employees carry out many detailed, specific activities in the search for profits. What the *Hang Seng Bank* case seems to be saying is that it is those detailed, specific activities which will determine the issue of source. Top level decision making may be relevant for the purposes of establishing “residency”, but that concept is relatively unimportant in Hong Kong. More specifically, establishing where top level operations occur, alone, *cannot* ever provide an answer to the source question.

In addition to the case law on any aspect of the IRO, one also needs to refer, where applicable, to relevant Departmental Interpretation and Practice Notes (DIPNs). The Commissioner is in the habit of regularly issuing DIPNs to clarify his understanding of the law. The DIPNs do not, of course, state the law. They are no more than administrative opinions on what the law is. Nevertheless, they enjoy considerable respect in Hong Kong amongst tax practitioners and academics. They usually are issued in a timely fashion and normally will cover the topic area comprehensively. They are thus very helpful in understanding the Commissioner’s views and serve as cogent, if sometimes controversial, commentaries on Hong Kong tax law.

In the case of the source issue, the Commissioner has issued DIPN 21 (which has been updated since its original issuance). DIPN

21 is most controversial in its interpretation of the source of commodity trading profits and manufacturing profits. Basically, it claims that unless a Hong Kong company is *both* buying and selling a given commodity offshore, then the resulting profits will be taxable in Hong Kong. In the case of manufacturing profits, where, as is often the case, a Hong Kong company is manufacturing across the border in the PRC Mainland, then a proportion of the profits arising will be taxable in Hong Kong. If a true arms length supply of goods is involved then there would be no liability to profits tax on the manufacturing aspect of the transaction, of course.¹² DIPN 21 deals with a range of other transactions, also, including real property transactions, share transactions and fees from service provision. The IRO itself addresses various source issues with respect to financial institutions.

Section 15 of the IRO deems certain profits to be profits which fall within section 14. In some cases they may do so in any event but section 15 puts the matter beyond doubt. In other cases, section 15 catches profits which would not otherwise fall within section 14. Sections 15(1)(a) and 15(1)(b) are worth noting briefly. Both relate to the taxation of payments to offshore taxpayers for the use of certain types of intellectual property or for the use of films and tapes and the like. Fundamentally, they impose a Final Withholding Tax (FWT) on royalty payments caught by the sections. The Hong Kong payer (of the royalties) is liable to collect the FWT for the Commissioner and is indemnified by the IRO against any recovery action with respect to the FWT by the offshore payee. The FWT used to apply at the rate of 10% of the usually applicable profits tax (that is, at a rate of 1.5% or 1.6%). Recent amendments to the IRO designed to end tax avoidance exploitation of these sections mean that, unless the Commissioner can be satisfied that the Hong Kong payer has, at no time, enjoyed any interest in the relevant property on which royalties are being paid, then the FWT is the normally

¹² For a careful review of the source issue with respect to profits tax which focussed, critically, on several of the interpretations in DIPN 21, see, Littlewood, Michael, *The Geographical Scope of Hong Kong Profits Tax: Manufacturers, Traders, and Apportionment* (1997) 11 Tax Notes International, 1549.

applicable profits tax (that is, 15% or 16%).¹³

It is important to note that section 14 excludes capital profits from assessment to profits tax. That is, Hong Kong has an explicit provision which excludes a tax on capital gains. This protection is less formidable than it may at first seem. The case law interpretation of the term “trade” in section 14 together with the definition section of the IRO make it clear that the term includes an “adventure in the nature of trade”. Thus, one-off transactions can still be regarded as “trade” caught by section 14. The Inland Revenue Department (IRD) has used this interpretation as a basis for imposing, administratively, a de-facto CGT. Typically, the IRD seeks to tax what it sees as speculative gains arising from real estate transactions. This practice is discussed further below. Thus far, this de-facto CGT has not been widely used to tax other speculative gains, for example based on stock market investing.

Section 16 of the IRO is the section providing for deductions. In the calculation of profits which are chargeable to profits tax, all outgoings and expenses to the extent that they are incurred in the production of profits are allowable deductions. Section 16, in addition to this general deduction provision, contains a list of specific deductions which are allowable. Section 17 then classifies certain expenditures as non-deductible, including familiar items such as, domestic or private expenditure, the costs of travelling between a residence and a place of business and expenses of a capital nature.

Attempts to exploit section 16 through contrived schemes (for example by using closely controlled “service companies” which charge out services on other than an arms-length basis have been rejected by the Board of Review (the initial level of independent appeal on tax issues in Hong Kong) and by the courts. The IRO also has been amended to tackle such problems.

Although Hong Kong does not have a formal tax credit provision with respect to profits tax, it has been accepted that, where a business liable to profits tax in Hong Kong has also had to pay tax akin to profits tax in another jurisdiction on the same profits, then

¹³ See, sections 20A and 21A of the IRO. See, also, Halkyard, Andrew, *Payments for the Use of Intellectual Property Rights* (1993) (June) Hong Kong New Gazette, 18.

the tax paid in the foreign jurisdiction may be an allowable deduction under section 16. Such a situation could arise if an Australian resident company operating in Hong Kong were regarded as having derived Hong Kong sourced profits. Such a company, as an Australian resident company, would be liable to tax in Australia on its World-wide income. The Australian tax payable with respect to the Hong Kong sourced income would be deductible in Hong Kong according to the prevailing interpretation of section 16 of the IRO.

Finally, it should be noted that Hong Kong has generous depreciation provisions for plant and equipment in Part VI of the IRO. These comprise initial depreciation allowances of up to 60% and continuing annual allowances which applying at varying rates depending on the item. There also are generous depreciation allowances for industrial buildings and lesser depreciation allowances for commercial buildings.

3.4 Salaries Tax

The provisions governing salaries tax are contained in Part III of the IRO. Salaries tax is an important source of revenue for the HKSAR Government, though significantly less so than profits tax. Salaries tax applies, initially, at progressive rates from 2% increasing to a top marginal rate of 25%. There is cap, however, of 15% flat on the total amount which can be taken from salaries or wages as tax. That is, once the application of progressive rates delivers a yield of 15% flat (on net income), no further salaries tax is payable.

The salaries tax system contains very limited scope for deductions, but it does incorporate a very generous set of allowances for those on lower incomes. These allowances favour families, especially. One curious outcome of the application of the salaries tax scale and these allowances is that over 60% of HKSAR wage and salary earners pay zero salaries tax. And less than 1% (mostly civil servants and others in government employment) pay at the top rate of 15% flat. In 1997, a single income family of husband wife and two children would need to be earning in excess of 3.6 million Yen per year before being liable to any salaries tax at all.

As was the case with profits tax, the main issue with salaries tax is source. Here though the situation is more clear. The wording of the IRO and subsequent interpretations have led to a somewhat “synthetic” definition of source applying but it has delivered clarity. Attempts to introduce the sort of arguments related to source in the case of profits tax have not been successful. Basically what the courts (and the IRD) have done, is “draw a line in the sand” based on the formalities of the contract of employment (its location, governing law, currency of payment and so on) and have declined to be drawn into detailed examinations of where work actually has been performed. The comparative simplicity of the source of a given salary (there is usually just one source from a single employer) helps the system to work. If an employer and employee feel that some sort of tax injustice is occurring, then it is possible to relocate the source of employment. In the case of a business, sources of income may be many and varied for a single business. The rather arbitrary source rules applying in the case of salaries tax could be quite dramatically unfair if applied to profits tax.

The leading case, *Commissioner of Inland Revenue v Goepfert*¹⁴ (*Goepfert’s case*) dates from 1987. In *Goepfert’s case*, the High Court of Hong Kong found that the location of an employment contract (and hence the source of income) was to be found by reference to legal-contractual tests of employment location (as stressed in UK case law) rather than a more substantive test based on employment activities (as stressed in Australian case law). The IRD accepted this finding and reinforced it in a DIPN which is issued. The IRD will reject clearly contrived attempts to exploit this approach, however.

To avoid problems of having to draw too fine distinctions, Part III contains some *de minimus* provisions. Many persons come to visit Hong Kong for work-related purposes. Section 8 of the IRO exempts from salaries tax, a person who spends all their time working outside Hong Kong even though they have a Hong Kong employment contract. Moreover, they may spend up to 60 days

¹⁴ (1989) 1 Hong Kong Revenue Cases, 100, 110.

working in Hong Kong in a given income year without jeopardizing this exemption. The IRD does not allow this exemption to apply to persons who are Hong Kong residents, however. Generally, this means those holding a permanent Hong Kong Residents Card. The “60 Day Rule” also benefits those employed under non-Hong Kong contracts of employment. Such persons may spend up to 60 days working in Hong Kong without incurring any liability to Hong Kong salaries tax. If they spend 61 days or more in a given fiscal year working in Hong Kong then they may be liable to Hong Kong salaries tax for the entire period spent in Hong Kong. Purely recreational visits are not counted but once some work is done, the total period of a visit, including recreational periods, is used to calculate the 60 days.

Where a salaries taxpayer has paid a tax akin to salaries tax on the same income in another jurisdiction, then an exemption (rather than a credit) from Hong Kong salaries tax is available under section 8. Thus, provided the taxpayer can satisfy the IRD that the other tax has been paid, no Hong Kong salaries tax will be payable, regardless of the amount paid elsewhere.

The other main issue with respect to salaries tax is the taxability of fringe benefits. The general policy in Hong Kong is to tax fringe benefits very lightly. The leading case on the topic is *Commissioner of Inland Revenue v Glynn*¹⁵ (*Glynn’s case*) from 1989. *Glynn’s case* eventually found its way to the Privy Council after the Court of Appeal in Hong Kong had found that a substantive test ought apply to the question of what was a fringe benefit or perquisite under section 9 of the IRO. The finding of the Court of Appeal suggested that a wide range of hitherto untaxed benefits in Hong Kong would become taxable because it rejected the old UK case law position on the question of fringe benefits epitomized in the 1892 case of *Tenant v Smith*¹⁶. In that case (and following cases) it was established that, where fringe benefits could not be converted into cash or its equivalent, they would not be taxable as income. The IRD had sought in *Glynn’s case* to apply salaries taxes to certain child

¹⁵ (1990) 3 Hong Kong Tax Cases, 245.

¹⁶ (1892) 3 Tax Cases, 158.

education benefits but the Court of Appeal went much further in its findings to the significant alarm of the IRD. Presumably because the IRD (and the Hong Kong Government) did not wish to upset a large number of existing employment contracts, a DIPN was issued after the Court of Appeal decision basically saying that, in most cases, the “cash-convertibility” test would continue to apply to fringe benefits. The Privy Council decision tended to take the same approach as the DIPN.

The present position remains that “cash-convertibility” is the test with certain exceptions including, child-education benefits, employee-share schemes and housing benefits. Housing benefits are very common in Hong Kong given the very high cost of residential accommodation outside of the public sector. Hong Kong always rates as one of the most expensive places in the World to live based on this measure. Rents for non-luxury accommodation on Hong Kong island range from 140,000 Yen per month for an old 40 square metre flat to 1 Million Yen per month for a modern, well located flat of 160 square metres. In fact housing benefits, although taxed, are only taxed very lightly. Regardless of the extent of the benefit, a salary is simply grossed up by 10% and then the taxpayer may deduct from that 10% any contribution to the rent which he is paying. Such contributions are common and are often around 7.5% of salary.

The outcome of this policy of only lightly taxing fringe benefits is that non-convertible benefits are very widespread in Hong Kong. They include: travel benefits; health insurance; free parking; provision of motor cars; club memberships; low interest loans; and so on. The system has also led to unacceptable tax planning. Recently, the use of interposed taxpayer owned service companies into what would normally be an employer-employee relationship has been curtailed through an amendment to the IRO. These companies were designed to convert salaries into a wide-range of (the taxpayer hoped) non-taxable fringe benefits.

3.5 Property Tax

Property tax applies at the rate of 15% flat to individual

assessable rental income from real property. Corporations receiving such income will normally be subject to profits tax. Property tax is not a major source of revenue. It solves the problem of how to collect tax on rental income from individuals where the activities creating their rental income stream may not qualify under section 14 as the carrying on of a trade or business.

The system applying is fairly simple. A standard deduction of 20% of rental income is allowed to cover repairs and outgoings. This 20% amount applies regardless of whether the outgoings are lower or higher than this. Individual taxpayers are able, also, to claim interest charges related to the property (that are not otherwise deductible) but only to the extent of the rental income. That is, it is not possible to offset interest charges in excess of rental income against other salary or wages income.

3.6 Anti-Avoidance Provisions

Although tax rates are low in Hong Kong, unacceptable tax planning has been on the increase for a good two decades. Much of this planning is imported by practitioners from much higher-tax jurisdictions who have moved to Hong Kong. Tax planning schemes common in Australia and New Zealand, for example, have a habit of popping up in Hong Kong.

The IRO now has a general anti-avoidance provision, section 61A, which is modeled on similar provisions in Australia and New Zealand. Section 61A has increasingly been put to use by the IRD. As is the case in Australia, the courts (and the Board of Review) generally have endorsed the wide scope of these newer general anti-avoidance provisions. The IRO also has an increasing number of specific anti-avoidance provisions, a number of which have been mentioned above.

The message is becoming more clear. Although Hong Kong clearly has a comparatively “taxpayer-friendly” revenue regime, excessive and contrived avoidance practices will not be tolerated. Hong Kong is not yet trying to “chase every fiscal rabbit down every burrow” as is the case in some jurisdictions, but the IRD is

demonstrating a growing intolerance of contrived tax avoidance planning.

3.7 Estate Duty

Hong Kong has had estate duty (and related gift duty) for many years. The Estate Duty Ordinance (EDO) does not raise a large share of yearly revenue but it is significant and it seems set to grow as numbers of newly wealthy Hong Kong citizens approach the end of their lives. In one sense, estate duty is easy to avoid as it only applies to assets in Hong Kong. The principal method of legitimate estate duty planning involves moving assets offshore, therefore. Real property assets can present problems in this regard, however. These problems are not insurmountable but the costs of proper planning can be quite high. Moreover, the difficulty of discussing the eventual death of specific family members in Chinese culture adds another factor to this equation. Estate duty planning obviously is premised on such discussions.

No estate duty is payable below a certain threshold. Generally, the family home will be exempt, although the exemption rules can be quite technical. The rates applying are 6%, 12% and 18%. As the various thresholds are crossed, duty on the entire estate is payable at the highest rate applicable; it is not a progressive scale. Generally, most gifts made within 3 years of death will be treated as passing on death and thus subject to estate duty.

To obtain probate of a will (or Letters of Administration) from the court, one has, first, to obtain a certificate from the Estate Duties Office. To obtain this certificate, one has to complete a complex affidavit covering all the assets of the deceased. Without the certificate, no court can authorize any dealing with the estate, so the assets remain, in effect, frozen. The significance of this system lies in the fact that the affidavits are reviewed carefully to see if the assets accumulation is at odds with the taxpayer's previous profits tax or salaries tax returns. Any discrepancies may be notified to the Profits Tax Unit or the Salaries Tax Unit of the IRD for review prior to the issuance of the vital certificate. The Estate Duties Office is part of the IRD so this procedure can be implemented quite easily.

The EDO, thus, serves as a further anti-avoidance tool in the application of the IRO.

3.8 Stamp Duty

Each year Stamp Duty raises around 10% of Government revenue. This percentage tends to rise when activity is very strong in the property market. This is the oldest tax administered by the IRD, dating back to 1866.

The Stamp Duty Ordinance (SDO) is a comparatively straightforward example of its type. In Australia, for example, stamp duty laws have grown quite complex. The explanation for the relative simplicity of the SDO lies principally in the fact that it applies only to a limited range of transactions. Like all stamp duty laws, the SDO is focussed on the “instruments” effecting given transactions. That is, it imposes duty on these instruments rather than on the transactions themselves. Instruments dealing with Hong Kong real property and Hong Kong stock transactions, together with Hong Kong bearer instruments are caught by the SDO.

Any system relying on the existence of instruments opens itself up for abuse where transactions can be completed without use of a given instrument. In Hong Kong, this has most notoriously occurred with speculative re-sales of real property which pass a beneficial interest without the need to rely on a formal instrument. The SDO now deals with this problem by mandating the creation of a stampable instrument in all such cases involving residential property. Thus, duty can no longer easily be avoided through “on-selling” or “flipping” prior to formal settlement on a residential property.

It was noted in the review of profits tax that the IRD imposes a de facto CGT in cases where they suspect speculative buying and selling rather than investment, especially in the real property market. This administrative CGT is facilitated by the operation of the SDO. In order to secure a good title that can be enforced in court, all stamp duties must be paid on any real property transaction. The records of the Stamp Duties Office on such transactions are comprehensive. It is, thus, comparatively easy to detect numbers of transactions involving profit taking over a short holding period. Such indications

of speculative activity are notified to the Profits Tax Unit who can then issue an assessment to profits tax for carrying on trade or an adventure in the nature of trade.

3.9 Summary

The Revenue Law regime in Hong Kong is, as it presently exists, relatively simple. Furthermore, it is characterized by low tax rates, a narrow tax base and a remarkable stability. The Ordinances that have been reviewed above have changed little in, any fundamental way, over the last several decades. This is in striking contrast to tax laws in most other developed jurisdictions. Those changes which have occurred have mainly related to stamping out unacceptable tax avoidance practices. The tax base remains quite narrow with no formal CGT and no VAT (or goods and services tax).

It could be said that the system has developed in a way which favours the very rich and the relatively poor more than the salaried middle class. The very low business tax rates and the ample opportunities for tax planning mean that big business is especially lightly taxed and the same can be said for the wealthy, generally in Hong Kong. There are excise duties on alcohol, tobacco and petroleum taxes and gambling is taxed but consumption, generally, is very lightly taxed. The absence of any sort of general goods and services taxes benefits all taxpayers but the rich more than others as they tend to be heavier consumers. At the other end of the scale, the very generous allowances which apply to lower income earners mean that the majority of Hong Kong citizens pay no income-type tax at all. And the problem of very high housing costs for this group is addressed through basic but inexpensive public housing.

Finally, it should be noted that the very high property values, from which the Government derives significant revenue still, do impose a de facto consumption tax on all Hong Kong consumers. The very high rents paid by all those providing goods and services in Hong Kong get passed on in the pricing of those goods and services.

4.0 SOME FACTORS WHICH HAVE SHAPED THE REGIME

This Part looks at how the development of the Hong Kong taxation regime appears to have been influenced by a matrix of factors. In a paper of this sort, it is not possible to give more than a summary of what some of these factors appear to be. In doing so, reliance has to be placed on generalizations. This overview does not claim other than to provide a guide as to what the influential factors appear to be. In particular, no attempt is being made here to quantify the effects of relative influences over time. Given the unusual nature of the Hong Kong revenue regime, it is still worth considering the broader influences at work as part of the process of trying to understand how it has come to be the way it is.

In the first place, there has always been very strong local business influence on the development of the taxation system. Even when the administration was more classically colonial in Hong Kong, the Government talked to business and listened to what business had to say, especially in regard to taxation. It is hardly surprising to discover that, over the history of Hong Kong, business has argued for low taxes and a simple system. As the World economy has grown more integrated, and yet more business has flocked to Hong Kong to use it as a regional base, the demands to maintain this low tax simplicity have been reinforced several times over.

Second, the strategy which the Hong Kong Government has employed to access land-based revenues has had an impact on the overall shape of the Hong Kong revenue system. Although reliance on direct land-related revenues is now below its peak in the mid-1970s, when it accounted for around 30% of all revenues, it continues to be significant. Moreover, that earlier heavy dependence helped underpin the fundamentals of the Hong Kong revenue system: low, relatively simple taxes imposed on a fairly narrow tax base.

Third, the emphasis on self-reliance in Chinese culture appears

to have lessened the demand for expenditures compared to many other advanced economies. The cause and effect relationship here is more difficult to pin down empirically than in the case of business influence but there is strong evidence of both the historical and continuing importance of self-reliance amongst the Hong Kong Chinese. The family remains a crucial socio-economic unit in a way not encountered in advanced Western economies. Within the family, the stress on sharing, on self-betterment through education and on material acquisition as a hedge against chaos all remain dominant values.¹⁷ The previous stress on children being responsible for the welfare of their parents in old age appears to be eroding, partly because of immigration patterns from Hong Kong, but it is still widely respected value. The vitality of these cultural norms appear to have influenced public expectations on the role of government, especially when one compares the expectations which prevail in Western Europe or even in North America. Hong Kong people certainly clamour for more help from government but they also like the low tax system and, at the end of the day, most of them can fall back on “privatized” family based processes to deal with day to day and longer term issues in their lives. These processes, with their networks of personnel and information which extend around the English speaking World (and beyond), are considerably more sophisticated than in most Western jurisdictions.

Fourth, the lack of any democratic decision making structure has made it difficult (though not impossible) to lobby for changed expenditure patterns. This is certainly not an argument against greater democracy. It is just a statement of fact. Politicians who are reliant on popular votes to keep their jobs are going to be more vulnerable to lobbying by specific groups to look after their special interests. It is likely that the absence of this mode of public action explains, to a degree, the extraordinary number of daily papers in Hong Kong. Newspaper readership in Hong Kong is amongst the

¹⁷ For further discussion of these issues and related matters, see Bond, Michael, Harris, *Beyond the Chinese Face* (Oxford University Press, Hong Kong, 1991) Chapters 2 and 6 and Lau Sui-kai, *Society and Politics in Hong Kong* (Chinese University Press, Hong Kong, 1991) Chapter 3.

highest levels in the World. It is straightforward to get a licence to publish and due to the population density, distribution is a manageable problem. Moreover, there are many wealthy individuals who can bear the start-up capital costs without much pain. The majority of papers seem to focus on starlets and race horses but they also serve as a lively mode for discussing all manner of public issues.

Fifth, successive Hong Kong Governments have moved to address many social expenditure issues on their own initiative. That is, the Government has been highly interventionist in certain areas. An early instance of massive government spending was on public housing. Squatter camps are now virtually eliminated, yet within the current generation they were housing hundreds of thousands of migrants from the PRC. There also has been massive government spending on the provision of health services and, more recently, tertiary education facilities were doubled in size within a decade. The Government has thus often moved to address pressing social issues in a timely fashion. The outcomes are far from free of controversy but there is no denying the massive changes in areas like housing, health and education over the last 20 years. One striking feature of these spending programs is that they have stressed the provision of infrastructure and services rather than “transfer payments” from the Government to individual citizens.¹⁸ The continuing pressures for yet more expenditure are discussed further below.

A factor related to that just discussed is the role of the Hong Kong Jockey Club. This non-profit institution holds the monopoly rights to manage all gambling in Hong Kong. The centrepieces of the Jockey Club empire are its two magnificent race courses, one at Happy Valley on Hong Kong Island and the other at Shatin in the New Territories. The turnover from gambling in Hong Kong is exceptionally high. The revenues of the Jockey Club are correspondingly immense. Its charter stipulates that it is to spend those revenues, after internal capital and running expenses are met,

¹⁸ See, *It's already 1997 in Hong Kong*, *The Economist*, December 18, 1997, 27.

on the provision of public goods and services throughout Hong Kong. The HKSAR is replete with all manner of Jockey Club facilities, including extensive sporting facilities and a wide variety of other public amenities. The Jockey Club financed the full capital cost (some 50 Billion Yen) to build Hong Kong's prestigious new University of Science and Technology.

Finally, the taxation system is now, to a degree, "self-perpetuating". It appears to have been very successful. Business has been attracted to Hong Kong because of the regime and, thus, strongly argues for its retention. The broad framework of the system is even made mandatory in the Basic Law (see further below). Also, the bureaucrats administering the revenue system also appear to prefer to keep it as simple as possible in the interests of making their own working lives more stable. This predilection stands in some contrast to the approach taken by taxation policy bureaucrats (mostly at the urging of deficit-burdened governments) in many other advanced economies. Their strategy, often, is to urge yet more taxation law-making rather like public civil-engineers urging the construction of yet more freeways.

5.0 CHALLENGES AND POSSIBLE REFORMS

This Part reviews a number of the challenges facing the Hong Kong Revenue Law regime. The fiscal achievements of Hong Kong are remarkable by any measure. There is no Government debt. The fiscal reserves of the HKSAR Government, including the funds backing the Hong Kong Dollar, the funds saved in the Land Fund and other reserves comfortably exceed 10 Trillion Yen. The Government in almost all fiscal years until very recently has run a budget surplus, so the reserves continued to climb. Hong Kong now has very strong public services in many areas. Its urban transportation system is World class as is the telecommunications system, basic housing is adequate and inexpensive, health and medical services are much improved and the tertiary education has

recently been vastly strengthened.

Despite these and other achievements, the HKSAR Government faces many related challenges however. These include:

- The ageing of the population;
- The rising expectations of the general population as the Hong Kong political-economy matures;
- International economic changes and pressures;
- Reforming the taxation base;
- Apparent inequities in the application of taxes; and
- The role for DTAs.

As is the case with many advanced economies, Hong Kong is faced with a major alteration of its demographic make-up. The birth rate is low and the existing population is ageing rapidly. Moreover, as the economy is maturing, Hong Kong citizens are looking to the Government to address a range of quality of life issues. These include:

- Providing access to better, privately owned housing for the majority of residents;
- Providing further educational improvements;
- Improving transport infrastructure throughout the HKSAR;
- Redressing the serious environmental degradation Hong Kong suffers;
- Providing better social services for the poor, especially those without families;
- Providing better retirement and health care systems for the aged;
- and
- Improving medical and health services

These and other issues are recognized as important by the new HKSAR Government and it already has announced plans to begin tackling them. Meeting these demands will be increasingly costly. As rising expenditure occurs, this will place new reform pressures on the Hong Kong revenue system. Most commentators feel that a likely early reform, probably sometime within the next decade, will be the introduction of a general goods and services tax. Many of

Hong Kong's neighbours now have one (or are implementing one) including Japan, China, Singapore and Malaysia.

Other areas for study likely will include how to spread the tax burden more equitably. The very low tax rates imposed on the wealthy and comparatively heavy burden born by the salaried middle-classes appears a curious way to distribute the income type tax burden according to many conventional measures. Finally, Hong Kong will need to continue to review whether it wants to remain outside the international tax system governed by DTAs and other international tax instruments. There are signs that the IRD and the Government would like to end Hong Kong's isolation in this regard. One problem is that Hong Kong's tax rates are so low that, *prima facie*, they place Hong Kong in the category of a "tax haven" according to many measures used by developed countries.

6.0 WIDER FACTORS SHAPING CHANGE

A number of the factors which historically have shaped the Revenue Law system in Hong Kong were discussed in Part 3 and a range of issues likely to have an impact on the future development of the system have just been discussed in Part 4. The purpose of this Part is briefly to take a note of some wider factors likely to shape changes in the system.

First, the competition for Hong Kong as a regional service centre is growing significantly. Certain services are now being attracted to the Philippines and many services can happily relocate, through the use of advanced technologies, to places as far afield as Australia. Possibly the greatest medium term threat comes from Shanghai, however. Its growth has been quite extraordinary over the last decade. It is far from sharing Hong Kong's infrastructure and other advantages. But it is making very rapid headway and it enjoys location and cost advantages. Moreover, it was, of course, once the principal entrepot to China. Once the banking system in the PRC undergoes serious reform and international financiers are allowed

full access, the major current impediment to Shanghai's further development as a regional centre will be removed. These reforms will not come quickly but they are being worked on.

Hong Kong also has benefited greatly from providing the principal interface for trade between Taiwan and the PRC. Most commentators feel it is really only a matter of time before cross-straits trade is progressively allowed to become far more direct. As this occurs, Hong Kong will fade in importance in this area of trade.

Hong Kong will also feel the impact of other circumstances arising out of the increasing globalization of economies. Sometimes these will be to Hong Kong's advantage but not in all cases. Costs in Hong Kong, especially due to property prices, are nowadays very high. This creates a significant incentive to relocate activities which are able readily to move to anywhere that electronic communications are good (and, increasingly, where English is widely spoken).

Some commentators feel that the development of "electronic money" poses almost insurmountable problems for national revenue regimes over the medium to longer term.¹⁹ In the case of capital, this already is proving to be very difficult to tax. Even goods and services taxes are under threat, however, as increasing supplies of both are available through the Internet. Thus, if you wish to avoid VAT in the UK, say, on the provision of legal advice, it already is feasible to obtain quality advice from outside the UK electronically and to pay for it in the same way. The day probably is not that far off when you can get your Sydney, Australia conveyancing settlement largely processed in Bangalore, India.

These sorts of developments do not spell an end to Hong Kong's prosperity, of course. What they do do, is suggest that growth rates in Hong Kong in the medium to longer term will be affected. This, in turn, will have an effect on growth in the revenue base.

¹⁹ See, for example, Kobrin, Stephen J., *Electronic Cash and the End of National Markets* (1997) (Summer) Foreign Policy, 65.

7.0 THE IMPACT OF THE CHANGE OF SOVEREIGNTY

Perhaps of all aspects of life in Hong Kong, the Revenue Law system is one of those that has been least affected by the change of sovereignty. Given that the Basic Law stresses the centrality of economic continuity for the HKSAR, this is not so surprising. The Basic Law does this in several ways, as does the Joint Declaration. First, there is the clear statement in the Joint Declaration that Hong Kong's current legal, social and economic systems are to be maintained after 1997.²⁰ Next, the Basic Law says that HKSAR revenues are to be used exclusively for HKSAR purposes and not to be handed over to the PRC Mainland.²¹ The Basic Law also stipulates that the PRC Mainland must not impose any Mainland taxes in Hong Kong²² and that the HKSAR is to have an independent taxation system.²³

Despite this emphasis on continuity, the handover may prove to be a precursor of change in subtle ways. China radically reformed its taxation system in 1994. On paper, it is a more up to date system, in many respects, than the Hong Kong system. The VAT in China has not been trouble-free but it has proved a comparative success. China has also moved to develop a CGT system. Moreover, China has signed many DTAs. There is bound to be greater pressure on the HKSAR to take note, at least, of taxation developments in the PRC Mainland. As these PRC Mainland reforms bed down, they may become persuasive examples over the medium term for the HKSAR. There are currently no obvious particular frictions between the two tax regimes but it is entirely conceivable that these could emerge in the future, producing a need to amendments in the HKSAR taxation system. One area where this may occur sooner rather than later is the taxation of salaries of those regularly working across the two borders.

²⁰ Joint Declaration, Paragraphs 3(3) and 3(5).

²¹ Basic Law, Article 106.

²² Basic Law, Article 106.

²³ Basic Law, Article 108.

Certain commentators have speculated that there are ways in which the PRC Mainland may be able to circumvent the limitations in the Basic Law placed on revenue sharing. The Hong Kong Monetary Authority holds around 10 Trillion Yen in hard foreign currencies and various securities to support the Hong Kong Dollar. If it were to shift some of these investments into Chinese Government Bonds, this would be one way of Hong Kong funds being transferred (assuming that the interest rates were below market rates). The Hong Kong Government could invest in PRC Mainland bonds, also. China's thirst for capital is vast. Much of the demand is met from private investment, especially from the overseas Chinese in Hong Kong and Taiwan, who contribute around 70% of total private investment in the PRC Mainland.²⁴ But China also is the heaviest borrower from the World Bank and it is close to the limit which the World Bank can lend to a single nation (although it is one of the bank's very best customers being completely reliable in its repayments). Moreover, the Central Government is running very large fiscal deficits partly because of the burden of sustaining the loss-making State Owned Enterprises (SOEs). All these factors, and especially the problem of dealing with the SOEs, highlight Hong Kong's position as a potential source of problem-solving (public) capital. Other modes of tapping into Hong Kong funds include suggestions that the PRC Mainland may be able to impose export taxes on goods and services, including water and electricity flowing from the Mainland to Hong Kong. Any such taxes would appear not to infringe the letter of the Basic Law, although they may contravene principles of international trade law as developed by organizations like the World Trade Organization.²⁵

The above comments are premised on no exceptional circumstances arising, especially in the PRC Mainland. Given the history of China this century, some may find this an heroic

²⁴ Chevalerias, Phillipe, *Investment Strategies in China* (1997) (13) China Perspectives, 63.

²⁵ These issues and others are discussed in some detail in Ching, Jae Ho and Lo, Shui-hing, *Beijing's Relationship with the Hong Kong Special Administrative Region: An Inferential Framework for the Post-1997 Arrangement* (1995) 68 Pacific Affairs, 167.

assumption. Despite all those traumas, however, including war against Japan, an appalling civil war, Mao Tse Tung's horrific famine inducing Great Leap Forward in the late 1950s and the shattering Cultural Revolution of the decade after 1966, China now finds itself far more prosperous than at any time in the last 200 years. If exceptional circumstances were to arise how might they do so? The most obvious source today would be through conflict with Taiwan. The civil war is still not over. Cross-straits relations are always tense but sometimes, as in 1996, they can become dangerously so. If serious conflict were to commence with Taiwan involving military engagement, then it seems axiomatic that Hong Kong would be rapidly drawn into that conflict and that process would be bound to mean accessing Hong Kong revenues to pursue the fight. Another source of extreme or exceptional circumstances would be some sort of economic "meltdown" in China. That is, if the sort of financial calamities which have affected several South East Asian countries since 1997 were to take hold in a serious way in the PRC Mainland, Hong Kong and Hong Kong revenues would be bound to be significantly affected.²⁶

There continues to be much speculation about how the Central Government will deal with the HKSAR Government and Hong Kong over time. It is now more than two years since the change of sovereignty occurred. It is clearly too early to speak about long-term trends but it is possible to note some current trends. First, it is clear that a "hands off" policy is normally being applied with respect to Hong Kong by Beijing. Beijing has deeply influenced the shape of the first HKSAR Government and it appears satisfied to let it get on with the job. China's Foreign Minister recently stressed the crucial importance of safeguarding the long term prosperity of the HKSAR and the need for a strict application of the "One Country - Two Systems" principle.²⁷ The New China News Agency has been

²⁶ For further discussion, see Cullen, Richard and Fu, Hua Ling, *Fiscal Reform in China: Implications for Hong Kong* (1997) 19 *Loyola International and Comparative Law Journal*, 389.

²⁷ Qian Qichen made these comments at a major conference in Beijing in June, 1997. See, *Monitor*, (1997) (13) *China Perspectives*, 68.

making the same point.²⁸ Very shortly after the handover, the respective heads of the two PRC Mainland agencies with the greatest responsibility for Hong Kong (the Hong Kong and Macau Affairs Office and the Hong Kong branch of the New China News Agency) were quietly replaced. The leaders of these two institutions prior to the handover were consistently aggressive and interventionist during the final period of British administration. Their replacements appear to be more restrained in their approach.

The HKSAR Government has also taken a very “hands on” approach, announcing plans for major lifts in capital and current expenditure on a range of areas including housing and education. Now that the fateful day has passed, the mood in Hong Kong, though still nervous, generally is less stressed than it was before July 1, 1997.²⁹ Moreover, across all sections of society a more long-term perspective is apparent.

The press is more outspoken now than before the changeover. The self-censorship introduced before July 1, 1997 is cautiously being relaxed in a number of publications.³⁰ Time is on Hong Kong’s side. The longer time that passes without radical change to the political-legal structure, the more difficult it will be to effect change. It does need to be noted, however, that during 1999, the HKSAR Government engineered something of a show-down with the CFA after Hong Kong’s new highest court produced a judgment on the Right of Abode in Hong Kong of persons from outside Hong Kong (and especially from the Mainland) which the Government did not like. The CFA read the relevant provisions in the Basic Law in such a way as to enhance access to the Right of Abode for those seeking it. The HKSAR Government subsequently organised an “interpretation” of the Basic Law by the Standing Committee of the National People’s Congress (SCNPC) in Beijing which reversed the findings of the CFA. The SCNPC applied a provision of the Basic

²⁸ New China News Agency Commentary, *An Important Contribution to the World: The Handover of Hong Kong to China*, *ibid*,

²⁹ Bonnin, Michael, *President Jiang’s New Clothes* (1997) 13 *China Perspective*, 4.

³⁰ *Ibid*.

Law to issue its interpretation – which interpretation was really more of a pronouncement. This undermining of its own judiciary by the HKSAR Government is the most significant retrograde political-legal step seen since the handover.

Of course, many threats to the general autonomy of the HKSAR remain. Stopping the seious migration of PRC Mainland style corruption at bay will be a huge task for authorities in the HKSAR. And, apart from the exceptional circumstances mentioned above, there is always the possibility of nasty authoritarian political spasms emanating from Beijing. It may be that the likelihood of this happening is fading somewhat, however. The last two major manifestations of this political phenomenon were: (a) sending the tanks and troops into Tiananmen Square on June 6, 1989; and (b) the “voting with rockets” episode in the Taiwan Straits in the run up to Taiwan’s first fully democratic Presidential elections. Both episodes brought some immediate “benefits” in the eyes of some PRC leaders, at least. Most would now recognize, however, that the medium term damage wrought in each case has been great. The consequences in both cases serve as a reminder that such tactics can be applied but only at real continuing cost.

In summary, the safeguards isolating the HKSAR revenue regime from that in the PRC Mainland are significant. Moreover, the political safeguards also are powerful. It is very much in the interests of the Central Government to maintain stability and prosperity in Hong Kong. The HKSAR holds massive investments from the Mainland, the World is watching most everything that is happening in the HKSAR and the HKSAR is meant to provide the concrete model which is to persuade Taiwan that it could return, formally, to the Motherland. These and other factors suggest that the HKSAR revenue system likely will continue to be shaped much more by internal Hong Kong factors than by any backwash from the change of sovereignty. There will be change but it will be evolutionary rather than revolutionary. In the event of exceptional circumstances arising, however, this position could change dramatically. In this regard, it is worth recalling that the introduction of income tax type taxes in Hong Kong was originally driven by a desire to help make

a contribution, on the part of the Hong Kong Government, to the British war effort in World War Two.

8.0 LESSONS TO BE DRAWN FROM THE HONG KONG TAX EXPERIENCE

It is likely that lessons can only be drawn from the Hong Kong tax experience in a limited way. From the above review, it can be seen that Hong Kong is a special case in many respects. The policy of successive Hong Kong Governments to access land-based revenues in manner rarely if ever seen in other jurisdictions sets it apart from the start. The comparative economic and social self-reliance of the Hong Kong Chinese has also relieved some of the pressure for expenditures which typically occur in Western, developed economies. Next, the Hong Kong Government has not had to answer to a democratically elected legislature. This has freed it from much of the near irresistible pressure to satisfy special interest groups experienced by democratically accountable governments. At the same time, successive Hong Kong Governments have spent heavily to address pressing needs, *inter alia*, in housing, education, infrastructure and health at the same time as they have resisted committing themselves to extensive programs involving transfer payments to individuals. Finally, Hong Kong has enjoyed special opportunities and faced exceptional challenges in the post Second World War period, especially.

There do seem to be some broad lessons which might be drawn, however, particularly for other East Asian and South East Asian jurisdictions. Moreover, the Hong Kong experience is useful for purposes of highlighting where tax policy may have gotten into trouble in developed Western economies.

One important comparative lesson is that by avoiding the lure of transfer payments on a large scale to individuals, the Hong Kong Government has been able to maintain expenditure controls in a way not possible in many developed Western Economies. This approach

has left some serious gaps in welfare provision for the truly needy and poor in Hong Kong. It is a scandal that some Hong Kong citizens have to endure abject poverty in the midst of such wealth (this risk is greatest for the elderly without families). These adverse effects have been softened to an extent by the resilience and self reliance of local family structures. A positive aspect of this approach is that the HKSAR Government is well placed to try and address Hong Kong's poverty problems without recourse to the solutions which have proved difficult to sustain in advanced Western economies.

Another important lesson to be learned is that, provided a government is able to maintain fiscal prudence and avoid long-term deficit financing, it is possible to maintain a simple, low rate taxation system. The advantages of such a system are significant for all concerned. First, it clearly leaves more decision about spending in the hands of individuals and thus enhances their autonomy. Secondly, governments running "in the black" can tolerate some revenue leakage and, most importantly, they are not driven to craft ever more complex tax laws to try and trap every last dollar owed. The problem with complex tax laws is that, rather like building more freeways, as soon as you have finished the latest edifice, you find that your "solution" has generated a need for yet more of the same "solution"; rather than solving tax problems complex tax laws seem often to exacerbate them further. Also, along with complex laws comes, almost always, a vast tax-compliance industry which consumes significant resources in what can only be described as unproductive ways.

From the perspective of Japan, as it begins to tackle, again, the issue of corporate tax rates, one special message is clear. Japan, although having a vastly different economy to that of Hong Kong, nevertheless can be seen, in the light of the Hong Kong tax system, to have built for itself an excessively complex system of corporate taxation which is widely recognized as distorting investment decisions in a serious way. It has helped produce very complex corporate structures, with subsidiary companies proliferating. It has encouraged Japanese investment to move outside of Japan and it

discourages inward capital investment.³¹ The difference with the Hong Kong tax system could hardly be more clear. It is impossible to consider emulating the Hong Kong business tax system in Japan. But any comparison with the Hong Kong system does re-emphasize both: (a) the need for serious corporate tax reform in Japan; and (b) the direction in which that reform ought proceed.

It is important to be cautious in drawing any of the lessons just discussed but, bearing that caution in mind, the Hong Kong tax experience can usefully be referred to in the course of the wider comparative tax policy debate presently raging within most advanced economies.

³¹ *Tax reform runs late*, *The Economist*, November 8, 1997, 91.