Task Force on Economic Challenges

Discussion Paper (2)

Provisional Profits Tax

Purpose

This paper proposes an alternative approach to relief in respect of Provisional Profits Tax (PPT).

Executive summary

2. The discussion paper submitted on 11 November 2008 proposed the extension of the payment due date and the deadline for application of holdover of PPT as a one-off alleviation measure in response to the repeated calls from the business sector for assistance. In the event an across-the-board extension of the payment due date is considered not appropriate, an alternative approach could be the twin measures of i) waiver of the late payment surcharge ii) acceptance of late applications for holdover of PPT on a case by case basis.

Discussion

3. As an alternative to the extension of the tax payment date, the Commissioner of Inland Revenue (CIR) may consider exercising her discretion to:-

- Waive the imposition of the 5% surcharge on late tax payment that would otherwise apply. Under Section 71(5) of the Inland Revenue Ordinance (IRO), the CIR may in her discretion impose a surcharge not exceeding 5% of the tax in default. In practical terms, this is interpreted to mean that the CIR may decide on the amount of the surcharge (up to a maximum of 5%) which includes a discretion not to impose the surcharge at all.

- Accept late applications for holdover of PPT. It has been a long standing practice that the CIR would accept late holdover applications in *exceptional circumstances.* The then CIR acknowledged this practice at the 1999 Annual Meeting between the IRD and the Hong Kong Institute of Certified Public Accountants; the relevant section of the meeting minutes is extracted below:-

> "*There is no provision in the IRO dealing with the acceptance of late claims for the holding over of provisional profits tax, the CIR said. The onus is on taxpayers to monitor their trading results so that timely applications are lodged.*
>
> *In exceptional circumstances, late applications may be considered. Taxpayers must demonstrate why they were prevented from lodging an application in time. Acceptance of late applications lacking a reasonable justification could not be assumed.*"

The current financial crisis should qualify as “exceptional circumstances” allowing the CIR to accept late holdover applications.

4. The combined effect of the two measures suggested above would give rise to the same assistance intended by the original proposal to extend the payment due date which is two folds:-

i) Cash flow

It is quite common for businesses to obtain tax loans from financial institutions to settle their tax bills. However, the financial crisis has led to a tightening of credit facilities to businesses and it has taken longer than usual for them to successfully obtain tax loans. Therefore, extending the tax payment due date (or not levying penalty on late payment which effectively means an extension of the payment due date) would allow more time for businesses to apply for the tax loans (where needed) or to assess their cash flow positions.

ii) Holdover of PPT

The impact of the financial crisis only became apparent to Hong Kong in late September (or even early October), although it hit Hong Kong rapidly. Therefore, some taxpayers might not have been able to predict the dramatic change in their financial position in early October when the deadline for holdover application expired. This explains why there have been repeated requests for a waiver of PPT since only the second week of October. These exceptional circumstances should justify acceptance of late applications for holdover of PPT.

5. Companies which adopt an accounting year end date between 1 January and 31 March should not have their tax payment due until January, meaning that they should have sufficient time to prepare and lodge their holdover applications. However, no distinction has been made in the assistance proposal as it might be difficult for the Government to only offer assistance to a particular class(es) of Profits Tax payers.

Ayesha Macpherson
8 December 2008

Task Force on Economic Challenges

Discussion Paper

Cash-flow Assistance Through Tax Loss Relief

Purpose

This paper considers possible changes to the tax loss regime under Hong Kong Profits Tax to help businesses cope with cashflow problems in a cyclical economic downturn.

Executive summary

2. The impact of the global financial crisis will lead to business losses and cash-flow problems for many companies in Hong Kong. Current tax legislation only allows a tax loss incurred by a company to be carried forward indefinitely and set off against its future profits. It does not allow tax losses to be carried back to offset against profits taxed in prior years, nor does it allow tax losses to be transferred between group companies. Many developed countries have introduced more flexible tax loss provisions to enhance their business environment. Introducing tax loss carry-back and group loss relief will lower the tax-burden on companies and help them during recessions.

Discussion

3. Under the current tax loss regime in Hong Kong, a tax loss incurred by a corporation can be carried forward indefinitely and set off against its future assessable profits until fully utilised (subject to anti-tax avoidance provisions). However, in contrast to many other jurisdictions, tax losses cannot be carried back to offset against taxable profits in prior years or transferred between group companies (commonly known as group relief).

4. Being able to carry-back tax losses is particularly important for small businesses to help them cope with cashflow problems, especially in a cyclical downturn. Even during times of economic prosperity, the SME sector finds it more difficult to gain access to credit than larger corporations. In times of economic downturns, this sector is generally starved of credit and tends to run into cash-flow problems quite soon even if the businesses are viable over the longer term. The current system only allows losses to offset future tax liabilities – if a business incurs a loss this year, it can carry the tax loss forward and offset it against profit in subsequent years, reducing the tax payable for later years. But for small businesses, next year may be too late. By adding a loss carry-back feature, businesses can offset current year tax losses against prior year's profits that have been assessed to tax and obtain a refund of tax paid. This would help to relieve the cash-flow burdens of businesses suffering losses during hard times.

5. A loss carry-back feature may lead to greater uncertainty in government revenue especially during economic downturns. However, there is no long-term impact on government revenue as the current system already allows losses to be carried forward. The loss of revenue arguably only arises if the company does not recover from its current losses and ceases business.

6. As regards the need to introduce group loss relief, the current Hong Kong loss utilisation rules work well where companies operate separate business lines under the same legal entity. However, these days it is less common for enterprises to organise their business lines under a single entity. Corporations are usually organised along lines of business operated through separate legal entities. This may be in order to limit the liability and risk of their investments or to reflect the structure of their businesses. Even though the business of the parent company may be legally separated from those of its subsidiaries, the group is commonly managed and controlled as a consolidated economic unit. However, corporations are not allowed to offset the losses of one company against the taxable profits of another within the same group. Each company in a group pays tax as a separate, stand-alone entity. As a result, setting up separate companies effectively raises the tax cost for the whole group.

7. The introduction of group relief will lower the tax burden on companies, and encourage more risk-taking and enterprise. It will also help companies during recessions or during the early years of new ventures, when they are likely to make losses. Companies which set up subsidiaries for risky ventures will be able to enjoy the limited liability benefit of separate subsidiaries, and still offset those subsidiaries' losses against their own profits.

8. It is generally accepted that a good tax system is one that incorporates neutrality and equity between different forms of commerce. Taxpayers in similar situations conducting similar transactions should be subject to similar levels of taxation. In the absence of any tax loss carry-back or group loss relief, the current tax loss regime in Hong Kong gives rise to an inequitable tax result. For example, a loss-making enterprise which derived profits and paid tax in the earlier years can never obtain a tax refund and will remain in a tax paying position overall even though it is in losses during its lifetime. Further, a corporate group consisting of profit-making companies and loss-making companies may suffer a higher overall tax burden and higher effective tax rate than would be the case had the businesses been carried out by a single company.

9. Many developed economies now offer some form of group relief mechanism to taxpayers and some also allow tax losses to be carried back. The following table provides examples of jurisdictions which offer these tax loss relief features:-

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

10. In assessing the competitiveness of Hong Kong's tax loss regime, one may perhaps argue that the tax systems of most developed economies are very different from, and hence are not directly comparable to, the tax system of Hong Kong. In particular, Hong Kong has a distinctive tax system which adopts:-

- a territorial tax scope (i.e., only local source income is subject to tax)
- low rates of tax (i.e., Hong Kong has competitive tax rates)
- no time limit to carry forward tax loss (i.e., tax loss can be carried forward indefinitely)
- one-tier taxation of dividend (i.e., dividends are exempt from tax in the hands of shareholders)
- no capital gains tax (i.e., profits from sale of capital assets are exempt from tax)

- simple compliance requirements (i.e., tax law is relatively simple and easy to comply with and administer both for taxpayers and tax authorities).

However, Singapore which shares all of the abovementioned characteristics has also adopted a group relief regime from the year of assessment 2003 and a tax loss carry-back regime from the year of assessment 2006 onwards.

11. The Government has expressed the following key concerns regarding the introduction of loss carry-back and group relief:-

i) That they may result in significant loss of tax revenue;

ii) That the two arrangements could be abused for tax avoidance;

iii) That they require complicated legislative provisions.

12. However, these concerns need not stand in the way of introduction of these features:-

i) As noted above, although there may be greater uncertainty in government revenue, there should be no long-term impact as the current system already allows losses to be carried forward. The size of the Government's finances should be able to withstand the fluctuations better than individual taxpayers;

ii) Existing tax law already has provisions to strike down tax avoidance schemes. Indeed, the converse should be the case as more flexible tax loss relief provisions mean that companies would not need to engage in transfer pricing or other means to avoid trapped tax losses. In addition, with group information for group relief, the IRD will be better equipped to deal with tax avoidance.

iii) The enactment of these features need not result in complicated legislative provisions. In this regard, it is worth noting that Singapore implemented group relief and tax loss carry-back successfully without any legal and regulatory difficulties or a fundamental overhaul of their existing anti-avoidance rules.

Ayesha Macpherson
November 2008

Task Force on Economic Challenges

Discussion Paper

A Statutory Corporate Rescue Mechanism for Hong Kong

Purpose

This paper sets out the need for a corporate rescue procedure in Hong Kong to provide an opportunity for companies in financial difficulty to turn around and to preserve employment that would otherwise disappear.

Executive summary

2. As we enter a global financial downturn, Hong Kong now stands virtually alone among the leading global financial centres in having failed to enact a statutory corporate rescue framework. New York, London and Tokyo all have statutory rescue regimes. In addition, since the introduction of the mainland's Enterprise Bankruptcy Law in 2007, Hong Kong now also lags behind almost all Asian jurisdictions, including Singapore which has introduced "judicial management" for more than 20 years. This is despite insolvency law reform efforts which began over a decade ago.

3. With the anticipated increase in business failures arising from the global financial crisis, it has become all the more important for a corporate rescue regime to be enacted in Hong Kong to give companies in financial difficulty a breathing space in which to explore survival options and thereby create an opportunity to save jobs that are, for want of such legislation, all too easily lost. Draft legislation in the form of the Companies (Corporate Rescue) Bill (the Bill) already exists. Priority should be given to the legislative process to enable the urgent enactment of a corporate rescue regime.

Discussion

4. At present, companies facing financial difficulty but seeking survival find very little support in terms of legislation. Section 166 of the Companies Ordinance (Ordinance) provides a cumbersome, complex and uncertain mechanism by which a company can make some kind of compromise. However, most importantly, because the section does not contain an automatic stay on creditors taking legal action to enforce their rights, a single recalcitrant creditor can always sabotage the process. For these and other reasons, the section is very rarely used outside of a formal winding up process.

5. Within current legislation, the only way in which a company can obtain the moratorium that is essential to a successful rescue is by having provisional liquidators appointed. But provisional liquidators can only be appointed once a petition to wind up the company has been presented (see section 186 of the Ordinance for the moratorium and section 193 for the appointment of provisional liquidators). However, the presentation of a winding up petition is

deemed to be the commencement of liquidation and, thus, has significant adverse consequences for the company. As a result, even though provisional liquidation (by gaining the moratorium) removes one barrier to a successful rescue, it erects many others. Moreover, the role of provisional liquidators has traditionally been as a preserver and protector of assets in anticipation of eventual liquidation, rather than as a promoter of a corporate rescue. Accordingly, a provisional liquidator is a poorly equipped rescuer.

6. Another key component in corporate rescue regimes around the world is the ability of the distressed company to obtain emergency funding, most often on a super-priority basis. In many rescue cases overseas, such emergency funding is often used to meet the wages of employees whilst a rescue is explored. The lack of appropriate legislative arrangements in Hong Kong means that it is almost impossible to obtain such funding.

7. The cumbersome nature of the section 166 scheme of arrangement, together with the absence of a statutory moratorium and the inability to secure emergency funding means that companies in financial distress have a very small window of opportunity in which to explore a rescue. What this means in practice is that too many companies are forced to close their doors and terminate their employees too soon.

8. For instance, in a recent significant corporate failure, the provisional liquidators received a number of very serious expressions of interest from parties wanting to get involved in putting together a rescue. However, formulating rescue plans for any business takes time. In this case, the provisional liquidators had a substantial payroll of several hundred staff, as well as very significant continuing financing obligations in respect of the critical plant and machinery that was secured to the banks and which was essential to the operations. The cash available to the provisional liquidators was sufficient to meet the payroll for only a very short space of time; the continuing financing obligations could not be met at all. Accordingly, within 10 days, the provisional liquidators had to make all of the staff redundant and the banks took steps to take possession of the assets. Obviously without either the machinery or the people to operate it, these events made a rescue of the business less likely and ultimately a rescue could not be achieved and the company is now in liquidation.

9. A successful corporate rescue would avoid the many social costs of a liquidation. Apart from the direct social costs arising from the loss of employment of the failed business, there may also be a substantial knock-on effect within the business sector as trade creditors, particularly SMEs who tend to rely on one or two trading partners for their own businesses, may find themselves in financial difficulty as a result of the liquidation. A corporate rescue should also be more attractive to unsecured creditors (who are often considered to have a raw deal in a liquidation) and to shareholders (who generally have the lowest priority when it comes to the distribution of the assets of a company that has gone into liquidation).

10. The Law Reform Commission has recommended a corporate rescue procedure in Hong Kong for companies in financial difficulty. Its recommendation aims to impose a moratorium during which a company is protected from creditors' action and put under the control of a provisional supervisor (an independent professional third party) whose task is to see whether a better outcome than liquidation can be achieved.

11. The legislative proposals to implement this recommendation formed part of the Companies (Amendment) Bill 2000 (the 2000 Bill), which was introduced into the Legislative Council in January 2000. The 2000 Bill proposed a Provisional Supervision regime in which a company in financial distress would be permitted to appoint a qualified professional to take over the management of the company and develop a rescue plan. The procedure was to be streamlined, with minimal court involvement. This is the model commonly adopted for use in Commonwealth jurisdictions and has proved successful in many countries. It is considered more appropriate for Hong Kong than the USA Chapter XI model because (a) the very heavy involvement of the courts in a Chapter XI makes it a very expensive process; (b) the introduction of a Chapter XI model in Hong Kong would require a substantial departure from the tradition of the UK-based system on which much of Hong Kong's law and legal system is founded; and (c) the financial community in Hong Kong is unlikely to accept the concept of debtor-in-possession which is a central feature of Chapter XI.

12. The issue that attracted the most debate was the way in which the 2000 Bill dealt with wages and other claims owed to a company's workers. It proposed that a company would have to either pay, in full, all wages and other entitlements owing to the workers, or set up a trust account with sufficient funds at a bank, *before* the company could go into provisional supervision. Doubts were raised on how a financially distressed company might raise the cash necessary to pay (in advance and in full) all outstanding wages, severance payments, long-service payments, etc. Many considered that the requirement would make it difficult for the corporate rescue procedure to be initiated, thereby defeating the purpose of the 2000 Bill.

13. The proposals were re-submitted to LegCo, in essentially the same form, as the Companies (Corporate Rescue) Bill 2001. During the Bill Committee stage, business and professional bodies raised the same concerns they had with the 2000 Bill as this later bill contains essentially the same proposals regarding employees' entitlements.

14. In view of the concerns expressed, Government proposed in a consultation paper issued in September 2002 a cap on such payments to bring the amounts payable to workers in a provisional supervision in line with the amounts that workers would receive in compulsory liquidations. The consultation ended in November 2003 and majority support was obtained for the proposed cap. However, little legislative progress has been made since the conclusion of the consultation.

15. In relation to the introduction of a corporate rescue procedure and in order to encourage directors and senior management to act on insolvency earlier rather than later, the 2001 Bill introduces the concept of "insolvent trading" to make responsible directors and senior management personally liable for the debts of a company which traded while insolvent. This is intended to encourage them to face the fact that a company was slipping into insolvency at an early date and to address the situation. In this sense, the improvement of corporate governance should by itself result in a reduction in corporate failures.

16. It should not be perceived that provisional supervision will be applicable in every case, nor will it provide a magic solution that will save every company. It will, however, significantly improve the chances of more rescues being attempted and will perhaps encourage directors to seek help on a more timely basis.

17. The need for the introduction of a statutory corporate rescue mechanism in Hong Kong is beyond dispute. The need has become all the more pressing given the likely increase in companies in financial difficulty with the onset of the global financial crisis. In the present climate, it is all the more important that provisional supervision is made available to provide a breathing-space to businesses which are fundamentally sound, but which are experiencing short-term financial difficulty in a cyclical economic downturn. In this way, they may be able to restructure and to work out a mutually-beneficial arrangement with their creditors and preserve jobs that would otherwise be lost.

Ayesha Macpherson
November 2008

Task Force on Economic Challenges

Discussion Paper

Providing Credit to Small and Medium Enterprises

Purpose

This paper sets out two options to develop further the Government's actions to support the provision of credit to the small and medium enterprise (SME) sector of the Hong Kong economy.

Executive summary

2. The SME sector is fundamental to the growth of the economy in Hong Kong. It employs approximately one third of the workforce and represents about 98% of all business units. In general, even in times of economic prosperity, this sector finds it more difficult to gain access to credit than larger corporations and government institutions. In times of economic difficulty, there tends to be a crisis of confidence in this sector as it is perceived as being even more risky and consequently is starved of credit.

3. The Government has already extended its guarantee for banks lending to this sector under the SME Loan Guarantee Scheme and the recently proposed Special SME Loan Guarantee Scheme. It is yet to be seen whether these schemes will lead to sufficient increase in credit to this sector.

4. In the event that further Government actions are considered necessary, two initiatives are proposed for discussion:-

(i) In the short term to provide through an agency lending scheme, immediate government funding to the sector through the banks as arrangers of credit (but not providers of credit), which would involve the Government depositing funds with local banks which are to be on lent to the SME sector; and

(ii) In the medium term to create an SME policy bank to provide better longer term support to this sector.

Discussion

Agency lending to the SME sector

5. The proposition is that the Government should in essence take over from the market in this situation where market forces are distorted by the effects of the crisis. The Government could deposit with local banks sufficient funds to provide credit to the sector, replacing the banks' role in this regard. These deposits would be designated by the Government for lending through an entrustment arrangement to SMEs. However, given that the banks are in the best position to distribute and administer this credit in the short term, it is recommended that the banks act as the arrangers of credit, receiving a fee for their services. Apart from the administration fee, all interest and principal should be repaid to the Government through the banks.

6. The Government would need to set the terms, interest rates (ensuring that central bank driven interest rate cuts are passed on) and repayment periods of this credit availability. It is important to emphasize that given the economic environment, credit losses would be expected to occur. However, given that the granting of credit in this sector is based (in general) on credit scoring, broadening the extension and reducing the rejection rate should not be too difficult to arrange. For example, the Government could adjust the banks' credit scoring ceilings for granting credit.

7. The immediate issue is to understand the extent of the real lack of credit to this sector. This can be established by examining the level and amounts of rejected applications or rollover of credit in the last few months by the banks.

8. The Government in this process will also require reporting of the scheme including the repayment of these loans in order to make decisions concerning the success of the scheme and the length of time that it needs to continue. It is hoped that once the banks observe that the sector can provide profitable business that they would then regain confidence in this business and therefore be encouraged to take on this business again voluntarily.

SME Policy Bank

9. The PRC Government has tentatively floated a proposal to set up a policy bank targeting SMEs, rather than raising credit quotas for SMEs as domestic banks are still hesitant to make loans to SMEs. The idea is that such a bank would help firms broaden their sources of finance and not suffer as much during downturns. The National Development and Reform Commission will take charge of drawing up the plan. With increasing pressure on this part of the economy due to the financial turmoil, it is hoped that by setting up such a bank, the effect will be blunted for small enterprises.

10. It may in this context be appropriate for Hong Kong to consider a similar approach. The SME sector has for a long time been affected by the winds of banking credit flows and is always the first sector to see reduction of credit lines in difficult economic times. Given this, it may be appropriate for the Government to consider putting in place an entity similar to the Hong Kong Mortgage Corporation to set a benchmark for lending to the SME sector. The policy bank in question could be financed by i) direct Government funding ii) securitisation of the SME loans iii) issue of bonds, or a combination of these options.

Ayesha Macpherson
November 2008

Task Force on Economic Challenges

Discussion Paper

Holdover of Provisional Profits Tax

Purpose

This paper proposes a response to the repeated calls from the business sector, in particular the SMEs, for some form of relief in respect of Provisional Profits Tax (PPT).

Executive summary

2. There is an existing mechanism for holdover applications and taxpayers wishing to have their PPT held over can make an application in accordance with the existing procedures. As a one-off alleviation measure, the payment due date and the deadline for application of holdover of PPT could be extended.

Discussion

3. The assessing system for Profits Tax consists of a PPT assessment in an estimated amount followed, after a return has been made, by a final Profits Tax assessment on the true figure in which the PPT already paid for the year of assessment is credited. In a continuing business, the PPT assessment is always in the same figure as the immediately preceding final assessment (less any unrelieved losses carried forward).

4. Because of the estimated nature of PPT, there are provisions to enable collection of the tax to be wholly or partly held over. The most common ground used for a holdover application is where the assessable profits for the year of assessment assessed to PPT are, or are likely to be, less than 90% of the amount assessed to PPT. In other words, if there is a drop in the business which is anticipated to result in the tax payable being less than 90% of the tax paid for the previous year, a holdover of the PPT can be made.

5. To be valid, a holdover application is required to be lodged within: (i) 28 days before the respective payment due date; or (ii) 14 days after the date of the demand note, whichever is later. In most cases, the rule under (i) applies since most demand notes are issued well ahead of the payment due date.

6. Since the due date for most taxpayers falls within the first two weeks of November, most taxpayers would by now have missed the holdover application deadline. Given the unexpected speed at which the financial crisis has hit Hong Kong, many businesses could not have anticipated the effect on their current year business results until the holdover application deadline has already passed.

7. A blanket waiver of this year's PPT may not be appropriate as this assistance would not be targeted at only those taxpayers in genuine financial difficulties. It would mean the payment of two years' tax liabilities in one go next year (being the tax for 2008/09 without any PPT credit plus the PPT for 2009/10). Furthermore, given the cash basis of Government accounting, the non-collection of PPT for all taxpayers would result in a significant fall in Government's revenue for 2008/09.

8. However, extending the payment due date would allow taxpayers additional time to lodge a holdover application and help alleviate the cash flow problem some of them are now facing as a result of the financial tsunami. For taxpayers who have already settled their tax payments, a refund could be made by the IRD where an application for holdover is made and accepted.

9. Extending the payment due date across-the-board should not have a revenue impact for 2008/09 if the extended payment due date still falls within the same financial year.

10. Since most of the Profits Tax payers need to make their first instalment tax payments in the week commencing 3 November, a 8-week extension would seem to be reasonable if the Government were to grant the extension. For example, where the tax payment was due on 3 November, the payment due date would be extended to 29 December 2008. The holdover application would be due for lodgement by 1 December 2008 (being 28 days before the extended payment due date), allowing the taxpayer about 3 weeks from now to prepare and lodge the holdover application.

11. As opposed to a full waiver of 2008/09 PPT, this proposal does not change the basic criteria to qualify for a holdover of PPT. Rather, it gives taxpayers more time to better estimate the impact of the external environment on their full year financial position.

12. The above measure could apply to taxpayers who have already received tax payment demand notes (i.e. taxpayers who adopt an accounting date falling between April and December). For those taxpayers who are yet to receive a tax payment demand note, the Government could consider deferring the usual tax payment dates (normally in January for taxpayers adopting an accounting date between January and March) when issuing the demand notes.

13. The above one-off alleviation measure should not require any legislative amendments and, hence, should not require LegCo approval.

Ayesha Macpherson
11 November 2008

Task Force on Economic Challenges

Discussion Paper

Building a Comprehensive Double Taxation Agreement Network to Enhance Hong Kong's Competitiveness

Purpose

This paper argues in favour of Hong Kong adopting a more liberal exchange of information (EoI) framework to enable Hong Kong to build a comprehensive double taxation agreement (CDTA) network.

Executive summary

2. Hong Kong's current level of EoI is below the internationally recognised standard. As a result, Hong Kong faces difficulties in building a CDTA network, the lack of which puts Hong Kong at a competitive disadvantage. An urgent policy decision is needed on whether Hong Kong should move towards adopting the international standard. The SAR Government concluded a focused consultation in September 2008 and should be in a good position to move forward on the issue.

3. It is vital for Hong Kong's tax policy to support the vision of how Hong Kong should position itself in the global economy post the current financial turmoil. A key potential benefit of Hong Kong adopting a new policy on EoI is the possibility to conclude a large number of double tax treaties. A CDTA network would enhance Hong Kong's competitiveness as an international business and finance centre.

4. The failure to adopt the international standard of EoI could result in a serious damage to Hong Kong's reputation. Furthermore, Hong Kong could be the target of defensive measures by other countries which are actions designed to neutralise the effects of harmful tax practices. These actions would be detrimental not only to Hong Kong based businesses investing abroad but also to SMEs with international transactions (eg with export sales).

5. The Liechtenstein tax scandal in early 2008 and the current financial crisis have resulted in more international focus on tax information transparency. The Organisation for Economic Co-operation and Development (OECD) is in the process of preparing a list of uncooperative jurisdictions and aims to publish the list by the summer of 2009.

Introduction

6. In September 2008, the Hong Kong SAR Government concluded a focused consultation with the business and professional community on whether Hong Kong should move towards a more liberal EoI provision when conducting CDTA negotiations. This was the third time the Government has approached the issue, having previously consulted the business and professional community in 2001/2002, and again in 2005.

7. Since the Government's announcement of its intention to enter into CDTAs with Hong Kong's major trading partners in the 1998-99 Budget, Hong Kong has concluded only three CDTAs, with Belgium, Thailand and mainland China and has signed a CDTA with Luxembourg (which is awaiting ratification). The key reason for the low success rate to date and the key stumbling block in Hong Kong's negotiations with OECD member countries is the EoI clause.

EoI

8. All CDTAs contain an EoI clause which sets out the terms on which the contracting parties may pass information to each other. In all three of Hong Kong's concluded CDTAs, the EoI clause is based on the 1995 version of the model tax convention of the OECD.

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

10. However, the OECD has moved to a more liberalised EoI clause in the 2004 version of the model tax convention, which stipulates that the domestic tax interest requirement cannot hinder exchange of information. Hong Kong cannot adopt this version without amending its legislation to remove the domestic tax interest requirement as a condition for the IRD to invoke their information seeking powers.

11. The EoI clause remains a hurdle to the successful conclusion of CDTAs with OECD member countries which have adopted the 2004 version as standard provisions in their CDTA negotiations. If Hong Kong wants to develop a CDTA network with OECD member countries, it will need to amend the IRO to enable it to agree to the more liberalised EoI clause.

Benefits of a CDTA network for Hong Kong

12. If Hong Kong has an effective CDTA network, Hong Kong companies conducting business overseas would enjoy tax benefits that would not otherwise be available. These include:-

- **Reductions in withholding taxes:** on various forms of income such as interest, dividends, royalties and capital gains.

- **Permanent establishment protection:** preventing a treaty partner from imposing tax on the business profits of a Hong Kong resident unless the Hong Kong resident maintains a "permanent establishment" (PE) in the jurisdiction of the treaty partner and the business profits involved can be allocated to the activities of that PE.

- **Exemption from personal tax:** allowing services under employment to be performed within the treaty partner jurisdiction without being subject to personal tax, provided that certain conditions are met.

- **Providing certainty for investors:** This certainty consists firstly of putting a ceiling on withholding tax rates irrespective of increases to these rates in the domestic legislation of the treaty partner. Secondly, and more

importantly, a CDTA settles procedures to avoid discrimination and resolve disputes.

- **Corresponding adjustments on transfer pricing**: Provides for corresponding adjustments in the event of transfer pricing adjustments being made by the treaty partner.

13. A CDTA network would clearly enhance Hong Kong's position as an international and regional business centre. As can be seen from the following table, Hong Kong is behind its Asia Pacific neighbours in terms of number of CDTAs:-

Table 1: Number of CDTAs signed and in force in Asia Pacific countries

Country	
Australia	42
China	89
Hong Kong	3
Indonesia	57
Japan	56
Korea	69
Malaysia	65
New Zealand	35
Philippines	36
Singapore	58
Taiwan	16
Thailand	52
Vietnam	37

Source: IBFD Tax Treaties Database (as at October 2008)

14. An effective CDTA network is all the more important for Hong Kong to capitalise on the Mainland's outbound investments. The Mainland currently has more than 80 CDTAs. For Hong Kong to establish itself as a "window" for outbound investment by Mainland enterprises, investments made through Hong Kong must be entitled to at least the same (if not additional) tax benefits.

Importance of EoI at the international level

15. In the face of globalisation, governments of many developed countries believe that they cannot stand back while their tax bases are eroded through the actions of countries which offer taxpayers ways to avoid taxes that would otherwise be payable to them. For some time, these developed countries, spearheaded by the OECD, have advocated expanding the scope of exchange of information between jurisdictions so as to combat tax avoidance or evasion at the international level.

16. In June 2004, the OECD Global Forum on Taxation endorsed a report entitled *A Process for Achieving a Global Level Playing Field*, which identifies achieving high standards of exchange of information and transparency as the core of such a process.

17. In November 2005, Hong Kong was invited to attend the meeting of the OECD Global Forum on Taxation in Melbourne. At the meeting, Hong Kong endorsed the principles of transparency and exchange of information for tax purposes that are reflected in the OECD 2006 report entitled *Tax Co-operation: Towards a Level Playing Field – 2006 Assessment by the Global Forum on Taxation.* One of these key principles is that there should be no restriction of information exchange caused by a domestic tax interest requirement. Accordingly, it can be argued that Hong Kong already has an international obligation to amend its domestic law to enable it to implement this principle.

18. In the OECD 2008 Assessment Report (the second update of the 2006 Report), Hong Kong is highlighted as one of only four out of the 83 jurisdictions which participated in the assessment that requires a domestic tax interest for exchange of information; the other three being Malaysia, Philippines and Singapore.

19. The Liechtenstein tax scandal and the current financial crisis have accelerated the move towards a tougher approach on EoI and transparency. On 21 October 2008, the finance ministers of 17 countries met in Paris to discuss co-ordinated efforts on the fight against international tax evasion and avoidance. The meeting concluded that a lack of transparency and EoI provides an environment that facilitates cross-border tax fraud and evasion. They also noted that an opaque environment provided by some jurisdictions have added to the current financial crisis and the need for public funds resulting from this crisis makes the fight against the loss of tax revenue more important than ever. The finance ministers at the meeting have asked the OECD to prepare a blacklist of unco-operative jurisdictions which could be the targets of defensive measures before their next meeting in the summer of 2009.

20. Defensive measures are actions which can be taken by countries to neutralise the effects of harmful tax practices. Examples include disallowing tax deductions on payments made to persons located in an unco-operative jurisdiction; additional reporting requirements for any resident who transacts with a person located in an unco-operative jurisdiction; higher withholding tax rates; denial of exemption or tax credit relief on income earned from an unco-operative jurisdiction. These measures, if applied to Hong Kong, would put all Hong Kong businesses at a competitive disadvantage. For example, an SME making export sales would be severely disadvantaged if payments for purchases from the Hong Kong company were to be disallowed for tax purposes in the customer country.

Way forward

21. Co-operation through exchange of information is now the international trend. As a responsible member of the global community, Hong Kong cannot afford to resist this trend. It would be detrimental to Hong Kong's position as a leading international financial centre if it earns a reputation as a haven for international tax evaders. Moreover, the failure to adopt more liberalised EoI provisions could result in Hong Kong being categorised as an unco-operative jurisdiction and potentially subject to defensive measures being contemplated by the OECD member countries.

22. To enable Hong Kong to comply with the 2004 version of the EoI clause, the IRO would need to be amended to expand the information seeking powers of the IRD to allow it to gather information requested by a DTA partner solely for exchange purposes.

23. Hong Kong should continue to emphasize that it would only accept EoI as part of a CDTA and that it has no interest in entering into standalone Tax Information Exchange Agreements. In other words, Hong Kong should retain EoI as a bargaining chip for beneficial overseas tax treatments.

24. It would not be necessary for Hong Kong to proceed on an all-or-nothing basis. Even if its tax legislation is amended to allow EoI without a domestic tax interest, the expanded EoI provision need not apply automatically to Hong Kong's existing CDTAs or to new CDTAs with treaty partners who do not require it (for example some countries in Asia).

25. Providing further information may assist the community in reaching a consensus on this issue. For example, the Government could perhaps consider releasing the following information:-

i) The estimated number of countries which would likely conclude a CDTA with Hong Kong if it were to implement the global standards of EoI.

ii) Simple numerical examples demonstrating the potential benefits of a CDTA.

iii) Potential consequences (eg damage to reputation and effects of defensive measures) of Hong Kong not adopting the international standard of EoI and the likely impact on each key sector of our economy, including the impact on SMEs.

iv) The safeguards available to ensure that exchange of tax information does not violate privacy rights.

v) Procedures involved in an EoI request to demonstrate that the contracting party is required to exhaust its domestic avenues before resorting to EoI.

vi) Experience of other countries in terms of the number of requests issued and received on EoI to dispel the myth that the acceptance of a more liberal EoI would lead to a huge number of EoI requests for the IRD. If it is not possible to obtain statistics on the number of EoI requests, an alternative may be to obtain information on the number of revenue personnel required by other countries to handle EoI requests, and the projected additional resources (if any) required by the IRD.

vii) Scope and limitation of EoI i.e. whether the Government intends to limit the scope of the EoI clause to the taxes covered by the CDTA and that the information received by a contracting party may not be passed to a third country.

26. It would also be helpful to maintain dialogue with the OECD as a demonstration of Hong Kong's eagerness to co-operate with the international community.

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