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The Hong Kong Tax Paradox Or Why Jurassic Park Exists in the Pearl River Delta

Abstract
Hong Kong's total financial reserves are, on any scale, vast. What is the nature of the taxation system to which this excess of riches can be attributed? What are the challenges facing that system as Hong Kong moves into the post-colonial era of the twenty-first century as a Special Administrative Region of the People's Republic of China? And how will, or how should, these challenges be met? This article tries to answer these questions. It then concludes by analysing the paradox: why has a tax system, redolent of colonial Great Britain at the height of power, operating inequitably and arbitrarily, been so highly productive of revenue that all by the most pressing avenues for reform have been eschewed in favour of the trite, but in Hong Kong oft-repeated, aphorism: "If It Ain't Broke, Don't Fix It."

Keywords
Hong Kong, tax, tax reform,
INTRODUCTION

Upon the resumption of sovereignty over Hong Kong by the People’s Republic of China (“PRC”) on 1 July 1997, Hong Kong’s total reserves were approximately US$42.4 billion. To a large extent, this amount was derived from budget surpluses achieved during the last 15 years; and, to a large extent,...
extent, these budget surpluses were in turn attributable to the excess of taxation revenue over public expenditure.\(^4\)

What then is the nature of the taxation system to which this excess of riches can be attributed? What are the challenges, particularly those affecting business and investment, facing that system as Hong Kong moves into the post-colonial era of the twenty-first century as a Special Administrative Region of the People's Republic of China? And how will, or how should, those challenges be met. This article will first attempt to answer these questions. It will then conclude by analysing the paradox: why has a tax system, redolent of colonial Great Britain at the height of power, operating inequitably and arbitrarily, been so highly productive of revenue that all but the most pressing avenues for reform have been eschewed in favour of the trite, but in Hong Kong oft-repeated, aphorism: "If It Ain't Broke, Don't Fix It".

But first let us set the Hong Kong scene, not as now a Special Administrative Region of the People's Republic of China, but rather as a fledgling trading port, a colony administered by Great Britain, having a taxation system derived from the earliest years of the nineteenth century.

THE FORMATIVE YEARS, ESSENTIALLY UNCHANGED\(^5\)

Taxation of earnings and profits was first introduced in Hong Kong in 1940 when the War Revenue Ordinance\(^6\) was enacted "to impose War taxes and to regulate the collection thereof". The Ordinance was based upon Addington's Income Tax Act 1803\(^7\) which introduced the concept of a schedular tax system, as distinct from a general income tax, in the United Kingdom. Its

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\(^4\) Over the last five years, tax collected by Hong Kong's Inland Revenue Department amounted to approximately 65% of total government general revenue. The major non-taxation item came from land sales, which in 1995-96 generated approximately 11% of total government general revenue: see Inland Revenue Department Annual Report 1995-96 (1997 Hong Kong Government Printer) at 8-9 and Hong Kong 1997 (1997 Hong Kong Information Services Department) at 69. Land revenue is, however, historically volatile. During the period 1987-88 to 1996-97, it varied from between 1% (in 1990-91) to 5% (in 1996-97) of gross domestic product: see The 1997-98 Budget, above n 1 at para 75. An analysis of the structure of Hong Kong's public finances is provided in Ho and Chau (eds), The Hong Kong Economy in Transition (1996 Asian Research Service, Hong Kong) at ch 3.

\(^5\) The following background commentary is largely taken from Willoughby and Halkyard, Encyclopaedia of Hong Kong Taxation: Income Tax, vol 3 (1995 Butterworths, Singapore) at I [1]-[23].

\(^6\) Ordinance No 13 of 1940.

\(^7\) 43 Geo. 3, c 122; see further, Whiteman on Income Tax (1988 3rd edn London, Sweet & Maxwell) at 1-10 ff on the origin of income tax.
brief life ended on Christmas day 1941 when the Japanese army invaded and occupied Hong Kong. No successor appeared until 3 May 1947 when the Inland Revenue Ordinance ("IRO")\(^8\) was enacted to "impose a Tax on Earnings and Profits".

The War Revenue Ordinance was designed to raise revenue in the special circumstances which prevailed in 1940. It was never intended to be a comprehensive tax on income. However, it influenced the ultimate form of the 1947 Ordinance which, in essence, represents the income tax law of Hong Kong today. Various factors influenced the government of the day against the introduction of an orthodox income tax system including: privacy of the individual, the advantages of a conveniently located free port and the fear of driving away foreign investment.\(^9\) This was in spite of the view expressed by the Committee on Taxation\(^10\) set up at the end of the Second World War that:

\begin{quote}
the imposition of a tax on incomes would theoretically result in the most equitable distribution of the burden of taxation and that a tax on income is inevitable here if the Budget of the Colony is to be balanced and if Hong Kong is to conform to the standards generally expected in the middle of the 20th Century.
\end{quote}

The end result, despite many technical amendments to the IRO since 1947, is that Hong Kong’s taxation legislation today is broadly similar in form and content to the 1940 Ordinance. The key features of that legislation are: low proportional tax rates,\(^11\) a jurisdiction to tax dependent almost entirely upon the concept of source,\(^12\) tax imposed upon only three types of income or business profits,\(^13\) no capital gains tax, no tax on dividends, no tax on interest

\begin{itemize}
\item \(^8\) Ordinance No 20 of 1947 (LHK, Cap 112).
\item \(^9\) Report of the War Revenue Committee (14 February 1940, Noronha & Co Ltd, Hong Kong Government Printer) at 8-12. The Hong Kong Hansard for 1939-40 and 1946-47 also make fascinating reading. Virtually all the non-government legislators of the day ("the Unofficials") were from business and professional backgrounds. They made their antipathy towards a general system of income tax, and indeed any form of income tax, clear beyond peradventure. Quoted in the Report of the Inland Revenue Ordinance Review Committee, Pt II (1968 Hong Kong Government Printer) at para 5.
\item \(^10\) The standard tax rate, which also represents the highest average rate of tax, for individuals is 15%; the corporate tax rate is 16%; see IRO, Schedules 1 and 8.
\item \(^11\) IRO, ss 5(1) (property tax), 8(1) (salaries tax) and 14(1) (profits tax).
\item \(^12\) Income from land and buildings in Hong Kong (property tax), income from an employment or office or pension sourced in Hong Kong (salaries tax) and profits from a trade, profession or business carried on and sourced in Hong Kong (profits tax).
\end{itemize}
income,14 and the virtual absence of any withholding tax.15 Hong Kong has not, however, entered into any comprehensive double tax agreements.16

THE PIECEMEAL EFFORTS OF TAX REFORM

In contrast to many of its Asian neighbours, including Australia, there has been no tax revolution, or indeed any tax bordering on revolutionary, in Hong Kong. Unlike Japan and Australia, which delineate the region’s most northern and southern boundaries, Hong Kong can hardly be said to have a sophisticated taxation system. As noted above, there is no capital gains tax,17 let alone any anti-deferral regime such as controlled foreign company legislation or detailed foreign tax credit legislation. Unlike Singapore and New Zealand, Hong Kong has no broadly-based system of indirect taxation such as a goods and services tax.18 It simply imposes tax on certain types of income,19 in what can only be called a piecemeal manner. Put in evolutionary terms, Hong Kong’s tax system belongs to the age of the dinosaur.

Recently, in virtually all the countries of our region, with the exception of Japan and, in relation to individual taxation, Australia, direct taxes have been reduced. In many instances, reductions in direct taxes have been implemented in the course of a thorough review of a country’s tax system.20

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14 Unless derived by a person in the course of carrying on business in Hong Kong: see IRO, s 15(1)(f) and (g).
15 The only significant exception relates to royalties which, provided certain anti-avoidance provisions do not apply, is imposed on non-residents at an effective rate of 1.5% (for individuals) and 1.6% (for corporations): see IRO, ss 15(1)(a) and (b) and 21A.
17 Although there is an estate duty, with a maximum tax rate of 15%, it is only imposed upon assets located in Hong Kong as at the date of death: see Estate Duty Ordinance (LHK, Cap 111), ss 5 and 10(b). It is, therefore, often referred to (appropriately) as a voluntary tax: see generally, Willoughby and Halkyard, Encyclopaedia of Hong Kong Taxation: Estate Duty, vol 1 (1993-Butterworths, Singapore).
18 A commonly neglected government impost concerns land rates which, having a broad tax base, may be characterised as the most significant of Hong Kong’s indirect taxes: see Ho and Chau, above n 4 at 35. Apart from the imposition of rates, such indirect tax legislation as exists is of very limited scope. The most wide-ranging is the Dutiable Commodities Ordinance (LHK, Cap 109) which taxes various luxury goods such as tobacco and alcohol, as well as hydrocarbon oil, upon import or domestic manufacture.
19 See above nn 12-13.
20 Singapore and New Zealand being examples where direct taxation reductions were promised as part of a package involving the introduction of a comprehensive goods and services tax.
Hong Kong has not followed suit. Its corporate and individual tax rates have always been low. With a low tax rate, and for many corporations and highly paid individuals an even lower effective tax rate, but tied to a tax regime productive of significant budget surpluses, it is hardly surprising that an undemocratic Hong Kong has not embarked upon any major review of its tax system for over 20 years.

To the extent that periodic changes to the IRO reflect gradual refining and improvement of Hong Kong’s taxation laws, the agenda is nearly always dictated by either government or business and professional interests. More often than not, these interests are sympathetic rather than antagonistic.

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21 Indeed, a dialogue continues to take place in Hong Kong between government and business interests on whether to reduce the corporate tax rate from 16% to the standard rate of 15%, or less: see, eg, Hong Kong Society of Accountants, Proposals for the 97/98 Budget (1997 Hong Kong) at para 5.1. See further below note 124.

22 Elections to the Legislative Council were only introduced, on a limited scale through several functional constituencies and an electoral college, in 1985. The first direct elections, again on a limited scale, only took place in 1995: see generally, Miners, The Government and Politics of Hong Kong (1995 5th edn updated, Oxford University Press, Hong Kong).

23 Since its enactment in 1947, amendments to the Inland Revenue Ordinance (LHK, Cap 112) have been piecemeal. The agenda for tax reform in Hong Kong, such as it is, has been dominated by the work of three Review Committees which reported in 1954, 1968 and 1976. In each case the Review Committees took the view that it was no part of their terms of reference to recommend fundamental changes to the system of taxation. The closest step to fundamental change was taken by the 1976 Review Committee which recommended that each taxpayer’s income from all sources in Hong Kong be aggregated and a single tax paid: see Report of the Third Inland Revenue Ordinance Review Committee (1976 Hong Kong Government Printer) at ch 2. Though most recommendations made by the Review Committee were implemented, this wide-ranging one, torpedoed by business interests, was not. The schedular taxation system described in the text accompanying notes 7 and 13 above remains in place today. Since 1976 there has never been a concerted effort in Hong Kong directed at wide-ranging tax reform: see also Harris, “Tax Reform in Hong Kong” (1987) 14(6) Tax Planning International Review 17 at 18.

24 Many business and professional groups, most visibly the Hong Kong Society of Accountants, make detailed proposals to the Financial Secretary for inclusion in the annual Budget Speech. 1996-97 was a stellar year for the accounting profession: the proposals for tax relief for hotel refurbishment (IRO, s 16F), reduced profits tax for interest and related income on certain long-term debt instruments (IRO, s 14A), and profits tax exemption for offshore mutual funds, unit trusts and other similar widely held collective investment schemes (IRO, s 26A(1A)) all being enacted: cf Hong Kong Society of Accountants, Proposals for the 1996/97 Budget (1996 Hong Kong) at paras 6-9 and 15-19.

25 One interesting and useful catalyst for change has been government support for a business and professional advisory group, the Joint Liaison Committee on
Various grass-root groups have tried, albeit somewhat half-heartedly, to establish a taxation agenda. They have generally been unsuccessful. The best example relates to the regular call for government to provide tax relief for owner-occupied housing, which has always been resisted. However, one example where such lobbying was successful relates to the reduction of effective tax rates for lower and middle income taxpayers, by increasing personal allowances and lowering the marginal rates of tax. But the spoils of this victory must be shared: business and professional groups were, of course, totally supportive of any reduction in tax rates.

In the context of Hong Kong’s taxation system, and for all its faults, this eschewing of wide-ranging reform is probably not a sign of neglect. On virtually every occasion when senior government officials describe Hong Kong’s tax system the discourse includes the need for preserving “simplicity”; indeed, this characteristic is usually referred to with pride. Simplicity, it is said, engenders efficiency, which enables tax revenue to be collected at relatively little cost and with relatively little administration. Efficiency in turn avoids much of the expense of compliance as well as the complexity which characterises tax systems of most developed countries. Government policy is seemingly guided by the belief that by maintaining tax rates at a tolerable level, much of tax avoidance (and evasion) which seems endemic in high tax jurisdictions is obviated.

Taxation ("JLCT"), whose constituent members include the Law Society of Hong Kong, the Hong Kong Society of Accountants, the General Chamber of Commerce, the American Chamber of Commerce, the Hong Kong Association of Banks, the Capital Markets Association, the Taxation Institute of Hong Kong and the International Fiscal Association. JLCT meets monthly with the Commissioner of Inland Revenue to discuss technical, rather than policy oriented, changes to taxation laws, and any current issues involving interpretation of tax law and departmental practice. Although there is a formal agenda for meetings, in practice the discussion is both wide-ranging and forthright. Many changes to tax law and practice have emanated from these meetings, the most recent being the current review of depreciation allowances and tax rates (see The 1997-98 Budget, above n 1 at para 94 and Profits Tax Review Consultation Document (July 1997 Finance Bureau, Government Secretariat)) and the enactment of s 20AA IRO and the amendment to s 26A(1A) IRO, dealing respectively with exempting brokers and approved investment advisers from certain profits tax obligations relating to profits derived by non-residents from stock exchange transactions and exempting foreign mutual funds, unit trusts and widely held collective investment schemes from liability to profits tax.

The cost of housing in Hong Kong is arguably the key issue facing low and middle income earners. The largest party in Hong Kong’s fledgling, and now emasculated, democracy, the Democratic Party, regularly calls for taxation relief in this area. Although government has been sympathetic to making public housing more affordable, calls for taxation concession have been consistently rebuffed: see, eg, the 1997-98 Budget, above n 1 at paras 89-90. Since this article was written, a small retreat has taken place: see below n 124.
The requirements of Hong Kong’s tax policy were summarised by the Financial Secretary, Sir Philip Haddon-Cave, in his 1978-79 Budget Speech:

the first requirement is to generate sufficient recurrent revenue to finance a major part of a given level of total public expenditure (which I have set, for guideline purposes, at 88%) and to maintain our fiscal reserves at a satisfactory level. The second requirement is that the tax system is as neutral as possible as regards the internal cost/price structure and investment decisions. The third is that the laws governing the tax system are adapted from time to time to make them consistent with changing commercial practices. The fourth requirement is that each and every levy - be it direct or indirect - is simple and easy (and, therefore, inexpensive) to administer and does not encourage evasion, for a low and narrowly based tax system cannot afford to finance costly overheads. The fifth requirement is that the tax system is equitable as between different classes of taxpayers or potential taxpayers and between different income groups (and this means, inter alia, setting relatively high thresholds for personal taxation and generally ensuring that the system rests as lightly as possible on the disposable incomes of those at the lower end of the income spectrum or leaves them virtually untouched). Exceptionally, and this is the sixth requirement, the tax system must be capable of being used to achieve non-fiscal objectives when necessary.  

Notwithstanding Haddon-Cave’s requirements, it must be acknowledged that Hong Kong’s pursuit of simplicity and efficiency has meant that matters of principle are often ignored and unfairness arises. Obvious examples in the Hong Kong context are the narrow tax base; the operation of the schedular system and non-mandatory personal assessment whereby persons with identical levels of taxable income can pay widely different amounts of tax; the obvious scope for avoidance and evasion; and the lack of
deductions for salaried employees who routinely incur expenses in the course of their employment, when contrasted with the exceedingly generous allowable deductions available to the self-employed. These unsatisfactory features are generally acknowledged, but tolerated in view of the preference for a simple, efficient and compliance friendly taxation system.

THE CHALLENGES AHEAD

From the standpoints of simplicity, efficiency and ease of compliance, the piecemeal nature of changes to Hong Kong’s tax system in recent years seems justified. However, the obvious question which arises, particularly in light of the resumption of sovereignty over Hong Kong by the PRC on 1 July 1997, is whether this arguably complacent state of affairs can continue. There appear to be a number of issues which recently, and not so recently, have occupied, and will continue to occupy, the attention of taxation advisers, academics and the public, and which may change the philosophical basis of Hong Kong’s tax system during the next few years.
These issues may be broadly summarised as follows:

1. The fragility of government revenues, and whether it is necessary to expand the tax base by imposing a broadly-based system of indirect tax.

2. The increasingly sophisticated business environment, as well as the growing amount of tax avoidance, in Hong Kong and the inevitable complexity which will arise as and when legislation is enacted in response to these changing conditions.

3. The limitations and exploitation of the “source” principle upon profits tax collection, particularly in an increasingly high technology age, which will put this cornerstone of the Hong Kong tax system under increasing attack.

4. The inevitable move towards self-assessment.

5. Retaining competitiveness in light of the regional trend towards lowering direct taxes and providing tax incentives for targeted industries and business. In this regard, particular attention will be placed upon Hong Kong’s move towards a high technology and service-based economy and providing the infrastructure necessary to support this move.

6. The effect of the resumption of sovereignty over Hong Kong by the PRC on 1 July 1997, particularly with respect to the effect of Hong Kong’s Basic Law (“BL”) 34 upon its tax system.

7. The democratisation of Hong Kong and the demands for greater fairness which this will engender.

Each of these issues is now addressed in turn.

**BROADENING THE TAX BASE**

1. **Is there a need for a comprehensive system of indirect tax?**

In the early 1990s the introduction of a broadly-based sales tax in Hong Kong appeared to be a real possibility.\(^{35}\) Notwithstanding its initial attraction, the

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\(^{34}\) The Basic Law of the Hong Kong Special Administrative Region of the People’s Republic of China promulgated by the President of the PRC on 4 April 1990 and which took effect on 1 July 1997.

\(^{35}\) See The 1989-90 Budget (10 May 1989 Hong Kong Government Printer) at paras 37-40. The author has previously argued that Hong Kong must eventually move towards implementing a broadly-based system of indirect taxation: see Halkyard and Olesnicky, above n 33 at 348-354. The following analysis updates and expands upon the argument in light of changes to the Hong Kong economy and political economy since 1989.
Hong Kong Government quickly shelved consideration of this issue.\(^{36}\) It was, apparently, influenced by the views of both business and public interest groups who argued that such a system was unnecessary in view of:

1. the high budgetary surpluses with which the Hong Kong Government operates;\(^ {37}\)
2. the effect that such a tax would have on inflation rates and tourism in Hong Kong;\(^ {38}\)
3. the complexity which an indirect tax would add to Hong Kong’s relatively simple tax system; and
4. perhaps most importantly, the inherently regressive nature of a broadly-based system of indirect taxation.

These arguments are, however, arguably simplistic and certainly short-sighted. It is true that since the enactment of the IRO in 1947, Hong Kong has been able to rely on a direct tax system which has proved both revenue productive and efficient in terms of administration and taxpayer compliance. But it is unlikely that this reliance can continue indefinitely. There are a number of reasons for this:

(a) Direct tax revenues are volatile. For example, there was a sudden decrease in profits tax collection in 1983 during the negotiations between the United Kingdom and the PRC over Hong Kong’s future.\(^ {39}\) Despite predictions to the contrary, such volatility did not continue during the lead up to Hong Kong’s change of sovereignty on 1 July 1997. But it must be appreciated that, with very few exceptions, Hong Kong has lived in exceptionally good economic times from at least the early 1980s to the present day. What has not changed during this period is the narrowness of the tax base.\(^ {40}\) Any major downturn in the

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\(^{36}\) See The 1992-93 Budget (4 March 1992 Hong Kong Government Printer) at para 108. The Financial Secretary stated that sales tax “is not [regarded] as attractive at a time of relatively high inflation, and is not currently under serious consideration.”

\(^{37}\) See above n 3.

\(^{38}\) See above n 36.

\(^{39}\) As a result, the corporate profits tax rate was raised from 16.5% to 18.5% with effect from the year of assessment 1983-84. It was not reduced back to 16.5% until 1989. See further below n 124.

\(^{40}\) In relation to salaries tax, see above n 28; in relation to profits tax, the Hang Seng Index (Hong Kong’s stock market index) is dominated by property companies as well as financial institutions which have a major stake in the continued good fortune of those companies. To illustrate the importance of the property sector to Hong Kong government revenue, reference could be made to the Inland Revenue Department Annual Report 1995-96 (1997 Hong Kong Government Printer) at 6 and 11 which shows that the property and banking sectors contributed 34.2% and 18% respectively of total profits tax assessed (profits tax accounted for 45.4% of total tax revenue). The imposition of land...
local property market, on which a significant part of the local economy depends, would underscore this point emphatically.

(b) Land revenues, which up to 1 July 1997 accounted for a significant portion of Hong Kong Government revenues, are historically even more volatile than revenue from direct taxation. Not only are they dependent upon a robust economy, they could in any event decrease as a result of growing pressure upon government to provide more affordable housing for the people. In this regard, it is fair comment that the cost of decent housing is one of the main social and economic concerns of most local families.

(c) It is government policy that any increase in public expenditure in Hong Kong must be tied to the growth trend of gross domestic product. However, the growing political sophistication in Hong Kong will undoubtedly place greater pressure upon government for further spending in the key areas of housing, education and the elderly. Government expenditure programmes cannot be expected to fluctuate on a short-term basis to reflect the revenue available from time to time. Much government planning is long-term and adjustments to long-term commitments may be very difficult to accommodate. Accordingly, any decrease in government revenue is likely to lead to unpopular ad hoc revenue raising measures (such as the sudden taxes on soft drinks and cosmetics imposed in 1985).

(d) There is a general perception, both inside and outside government, that the corporate and standard tax rates should not be increased in order to maintain Hong Kong's business attractiveness to both foreign and local investors. Indeed, there is a commonly-held view that these rates is, in contrast to salaries tax and profits tax, broadly-based and historically represents approximately 1.2% of Hong Kong's gross domestic product: see Ho and Chau, above n 4 at 35-36.

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41 See above n 4.
42 As virtually all land in Hong Kong is held under government lease, any land released or rezoned for development is wholly within the province of the Hong Kong Government.
43 Housing was a keynote issue in the first major address given by the Chief Executive, Mr Tung Chee-hwa, after the resumption of sovereignty over Hong Kong by the PRC on 1 July 1997: see A Future of Excellence and Prosperity for All (1997 Hong Kong Government Printer) at 15-16.
44 See The 1997-98 Budget, above n 1 at para 20; see also Ho and Chau, above n 4 at 25.
45 See Ord No 20 of 1985. The taxes on concentrates and non-alcoholic beverages and cosmetics were repealed in better economic times: see Dutiable Commodities Ordinance (LHK, Cap 109), Pts VII and VIII, repealed respectively in 1992 and 1993.
should, if possible, be decreased. The cost of any decrease might be funded by expanding the tax base to include a more broadly-based system of indirect taxation.

(e) With the anticipated growing number of elected representatives on various law-making bodies, demands for increases in public expenditure can be expected and may be difficult to resist, particularly in the long-term. This underscores the need to ensure a stable source of predictable revenue.

2 Principles which should be reflected in a broadly-based indirect tax system

If the above analysis, namely, that eventually Hong Kong should introduce a broadly-based system of indirect tax, is accepted, it is then necessary to consider what type of indirect tax system should be introduced. In this regard, the first step should be to identify principles that should be reflected by such a system and then to identify an indirect tax system which incorporates those principles. Relevant principles include the following:

(a) Simplicity. Simple tax systems generally create fewer anomalies. They are more easily understood by taxpayers, so that a higher level of compliance can be expected. From government’s perspective, they are easier to administer and thereby reduce its costs of collecting tax. These factors make a simple system relatively efficient.

(b) Low rate. The rate of the indirect tax should be as low as possible. This facilitates acceptance of the tax by the community. It also discourages avoidance and evasion, which obviates the need for complex anti-avoidance provisions that detract from the system’s simplicity. Furthermore, a low tax rate mitigates the undesirable effects of the new tax on the economy and on the tourist industry.

(c) Efficiency. The system must be efficient in both administration and compliance. The costs of collecting revenue must be relatively low, and complexities should be avoided. To a large extent, this will be the case if the indirect tax system is simple with a low rate.

(d) Breadth. The system should apply with respect to the broadest range

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46 See, eg, Hong Kong Society of Accountants: “Proposals for the 97/98 Budget” (1997 Hong Kong) at paras 5.1 and 5.3 and below n 124.

47 Needless to say, this suggestion would not be welcomed by business interests and, as will be shown below, would likely be castigated by public interest groups.

48 See BL 68 which, amongst other things, states; “The ultimate aim is the election of all members of the Legislative Council by universal suffrage.”
of persons and goods possible. This will avoid the need to define what persons and goods are to be exempted from the system, and thereby avoid much complexity. In other jurisdictions with indirect tax systems (including the British VAT regime), one of the biggest complications arises from classification disputes which are inherent in any system which attempts to limit the range of taxable persons and goods (for example, by zero-rating or exempting food and clothing and education). Any efficient system should avoid this quagmire. If a low rate of tax can be achieved, the lack of exemptions is more justifiable. This will also have the advantage of discouraging lobby groups from exerting pressure for additional exemptions.

A broadly-based system enables the tax burden to be shared between as many taxpayers and spread over as many goods as possible, thereby enabling the tax rate to be kept as low as possible. There will, of course, be cases to which it is judged politically unacceptable to levy tax, such as on sales of rice and other staple commodities or on the provision of education. But this should not detract from the goal that any system adopted should contain as few exemptions as possible. It cannot be over-emphasised that indirect taxation systems which distinguish between different types of goods or taxpayers (either for the purpose of granting exemptions or setting rates of tax) are notorious for their complexity.

(e) Fairness. The system should be equitable, although it seems inevitable that attaining this goal generally dictates complexity. For example, a truly fair system should allow for many exemptions and for different rates of tax in order to take into account the ability of different groups of taxpayers to pay. Apart from granting exemptions, a compromise might be to use the social welfare system to compensate those people who are unfairly disadvantaged. In other words, a policy favouring direct and accountable public assistance should be adopted rather than one favouring indirect assistance through unaccountable tax expenditures.

As indicated, the above criteria will, to some extent, conflict. Accordingly, any system of indirect tax chosen for Hong Kong should be the least objectionable. The ideal system is perhaps utopian rather than achievable.

3 Types of indirect tax systems

Possible types of indirect tax systems include:

(a) an excise or import duty upon goods which are manufactured in, or

49 As indicated above, these should ideally be kept to a minimum.
imported into, Hong Kong;
(b) a wholesale sales tax upon goods which are sold to retailers;
(c) a retail sales tax upon goods, and perhaps services, which are sold to end-users; and
(d) a goods and services tax (or value added tax) upon goods and services, imposed upon successive stages of production and the rendering of any service.

Having regard to principles set out above, the preferable system should be a goods and services tax with minimal exemptions and with a single tax rate. However, in the Hong Kong context, such a system could pose significant practical difficulties. This is largely because there would be too many taxpayers in the goods and services tax net. This will make administration difficult because of the number of returns that will need to be examined and the amount of compliance investigation which will be necessary. Moreover, it could be expected that, notwithstanding a low tax rate, the level of taxpayer compliance would give rise to concern. From an accounting viewpoint, such a system can impose complications beyond the ability of many small taxpayers because of the need to account for their taxation inputs and outputs upon the purchase and sale of goods and upon the provision of services. Nevertheless, a much less sophisticated economy, namely, that of the PRC Mainland, has implemented a package of indirect taxes having a very broad coverage; unfortunately, it is replete with administrative and compliance problems.

4 Probable choice - wholesale sales tax

If Hong Kong were to adopt a broadly-based system of indirect taxation, government would probably have a preference for a wholesale sales tax, similar to the existing and outdated Australian system. Such a decision, if implemented, would appear to be dictated by practical considerations rather than by principle alone. Objections in principle to such a system can be identified as follows:

A wholesale sales tax system applies only to goods and not to services. This means that classification disputes will inevitably arise as to whether a transaction is one for goods or for services (for example, a portrait

50 The Hong Kong Government has adopted a zero-growth policy applying generally to Civil Service recruitment. This could severely restrict the ability of the Inland Revenue Department to administer any complex new form of broadly-based indirect taxation: see below n 91 and accompanying text.

51 VAT (basically applying to goods), Business Tax (basically applying to services) and Consumption Tax (applying to luxury items) were all introduced under comprehensive tax reforms taking effect from 1 January 1994: see generally, Deloitte Touche Tohmatsu, China Tax Guide (1997-, CCH Asia Ltd, Singapore).
commissioned from an artist). Also, it allows for avoidance because suppliers might attempt to apportion their charges between goods and related services (for example, a charge for the sale of a television, with further charges for delivery, installation and warranty services which currently are bundled up into the sale price). This in turn leads to anti-avoidance legislation which detracts from the principles of simplicity and efficiency which an indirect tax system should ideally incorporate.

Another effect of not taxing services is that a higher rate must be applied to goods alone in order to collect the same amount of revenue. Thus, the tax rate must be higher than would otherwise be the case. This encourages avoidance and evasion.

By taxing goods at their wholesale price rather than at their retail price, a higher rate must again be applied in order to collect the same amount of tax revenue than would be the case under a retail sales tax or a goods and services tax. Again, an opportunity for minimising the tax rate will be missed.

Conversely, there are certain practical advantages of a wholesale sales tax that should not be ignored. First, there are obviously fewer wholesalers in Hong Kong than there are retailers, so that government’s administrative and investigative burdens would be substantially reduced by restricting the tax to the wholesale level. Second, wholesalers tend to be of a relatively large size compared with many retailers, so that compliance should be less disruptive to their businesses and hence more likely. Third, few countries have imposed a retail or goods and services tax from the outset. Normally they start with a simple, more basic indirect tax system. Practically, it makes sense to begin with a system which is administratively more manageable and then, through a process of educating taxpayers and administrators alike, progressing to a more ideal system.52

5 Regressive nature of indirect taxes

A frequent objection against indirect taxes is that they are inherently regressive: they affect lower income earners to a greater extent than higher income earners. This is because lower income earners tend to spend a greater

52 Compare Chelvathurai, “Whither Taxation in the Commonwealth?” APTIRC Bulletin (January 1991) at 5 who states: “Countries which are contemplating the introduction of VAT should undertake a careful study of the administrative implications and should take their time over it” and Messere, “Taxation in Ten Industrialised Countries Over the Last Decade: An Overview” Tax Notes International (21 August 1995) at 513 who states:

In the mid-1980s, expenditure taxes plus cash-flow corporation taxes were all the rage (and are still being advocated by public finance economists), whereas nowadays, it is generally recognised that such a radical departure from present tax structures would present too many practical problems.
proportion of their income on consumption of goods. In addition, a larger proportion of their consumption is on staple goods. It is therefore inevitable that a broadly-based tax will give rise to many complaints concerning fairness and social justice. Objections along these lines are certainly valid. However, in the Hong Kong context, arguments can be made for imposing a greater proportion of taxation on lower income earners than at present. These include the following:

(a) Hong Kong society is now more affluent than ever, and there is no longer justification for exempting many untaxed middle-lower range income earners from sharing at least some tax burden. To a large extent, the current system of direct taxation, which involves granting very generous personal allowances, means that many people in Hong Kong pay no tax even though they can afford to do so.

(b) A tax system should not aim to implement social policy but should concentrate on collecting revenue as efficiently and as simply as possible. To the extent that disadvantaged groups should be benefited, the proper relief lies in granting subsidies or other direct assistance which is quantifiable and accountable, rather than in providing tax expenditures in the form of exemptions and incentives.

(c) Under a broadly-based system of indirect tax, government may find itself constrained from increasing the tax rate if taxes on staple goods will thus be raised. Therefore, the policy of maintaining a low rate of tax seems more likely to be achieved under a broadly-based system.

6 Opposition to indirect tax

One can anticipate that government will face many difficulties if it finally decides to introduce a broadly-based indirect taxation system in Hong Kong. Reaction to date has been largely negative. In part, this may be due to an absence of a concerted campaign to explain to the public the reasons for such a tax. Civic education and adroitness will be necessary for government to attempt to overcome the objections which have been raised. In this regard, government would, at the very least, need to reduce other forms of taxation as part of an overall package heralding the introduction of any broadly-based system of indirect tax. Emphasis should be given to revenue neutrality.

It should be appreciated, however, that in the Hong Kong context revenue sources which might be reduced as part of such a package are direct taxes. This would not benefit lower income earners who do not currently pay direct tax and who are likely to be hardest hit by any indirect tax. Reductions in public housing rents, rates and cost of education are more likely to strike a responsive chord with lower income earners. Likewise, hotel accommodation and airport departure taxes could be reduced or abolished, and this will go
some way to appeasing the tourist industry which, to date, has been one of the most vocal critics of Hong Kong introducing a broadly-based system of indirect tax.

7 Conclusion

Notwithstanding the Hong Kong Government’s early philosophical attitude favouring the introduction of a broadly-based system of indirect tax, no positive action has been taken in this regard since it was first mooted nearly 19 years ago. In short, the economy has been too strong and the Budget surpluses too large for government to enact what surely would be an unpopular form of taxation. Eventually, change must come: but while the economy remains robust and direct taxation continues to yield sufficient revenue for government expenditure, there seems little short-term prospect for reform.

SIMPLICITY UNDER ATTACK: THE AGE OF COMPLEXITY AND TAX AVOIDANCE

Many tax proposals put forward by government are opposed by business and professional groups on the ground that such proposals will detract from the simplicity of Hong Kong’s tax laws. As will be shown below, the Hong Kong Government often prefers to enact simple, rather than complex, legislation. Indeed, simplicity is very much touted as one of the main advantages of Hong Kong’s tax system. Yet, despite government’s best intentions, it appears that this characteristic of simplicity may in the future no longer serve Hong Kong as well as it has in the past.

Hong Kong is the world’s largest container port, one of the world’s major financial centres, one of the world’s major trading jurisdictions and an entrepot for world trade with the rest of the PRC. In short, it has become too sophisticated to be governed by a simple tax system, unless one is prepared to accept uncertainty as to how complex cross-border transactions will be.

53 An Australian tax practitioner looking at the IRO for the first time will consider, probably justifiably, that Hong Kong is somewhat akin to tax heaven. The IRO consists of ss 1-89; the legislation covers only 200 pages, including schedules. Similarly, the authorised court reports, Hong Kong Tax Cases, in total are contained in three volumes.

54 Compare the provisions dealing with trafficking in loss companies, IRO, s 61B, which consist of 15 lines with the Australian equivalent in the Income Tax Assessment Act which runs to many pages.

55 Discussed in detail below under the heading “Impact of democratisation”.

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taxed\textsuperscript{56} as well as the revenue leakage which arises through either lack of
coverage or avoidance. If a complex business environment is to be relatively
immune from leakage of tax or tax avoidance, it must inevitably be regulated
in a complex manner. At present, however, it could be said that in many
complex areas taxation is by default rather than by design.

Another way of illustrating this problem is to consider the increase over the
last 20 years in the number of tax professionals who advise on Hong Kong tax
laws and, doubtless, on tax avoidance. In the 1970s tax advice in Hong Kong
was generally dispensed by accountants engaged in audit activity. The 1980s
heralded a major change. There was an influx of tax professionals, many
from Australia, and a new lexicon consisting of phrases such as leveraged
leasing, trafficking in loss companies, sale-and-lease-back and many more,
was in vogue "downtown".\textsuperscript{57} Then, as now, all the major international
accounting firms\textsuperscript{58} were established in Hong Kong. Each has a large tax
advisory department. It would be unrealistic in the extreme to think that they
are solely occupied with tax compliance matters. With Hong Kong’s growing
sophistication and the increasing complexity of cross-border financing and
business operations, it is no longer realistic to expect it to continue to operate
with a simple set of tax laws. Yet, by and large, it continues to do so.

Notwithstanding that general and specific anti-avoidance legislation has been
enacted in Hong Kong from 1986 onwards,\textsuperscript{59} to a certain extent tax avoidance
has been tolerated by the Inland Revenue Department. The best historical

\textsuperscript{56} Taxation of profits arising from more complex transactions, such as those
involving financial instruments and foreign exchange gains and losses, is
generally established by industry and accounting practices which are sometimes
overlaid by aged common law authorities, particularly those from England. The
IRO does not contain any provisions dealing specifically with these matters;
neither has Hong Kong’s Inland Revenue Department published any practice
notes, the typical form in which departmental policy, practice and interpretation
is disseminated, on those or similar matters.

\textsuperscript{57} If readers harbour any doubt on the antipodean influence on Hong Kong’s tax
law and practice in the 1980s, they need only refer to the enactment of IRO,
s 61A, a general anti-avoidance provision modeled upon Pt IVA of the Income
Tax Assessment Act 1936 (Cth): see further, Halkyard, “Hong Kong: A Tax

\textsuperscript{58} And many international law firms.

\textsuperscript{59} See eg, IRO, ss 61A (general anti-avoidance provision), 61B (provision
restricting trafficking in loss companies), 39E (provision restricting depreciation
allowances in certain leveraged leasing and sale-and-lease-back arrangements),
16(2) (provision restricting interest deductions on loans, particularly where the
lender is a non-financial institution), 22B (limitation of losses, arising from a
limited partnership, which are allowed to be set off against other profits of a
limited partner), 15A (specific provision taxing certain transfers of income
streams), 21A (withholding tax provision affecting certain transactions
involving the sale-and-lease-back of intellectual property) and 9A (provision
restricting the use of personal service companies).

http://epublications.bond.edu.au/rlj/vols/iss1/2
examples relate to leveraged leasing (whereby a Hong Kong party with no connection to an international leasing transaction was introduced into the arrangements for the purpose of taking the benefit of substantial depreciation allowances) and the use of service companies by professionals (for the purpose of giving such persons tax-efficient fringe and other benefits). Although avoidance of taxation in these areas has been restricted by legislation (in the case of leveraged leasing) and by departmental practice (in the case of service companies), by no means has it been eliminated. Specifically, leveraged leasing of aircraft and ships owned by a Hong Kong operator continues to provide tax depreciation advantages for the Hong Kong financier and the sole proprietor or partnership establishing a service company arrangement obtains various tax advantages so long as the mark up charged by the service company for the services provided does not exceed 12.5% and does not relate to the provision of:

(1) any services by the proprietor or by any partner or
(2) professional services by any other person.

One can surmise that this agreeable state of affairs for the business and professional communities may continue so long as Hong Kong’s budgetary surpluses continue. Despite predictions to the contrary, no change is in sight. Therefore, at least in the short term, Hong Kong’s tax laws will doubtless retain their simplicity. However, with the growing sophistication of the tax advising community in Hong Kong, more tax avoidance arrangements are being devised which in turn must eventually prompt the government to take corrective action, particularly if budgetary surpluses decrease. Simple legislation cannot be expected to close loopholes in the face of such growing sophistication. As tax advice and tax schemes become more complicated, experience has shown that anti-avoidance provisions follow suit.

Notwithstanding the above analysis, the existence of a general anti-avoidance provision in the IRO, s 61A, goes some way towards obviating the need for complexity. The revenue authorities have, after several years of quiescence, sought to apply these provisions in various cases, such as those involving the transfer of an income stream to a loss company and arrangements involving the sale-and-lease-back of intellectual property to an offshore associate. But whether this action has encouraged tax advisers to take a less aggressive

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60 See IRO, s 39E and Departmental Interpretation and Practice Notes No 15 (revised, September 1992).
61 See Departmental Interpretation and Practice Notes No 24 (August 1995).
62 See above n 3.
63 It was enacted in 1986: see Ord No 7 of 1986, s 10. The first reported case involving an assessment made under the provision was in 1992: see below n 64.
64 See D20/92 7 IRBRD 166.
65 See D44/92 7 IRBRD 324 and D67/95 11 IRBRD 44.
approach to tax planning is doubtful. Indeed, whatever *in terrorem* effect s 61A may possess, government's approach has been to counter avoidance activity by introducing specific anti-avoidance legislation. A certain amount of complexity has, therefore, been introduced into the IRO and this trend is probably inevitable if tax avoidance is to be properly countered. One thing is certain, the status quo cannot continue indefinitely.

In any event, it is clear that in recent years the courts in Hong Kong have taken a hostile stance towards cases of perceived tax avoidance and doubtless will continue to do so. This may very well be explicable by virtue of Hong Kong's simple, low rate tax system and may well have positive effects. It reminds taxpayers and their advisers that overly technical arguments and aggressive attitudes towards tax compliance obligations, often more prevalent in high tax environments, are not appropriate to a low rate, narrowly-based system of taxation.

**THE LIMITATIONS OF THE SOURCE PRINCIPLE**

As noted above, Hong Kong has a source based system of taxation. Domicile and residence, often touchstones for tax liability in other countries, have virtually no part to play in Hong Kong. While Hong Kong had a relatively unsophisticated economy, this simple jurisdiction to tax and the fairly antiquated case-law which related to source of profits worked fairly well. However, as Hong Kong developed first into an entrepot, then into a major trading and international financial centre, the strains of a source-based taxing principle have become obvious. Simply put, it is difficult to apply a simple source system in a world where commercial boundaries are increasingly being brought closer together and are no longer respected by many forms of instantaneous communications through which deals are concluded and substantial profits derived.

Perhaps the best example of this relates to "offshore trading" operations which over the last 15 years have given rise to a great deal of controversy. In order for a taxpayer to be liable to profits tax, it must first carry on a trade or

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66 See above n 59.
67 See Willoughby and Halkyard, above n 5 at II [18726]. An early flavour of the judicial anti-avoidance attitude is noted in Halkyard, “Hong Kong: The Commissioner in the Ascendancy” (1987) 16 AT Rev 243-244.
68 On the other hand, it has been argued that taxation law should be as clear as possible and not subject to continual change as a result of shifting judicial tendencies: see Halkyard and Olesnicky, above n 33 at 354-356.
69 See above n 12.
70 The source principle was derived from the model colonial tax ordinance which was adopted by most British colonial territories: see generally, Chelvathurai, above n 52 at 3.
business in Hong Kong; second, there must be profits of that trade or business; and third, the profits must be derived in or arise from a source in Hong Kong. These conditions are cumulative. It is, therefore, entirely consistent with the structure of the IRO for a company to have its sole place of business in Hong Kong yet derive offshore tax-exempt profits.

Two Hong Kong cases decided in 1960 and 1971, CIR v The Hong Kong & Whampoa Dock Company Ltd and CIR v International Wood Products Ltd accepted that the so-called "operations test" determined the source of profits for profits tax purposes. This has been confirmed by three factually disparate Privy Council decisions in the 1990s, CIR v Hang Seng Bank Ltd, HK-TV B International Ltd v CIR and CIR v Orion Caribbean Ltd. The operations test focuses upon identifying those activities which substantially give rise to the gross profits derived from individual transactions and then ascertaining where those activities take place.

In accordance with this test, the Inland Revenue Department historically accepted that operations with substantial connections outside Hong Kong (such as those of a typical trading operation based in Hong Kong but dealing with foreign sellers and buyers) did not give rise to taxable profits in Hong Kong. In the majority of cases, this test seems to have worked acceptably but, particularly in the trading area, more recent cases have expanded the perceived ambit of the operations test and introduced an unsatisfactory level of uncertainty.

The first major indication of future difficulty in applying the operations test arose from Sinolink Overseas Ltd v CIR. When this case was decided, it attracted widespread attention because it subjected to profits tax the profits of a so-called "China trader". In that case a company, whose business was controlled in Hong Kong and which had no branch operation outside Hong Kong, sent agents to the PRC to conclude sales contracts. Notwithstanding that the agents had full authority to contract and did conclude contracts in the PRC, all of the company's profits were held by the High Court to be subject to tax in Hong Kong. It appears that considerable emphasis was placed by the court upon the fact that the company's headquarters and sole place of business were in Hong Kong, even though this was not previously

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71 IRO, s 14(1).
72 See CIR v Hong Seng Bank Ltd [1991] 1 AC 306.
73 (1960) 1 HKTC 85.
74 (1971) 1 HKTC 551.
77 (1985) 2 HKTC 127.
determinative in deciding the issue of source of profits.\textsuperscript{78}

As a result of the Sinolink case the Commissioner of Inland Revenue apparently made a more concerted attempt to tax profits derived from offshore operations by Hong Kong entities. This trend can be expected to continue, particularly in light of the Privy Council decision in \textit{HK-TVB International Ltd v CIR} where Lord Jauncey stated: \textsuperscript{79} "It can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax."

In view of the perceived uncertainty concerning the scope of the operations test, some professional advisers began advising their clients to operate, as far as possible, outside Hong Kong.\textsuperscript{80} In some cases, businesses which would benefit the Hong Kong economy, but whose profit-generating activities take place offshore, are relocating to jurisdictions which are genuine tax havens. This is not to say that Hong Kong should indiscriminately accommodate foreign investors who are interested in finding a tax-free base for their operations. However, Hong Kong has traditionally been a base for many multinational entities which have relied upon its exemption for offshore profits, and whose connections with Hong Kong have consequently been tentative while at the same time beneficial to Hong Kong. Because of the growing uncertainty relating to this crucial source issue, which is at the very heart of Hong Kong's tax system, such businesses are now being established in other jurisdictions whose governments are prepared to provide more certainty. Similarly, many Hong Kong businesses are now setting up offshore entities through which their offshore activities are being channelled. It seems ironic that Hong Kong, which has an international reputation as having a tax friendly environment, is itself being subjected to tax avoidance through use of other tax havens.

\textsuperscript{78} See the Whampoa Dock case, above n 73 at 112-113 where the Court of Appeal stated that it was wrong to determine the source of profits simply by asking the question where does the company carry on business.

\textsuperscript{79} [1992] 2 AC 397 at 409.

\textsuperscript{80} This is illustrated by the following extract from a newsletter issued by an offshore company service provider which, under the banner "High Court Decision Puts Re-invoicing Activities in Jeopardy", stated:

In particular, we are now frequently recommending that re-invoicing is conducted through a Caribbean type offshore company which arranges for a Hong Kong correspondent office address and a Hong Kong bank account. As neither a Hong Kong company nor a Caribbean company need state its registered office address or place of incorporation on its letterhead, this enables the Caribbean company to appear to have Hong Kong persona but avoids the more expensive and onerous Hong Kong company compliance procedures and any danger of the company being liable to Hong Kong tax. The company would, however, still be able to access the extremely efficient and trade oriented Hong Kong banking system.

These developments are detrimental to Hong Kong, and clarification of the outstanding source problems is called for. In 1992 the Inland Revenue Department issued a practice direction setting out its views on the concept of the source of profits. This was revised in 1996 and, to give the Commissioner of Inland Revenue due credit, the revisions were both conciliatory and useful. However, source of profits is an issue which simply has not gone away and is still regularly litigated, notwithstanding the three Privy Council decisions referred to above. Although most areas are not contentious, the three current items of dispute involve: the source of trading profits, the extent to which a Hong Kong manufacturer with operations outside Hong Kong, typically in the Chinese Mainland, can be said to derive Hong Kong-sourced profits and the extent to which apportionment is available so that some profits are accepted as derived offshore while others are accepted as derived from a source in Hong Kong.

There is no simple answer to these problems. The Commissioner can hardly go back to the pre-1985 days when the source of trading profits seemed essentially determined by where the sales contracts were concluded, when Hong Kong manufacturers carried on business in Hong Kong and not across the border in the Chinese Mainland and places further afield, and when apportionment of profits was not generally accepted. Equally, as modern case law illustrates, taxpayers and their advisers will not simply accept Inland Revenue Department practice in source of profits disputes which are open to different interpretation.

One way to cut this gordian knot would be for Hong Kong to enact specific source rules, relating to different types of profit-earning activity. Precedents

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81 See Departmental Interpretation and Practice Notes No 21: “Location of Profits” (revised, November 1996). See further below n 124.

82 See Magna Industrial Co Ltd v CIR [1997] HKLRD 173 where the Court of Appeal upheld a direct challenge to Departmental Interpretation and Practice Notes No 21, above n 81. In this case, the Court of Appeal decided that the company’s trading profits were sourced outside Hong Kong notwithstanding that all its contracts of purchase as well as other ancillary activities were effected in Hong Kong. See further below n 124.

83 Specific areas of dispute include the extent to which a manufacturer with operations both in and outside Hong Kong can apportion its total profits between an offshore and a Hong Kong source and, more generally, what basis of apportionment should be adopted (the Commissioner normally insists upon a 50-50 basis).

84 Not only does modern case law preclude this approach (see CIR v Hang Seng Bank Ltd, above n 72), but it would be an absurdly inappropriate test in this age of instantaneous global communication.

85 See, eg, CIR v Orion Caribbean Ltd [1997] STC 923 (a case involving the source of interest income which the Commissioner won), and Magna Industrial Co Ltd v CIR [1997] HKLRD 173 (a case involving the source of trading profits which the Commissioner lost).
are available for adopting this approach in many jurisdictions, including the United States and Japan. But, invariably, these jurisdictions have tax systems infinitely more complex than that of Hong Kong. Although it is argued above that Hong Kong can not always cling to the known virtues of legislative simplicity and ease of compliance, this does not mean that simpler less sophisticated solutions should necessarily be eschewed in favour of the state-of-the-art. Indeed, in this regard, a less sophisticated solution may well be appropriate.

Specifically, many of the current source disputes might be solved by the Commissioner accepting that apportionment of profits is more readily available in addition to the currently accepted cases involving manufacturers and service providers. This possibility has already been hinted at in two recent decisions of the Inland Revenue Board of Review, D77/94 and D14/96. D77/94 is particularly noteworthy. In this case the Board allowed a publishing company based in Hong Kong to apportion its profits between a Hong Kong source and an offshore source. The profits in dispute concerned the sale of magazines and advertising space in those magazines. The activities of the taxpayer outside Hong Kong included soliciting and concluding sales, and the production of the editorial, pictorial and advertising content for publishing the magazines. The activities of the taxpayer in Hong Kong included typesetting, colour separation, printing and binding operations. The Board held that the offshore and onshore activities to produce the taxpayer’s profits were so interdependent that it was impossible to attribute those profits to one or other of those activities. The Board thus ruled that apportionment of profits was appropriate and hinted broadly that this should be on a 50-50 basis.

The Commissioner of Inland Revenue has also taken a pragmatic approach in relation to taxing interest and other profits derived by financial institutions where the source of funding and loan initiation took place both in and outside Hong Kong. In essence, the Commissioner allows de facto apportionment in these cases, invariably on a 50/50 basis. This compromise seems to have worked well and no source disputes involving financial institutions have been

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86 See Departmental Interpretation and Practice Notes No 21, above n 81, at paras 12-18 and 20-21.
87 10 IRBRD 42; (1995) 1 HKRC §80-354.
88 A case involving a tour operator which had a significant retail operation in Hong Kong selling packaged tours to the public and yet discharged its contractual obligations to its customers by carrying out or performing the tour services in the foreign destination: see 11 IRBRD 406. In the event, neither the Commissioner nor the appellant admitted the possibility of apportionment, so the case was decided on the application of the broad guiding principles set out in CIR v Hong Seng Bank Ltd, above n 72.
89 See Departmental Interpretation and Practice Notes No 21, above n 81 at para 27.
reported since it was instituted some 10 years ago. A similar innovative, yet simple, approach could well be justified in relation to the remaining source of profits disputes.

THE INEVITABLE MOVE TOWARDS SELF-ASSESSMENT

As is the case with many efficient organisations, the Inland Revenue Department has for many years been continually examining means to make the optimum use of its resources. This has been especially critical over the last few years because, in line with general government policy, zero-growth rate restrictions apply to staffing. In this regard, some significant developments over the last decade involved the introduction of a Composite Tax Return in 1994, which greatly simplified return filing and assessment of individual taxpayers; the phased introduction of a field audit system in 1991, which diverted existing resources from the traditional assessing function; and the imposition of heavy penalties for improper business record keeping in 1995. All are noteworthy because they are consistent with, and arguably herald, a long-term but seemingly inevitable move towards self-assessment.

As stated above, Hong Kong’s current taxation system is both relatively simple in terms of its tax laws and straightforward in terms of taxpayer compliance. It thus lends itself to providing taxpayers with a sufficient degree of certainty in computing their own taxation liabilities if a self-assessment regime were introduced. It is clear, however, that such a radical move would require major changes to long established procedures which will

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92 Previously, individual taxpayers had to file separate tax returns for salaries tax, property tax and profits tax.
93 Although each return is still formally “assessed”, for various categories of taxpayers the process takes the form of “rapid assessment” with field audit assuming the role of risk management: see generally, *Inland Revenue Department Annual Report 1995-96* at 36-38.
94 IRO, s 51C.
95 See generally, IRD, “Self Assessment: The Challenges Ahead” *The Hong Kong Accountant* (January/February 1997) at 52-53. This article was based on a speech made by the Commissioner of Inland Revenue to the Hong Kong Society of Accountants on 19 November 1996 (a copy of which is in the author’s possession). The Commissioner made clear that self assessment, if implemented, would initially only be available to taxpayers liable to profits tax who have their accounts audited by registered accountants in public practice.
impact upon the taxpaying community. These include:

1. Establishing a formal system of tax rulings whereby taxpayers can seek the views of the Inland Revenue Department in cases where the law is unclear or the facts are contentious.
2. Introducing a process where taxpayers can amend their assessments, also on a self-assessment basis, when they have lodged incorrect returns.
3. Instituting interest charges on any overdue tax liability resulting from an incorrect return.
4. Reviewing the penalty provisions to reflect the changed compliance and reporting obligations.
5. Introducing a system of registration for tax representatives.

Although no firm decision has been made, the attitude of the Inland Revenue Department apparently is that in the long-term it will be necessary to embrace fully self assessment as the basis of profits tax filing and assessment. To this end, a public dialogue has been initiated by the Commissioner of Inland Revenue. Interested parties will doubtless have suggestions as to whether and, if so, how self-assessment should proceed. From a practical perspective however, the issue now appears to be when, rather than whether, self-assessment will be implemented. At the very earliest, this would be the beginning of the next millennia; but that is now not very far away.

TAX INCENTIVES FOR TARGETED INDUSTRIES AND BUSINESS

For some time it has become fashionable, particularly in business circles, to point to all the taxation and other incentives passed by Hong Kong’s trading competitors, especially Singapore and, more recently, Australia and to conclude that Hong Kong should follow suit in order to attract and retain

96 See above n 95.
97 Similar to the tax agents registration system in Australia.
98 For a contrary view, see Ho, “A Feasibility Study on the Introduction of a Self-Assessment System in Hong Kong” Taxation (June 1996 Issue No 25) (Taxation Institute of Hong Kong, Hong Kong) at 11 who argues that self-assessment may not be appropriate for Hong Kong because its narrow jurisdiction to tax, which excludes offshore profits and capital gains, provides many opportunities for taxpayers to be less than forthcoming about their taxation liabilities.
99 See generally, Dabner, “Should Taxation Incentives Be Introduced to Encourage the Location of South East Asian/South West Pacific Regional Corporate Headquarters to Australia?” (copy in the author’s possession; it is a report, dated 5 November 1994, submitted to the Senate Economics Committee).
Before embarking upon this analysis, it is useful to reiterate that Hong Kong’s taxation and foreign investment regime is based upon the concept of neutrality. That is, Hong Kong does not, generally speaking, encourage particular types of business activity through providing tax and other incentives such as rules for enhancing deduction of expenses, reduced tax rates and tax holidays, and concessions relating to property rates and utilities. The major exceptions involve various forms of government assistance, usually indirect, provided to industry. For example, the Hong Kong Industrial Estates Corporation makes land available for industrial use by way of lease at a fixed price.

The main taxation exception is contained in IRO s 16E, a concession introduced in 1983 as an incentive for local industry to upgrade technology. The section allows a deduction for capital expenditure on the purchase of certain types of intellectual property used in Hong Kong. Interestingly, the incentive was abused and s 16E was amended in 1992 to restrict the deduction to the cost of patents and industrial know-how and to deny deduction for payments made to associated parties. Hong Kong has also enacted a very generous regime allowing accelerated depreciation on the purchase of plant and machinery and on the construction of industrial buildings and structures. Again, it is no coincidence that this provision was abused, specifically in relation to leveraged leasing transactions involving aircraft. In the result, the IRO was amended to effectively outlaw leveraged leasing of aircraft operated by non-resident operators.

It is commonly said that Hong Kong has no foreign investment and taxation incentives. This is not correct. The incentives in Hong Kong’s business regulation and taxation regimes are inherent rather than explicitly carved out in favour of certain types of economic activity. In other words, the philosophy underpinning Hong Kong’s economic and taxation system is to provide maximum incentive to all businesses to earn greater profits without regard to the form any such business should take. Indeed, foreign investors may be surprised to learn that it is still the case today that most business

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100 For a contrary view, see Halkyard, “Regional Headquarters for Multinational Corporations: Tax Incentives for Hong Kong?” (1991) 18(9) Tax Planning International Review 23.


102 Through the use of sale-and-lease-back arrangements, typically involving trademarks: see, eg, D44/92 7 IRBRD 324.

103 IRO, Pt VI.

104 See Willoughby and Halkyard, above n 5 at II [15842] ff.
transactions in Hong Kong are not structured with regard to taxation considerations at all.\textsuperscript{105} There are several very good reasons for this, including:

1) Hong Kong's adherence to a source-based taxation system which only seeks to tax profits having a local source;

2) The total exemption from tax of dividends and the absence of withholding tax on interest;

3) The existence of only a minimal withholding tax on royalty payments for the use of intellectual property in Hong Kong, and most importantly;

4) The low rate of tax - the maximum tax rate on business profits is still a modest 16\% for corporations and 15\% for individuals.

Notwithstanding factors such as political stability and the availability of a well-trained English speaking workforce in Hong Kong's most visible regional competitor, Singapore, it appears that multinational groups are not abandoning Hong Kong. Indeed, there is scant empirical evidence available to indicate that the taxation and other economic incentives offered by its trading competitors have adversely affected Hong Kong.\textsuperscript{106}

To date, the Hong Kong Government has adhered to its long-held policy of not "picking winners",\textsuperscript{107} let alone "tax winners". However, in order to retain competitiveness within the Asian region, various initiatives are necessary to create a more business-friendly environment in Hong Kong. This has been recognised by the Hong Kong Government. Particular support has been pledged to promote the high value-added, technology-based manufacturing sector, to create an environment in which a services and skills-based economy can flourish and to provide the infrastructure necessary to accomplish these goals.\textsuperscript{108} However, these initiatives\textsuperscript{109} are not, and should not be, based upon

\begin{footnotesize}
\begin{enumerate}
\item Although as indicated above, it must be admitted that the extent and sophistication of tax avoidance activities in Hong Kong have increased in recent years.
\item See Dabner, above n 99, particularly at p 1, n 4. Since publication of this report, there has been no noticeable drift of business away from Hong Kong.
\item This policy has been reiterated on many occasions: see, eg, The 1996-97 Budget (6 March 1997 Hong Kong Government Printer) at para 114 where the Financial Secretary, in the context of promoting Hong Kong as a service centre, stated: “Our aim has not been, and never will be, to ‘pick winners’ or to second-guess markets and entrepreneurs.”
\item See The 1996-97 Budget, above n 107 at para 90 ff.
\item They relate to matters such as strengthening intellectual property protection, enhancing the language skills of the workforce, improving rail, port and airport facilities, deregulating telecommunications, building a science park, streamlining government administration and procedures, and supporting a long-term study on industrial development: see The 1996-97 Budget, above n 107 and The 1997-98 Budget, above n 1 at para 30 ff.
\end{enumerate}
\end{footnotesize}
The main reasons for this are firstly, that comparisons with the claims of Hong Kong's competitors, such as Singapore, continue to show Hong Kong in a favourable light when viewed from a taxation perspective and secondly, Hong Kong's experiments with tax incentives, small as they may be, have simply not worked. In these circumstances, the way forward for government appears clear: any incentives should be direct and accountable (such as providing cheap financing, and subsidies for designated research or employment practices) or made available to the community as a whole (such as providing sound infrastructure and efficient administration); not indirect and unaccountable (such as double depreciation, tax holidays and other similar tax expenditures). On this basis, Hong Kong's tax neutral, low tax system and laissez-faire economy can operate to attract investment which can flourish without being driven by the exchequer.

THE RESUMPTION OF SOVEREIGNTY OVER HONG KONG BY THE PRC

1 Introduction

At midnight 30 June 1997, the PRC resumed sovereignty over Hong Kong. Hong Kong will not, however, be integrated into the political, economic and social system of the PRC. Instead it will enjoy a special status under article 31 of the PRC Constitution as a Special Administrative Region. In accordance with The Basic Law of the Special Administrative Region of Hong Kong, Hong Kong is promised a high degree of autonomy. The Basic Law also provides that Hong Kong's capitalist market system will remain unchanged for 50 years after 30 June 1997.

2 The basic law of the Special Administrative Region of Hong Kong

In relation to the fiscal system to be applied in Hong Kong, an apparent problem exists, namely, that certain economic objectives are set out in the substantive provisions of Chapter V of the Basic Law. Although these appear

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110 See above nn 102-104 and accompanying text. That is not to say that selective and carefully monitored tax incentives, such as those provided in Singapore, can never be effective to encourage specific government policies. However, Hong Kong simply has a different economic philosophy which to date has served it very well.

111 Enacted in April 1990 by the National People's Congress of the PRC: see generally, Ghai, Hong Kong's New Constitutional Order: The Resumption of Chinese Sovereignty and the Basic Law (1997 Hong Kong University Press, Hong Kong).

112 Ghai, above n 111 at 468, concludes that the principal objective of the Basic Law is the separation of the economy of Hong Kong from that of the mainland, rather than autonomy as such.
akin to policy objectives, their status is debatable. The better view seems to be that they represent broad economic guidelines or directions for the future governments of the Special Administrative Region to follow; they can be distinguished from substantive rights, such as the right of abode, and do not seem to be justiciable.113 Thus, depending upon Hong Kong’s economic needs and circumstances, future governments should be empowered freely to decide on their implementation.

The contrary view is that their enactment in the Basic Law amounts to entrenching a certain philosophy, deliberately included to fetter the government of the day. For example, BL 108 prescribes that Hong Kong shall continue to practise a low tax policy. Although this is clearly in line with previous policy and appears generally to meet with the approval of the Hong Kong public, it is highly debatable whether such a policy should be enshrined as a mandatory provision in the laws of the Special Administrative Region of Hong Kong. This provision appears to limit the discretion and policy choices available to future governments of Hong Kong. The same could be said of BL 107 which provides that Hong Kong shall follow the principle of balancing its budget and avoiding deficits.

BL 114 is a peculiar provision. It provides that Hong Kong “shall maintain the status of a free port”. Before 1 July 1997, as now, Hong Kong was not a duty-free port. Various luxury commodities such as alcohol and tobacco, and other non-luxury items such as hydrocarbon oil, are all subject to duty.114 This article therefore also appears to unduly restrict the powers of the government because, taken at face value, it seems to call for the abolition of existing duties. Moreover, this article arguably restricts consideration of any legislative scheme to introduce a wide-ranging system of indirect taxation in Hong Kong, and could thereby deny to Hong Kong the advantages of adopting a more broadly-based taxation system.

In summary, the goals set out in Chapter V of the Basic Law dealing with the economy, such as maintaining a free port, balanced budgets, and low rates of taxation, seem generally laudable as policy objectives. They seem to have been supported by the public in Hong Kong, have been adhered to for many years and, subject to a stable economic environment, will no doubt continue to be pursued in the foreseeable future. However, given the increasing economic volatility of international business, the ability of the Hong Kong Government to pursue these goals successfully in the longer term, let alone on an annual basis, is questionable. To enshrine these policies in what is essentially the constitution of the Special Administrative Region of Hong Kong restricts the policy choices available to the Hong Kong Government. As

113 Similar criticisms were made of the first published draft of the Basic Law: see Byres, “Hong Kong - Tax Considerations for the 1990s” (1988) 15(9) Tax Planning International Review 39.
114 See above n 18 and accompanying text.
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The Hong Kong Tax Paradox

Ghai\textsuperscript{115} suggests in a broader political, social and economic context, the separateness of Hong Kong’s economy from that of the Mainland has been preserved by the Basic Law: but preserved at the expense of true autonomy.

3 Independence of Hong Kong’s tax system and the status of the PRC’s tax treaties

A related issue is the extent to which the tax systems of Hong Kong and the rest of the PRC will interact after 1 July 1997. BL 108 provides that Hong Kong will have “an independent taxation system”. BL 106 goes on to provide that the Central People’s Government will be prohibited from levying taxes in the Special Administrative Region of Hong Kong. Under BL 151 Hong Kong may, on its own, maintain and develop tax relations, and sign and implement tax agreements with foreign states and regions as well as with relevant international organisations. Accordingly, Hong Kong will be able to enter independently into double taxation treaties with interested states. The implication of these provisions must be, as all of the PRC’s double tax agreements at least imply, that they were not intended to apply to Hong Kong after 30 June 1997.\textsuperscript{116}

As indicated above, Hong Kong has not entered into any comprehensive double tax agreements. The only limited exceptions involve the exchange of notes between the Hong Kong and United States Governments (relating to the abolition of tax on certain types of shipping income), and the Governments of Canada, New Zealand, South Korea, Germany and the United Kingdom (relating to the double taxation of aircraft operators) and a more detailed “Memorandum” relating to the avoidance of double taxation of income with the PRC Mainland.\textsuperscript{117} Although one hopes that these limited agreements signal a trend for Hong Kong’s fuller participation in the international taxation community, despite tentative steps taken by the Hong Kong Government, potential treaty partners do not appear to have responded with any enthusiasm: doubtless because Hong Kong imposes tax only on Hong Kong source income and is also perceived by other countries to be a tax haven. It is also fair comment that although Hong Kong taxpayers theoretically might suffer double taxation problems in both the Mainland and other countries, this has not yet emerged as a significant practical problem. Should it do so, the Hong Kong Government will be under pressure to take action to alleviate this unacceptable state of affairs. Such relief could either

\textsuperscript{115} See above n 112.

\textsuperscript{116} Compare Cullen, “Double Tax Treaties in Hong Kong” (1996) 6(11) Company Secretary 32; see generally, above n 16.

\textsuperscript{117} See Willoughby and Halkyard, above n 5 at II [17015] ff and [24341] ff and below n 124.
be unilateral\textsuperscript{118} or, where practical, by mutual arrangement with a foreign state.\textsuperscript{119}

4 Conclusions

Looking to the future, potential difficulties are apparent in that:

(1) It is clearly preferable that the Basic Law should, insofar as it deals with fiscal matters, draw a clear distinction between policy guidelines and mandatory provisions. Ideally, the Basic Law provisions relating to Hong Kong’s economic and fiscal system should be interpreted as having a guiding, rather than a mandatory, effect; and

(2) Double taxation issues may become a practical rather than, as currently, a potential problem. Specifically, this problem is most likely to arise in relation to activities of Hong Kong investors in the Mainland, particularly given the increased tax compliance and enforcement action recently taken by the PRC State Administration of Taxation. More generally, the absence of comprehensive double taxation treaties entered into by Hong Kong does little to assuage investors’ fears in this regard, whether or not such fears are well founded.

It must be reiterated that these problems are potential rather than pressing. In the meantime, however, provided that commercial activity in Hong Kong will be free of taxation consequences in the Mainland (this is precisely what is promised in the Basic Law), stability and prosperity in Hong Kong in the post-1997 era will undoubtedly be enhanced.

Finally, in this regard, it should not be forgotten that an effective taxation system is increasingly dependent upon the co-operation of the general body of taxpayers. To the extent that the taxpaying public has trust that the Inland Revenue Department will continue to assess tax and administer the law fairly and openly, and with independence and autonomy, this can only help ensure that the aspirations of the Hong Kong people for good government can be fulfilled. This challenge of nurturing co-operation and mutual trust, which faces both tax payer and tax collector alike, is perhaps one of the most

\textsuperscript{118} Compare IRO, s 8(1A)(c) which was introduced to relieve a double taxation problem relating to salaries tax, where employees with employments located in Hong Kong were taxed elsewhere (most commonly in the Chinese mainland) as well as in Hong Kong.

\textsuperscript{119} Under the authority set out in BL 151. See further below \textsuperscript{124}.
A Halkyard  

**IMPACT OF DEMOCRATISATION**

It has been pleasing to witness, albeit with reservations as to the slow rate of progress, the democratisation of Hong Kong\(^{121}\) and the greater influence over government policy which elected representatives to District Boards, the Urban and Regional Councils and the Legislative Council are having and will continue to have over the coming years. These developments will have profound effects on future taxation policies in a number of ways. Before considering these effects, it is important to note that government policy is to match its spending to the growth trend of gross domestic product.\(^{122}\) This sounds good in theory, but it has a deep flaw: namely, the base line for government spending, and therefore the services provided to the people, is way too low.

The democratisation of Hong Kong will clearly lead to demands for further government spending in the three main areas of public concern: housing, education and social welfare.\(^{123}\) It will gradually become more difficult for the Hong Kong Government to resist these demands. This in turn will lead to a need to increase government revenues, which will almost certainly be effected through the taxation system. As effective tax rates and the total yield from the taxation system increase, this will encourage avoidance and evasion of taxes, which in turn will lead to government taking preventive measures in order to counter such abuses. In the long run, this will add to the complexity of Hong Kong’s tax system.

As noted above, unfairness is inherent in the Hong Kong tax system. Until recently, it has been relatively easy for government to ignore criticism along these lines and to give greater weight to the criteria of simplicity and efficiency. It is unlikely, however, that demands to mitigate unfairness can be resisted so easily in the future. Democratically-elected representatives will

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\(^{120}\) See also Messere, above n 52 at 512-513 who states in relation to tax policy in OECD countries:

> a reasonably valid generalisation would be that the predominant theme of the last half of the 1980s was broadening the tax base and lowering the rates of the personal and corporate income tax, and the predominant theme of the last five years has been improvements on the tax administrative side.

\(^{121}\) See BL 68 and Annex II which provides a framework for electing the Legislative Council up to 2007 and states that, “The ultimate aim is the election of all the members of the Legislative Council by universal suffrage.”

\(^{122}\) See The 1997-98 Budget, above n 1 at para 20.

\(^{123}\) These were the major themes of the first policy address given by the Chief Executive, Mr Tung Chee-hwa, after the resumption of sovereignty over Hong Kong by the PRC on 1 July 1997: see “A Future of Excellence and Prosperity for All” (1997 Hong Kong Government Printer).
inevitably seek to respond to the needs of their constituents, and will have a public platform from which to voice their demands. As a result, the publicity given to such demands will increase. The public response to this will make it increasingly difficult for government to resist making concessions.

CONCLUSIONS

There are several challenges currently affecting all of the Hong Kong Government, business interests and taxpayers generally. Crucial to the future, and fundamental to all other issues, is the provision in the Basic Law that Hong Kong shall enjoy a high degree of autonomy. In the taxation area, this issue has been addressed unambiguously in the Basic Law, namely, Hong Kong shall operate its own independent system of taxation and the taxation laws of the Chinese Mainland shall not apply to Hong Kong. On this ground, there is no room for complaint apart from reiterating the comment that, ideally, the policy guidelines set out in the Basic Law should be clearly delineated from mandatory provisions and that these should not be interpreted so as to fetter the discretion and policy options open to future Hong Kong Governments. This could best ensure that the promised autonomy does devolve to the Hong Kong Special Administrative Region Government in fiscal matters.

Looking back over the last 50 years since the enactment of the Inland Revenue Ordinance in 1947, there has been little attempt to reform the outdated, simplistic legislation on which Hong Kong relies for most of its revenue. Generally, when problems with existing legislation are perceived, amending legislation is enacted on a piecemeal basis. This is explicable no doubt by the fact that during this period the Hong Kong Government’s financial position has been in a very healthy state. In recent years, it has continued to achieve record budgetary surpluses and very little pressure has therefore been placed upon it to embark upon a major reform of its taxation system. This state of affairs is exacerbated by the Basic Law which provides that Hong Kong’s economic system will remain unchanged for 50 years and that its tax policies based on a low tax rate and a simple system of taxation will be continued.

Nevertheless, it is clear that major changes to Hong Kong’s existing taxation system must eventually take place.124 An attempt has been made in this

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124 Since this article was written, Hong Kong’s 1998-99 Budget has been handed down (18 February 1998 Printing Department). Although the analysis and conclusions reached in the article have not been affected, readers are advised of the following developments which state the law as at 21 April 1998.

- The corporate profits tax rate has been reduced, with effect from the 1998-99 year of assessment, from 16.5% to 16%. This change has been reflected in the text of the article. See above nn 21 and 39 and accompanying text.
A Halkyard

article to identify the challenges facing Hong Kong in the taxation arena and to suggest appropriate responses to meet them. The key issue involves an appreciation that the tax base in Hong Kong is narrow and dependent upon confidence and the healthy state of the property market. It should be anticipated that great pressure will be placed upon that narrow tax base in times of economic downturn and, in any event, by growing public demand for increased government spending and cheap housing. All these factors bring into sharp focus the question whether Hong Kong’s present reliance upon direct taxation for providing the bulk of government revenue can continue indefinitely and whether the imposition of a broadly-based system of indirect taxation can be postponed indefinitely. Change in this regard is almost inevitable and, in a time of healthy budget surpluses, that time should be sooner rather than later. In the real world, however, it seems that this will only occur when budgetary needs dictate. In the meantime, Jurassic Park° really does exist in the Pearl River Delta.

- A significant development was the announcement regarding the “Memorandum Between the State Administration of Taxation of the Mainland of China and the Finance Bureau of the Hong Kong Special Administrative Region Concerning the Arrangement Between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income” (27 February 1998, LN 126 of 1998). Although by no means a comprehensive double taxation agreement (e.g., it does not deal with withholding tax), it none the less contains several standard OECD model treaty provisions and raises the tantalising possibility that this is a precursor to Hong Kong more energetically pursuing a tax treaty agenda. The 1998-99 Budget states at para 115 that “[The Financial Secretary proposes] to select a few target countries for negotiation of comprehensive double taxation agreements, where this would be in [Hong Kong’s] overall interest.” See above nn 16 and 117-119 and accompanying text.

- After years of resisting calls to provide tax relief for owner-occupied housing, a new salaries tax deduction of a maximum of US$12,820 per year per property for home mortgage interest payments has been enacted: see The 1998-99 Budget at para 94 and the Inland Revenue (Amendment) Ordinance 1998 which introduced a new s 26E into the principal ordinance. See above n 26 and accompanying text.

- The Financial Secretary acknowledged that there is some uncertainty over the application of the territorial source principle to determine taxable profits: see The 1998-99 Budget at para 114 and the Inland Revenue (Amendment) Ordinance 1998 which introduced a new s 88A into the principal ordinance to authorise the Inland Revenue Department to provide, on a cost recovery basis, an advance ruling service which includes the source of profits. Additionally, Departmental Interpretation and Practice Notes No 21: “Location of Profits” was further revised in March 1998 to reflect the Commissioner’s views on matters such as the decision in the Magna Industrial case. See above nn 76-82 and accompanying text.

° Apologies to Steven Spielberg.
TAX HARMONISATION AND THE CASE OF CORPORATE TAXATION

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1 INTRODUCTION

The issue of tax harmonisation has not always generated harmony. Corporate taxation has been one area experiencing particular difficulty and progress towards corporate tax harmonisation between Australia and New Zealand has been slow and uncertain. In Europe more determined efforts have been made over a longer period, but the result has still fallen far short of a harmonised corporate tax system. There are various possible reasons why this might be.

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