

taxtalk newsletter

Grant Thornton 
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Contents

- 1 Consultation...but no concessions
- 2 Goods and Services Tax
- 3 Rent...or a cash allowance?
- 4 Green Taxes

Consultation...but no concessions

The taxation highlight for the first quarter of the year in Hong Kong is the budget speech by the Financial Secretary. This year the Financial Secretary was able to announce that he has met the fiscal targets he set for himself in 2004 some three years ahead of schedule. But the Financial Secretary indicated that prudent management of government finances required that he consolidate the government's reserves and not make any significant tax concessions.

Although the Financial Secretary has, with the help of the economic recovery in Hong Kong, managed to bring government Operating Expenditure under control, closer examination of the government's current forecasts indicate that in the next four years Operating Expenditure is set to increase significantly. This is even more apparent when the 2006 forecasts of Operating Expenditure are compared with the forecasts for the same four years made by the Financial Secretary in his 2005 budget. In the light of these significant increases in Operating Expenditure and, also the government's wish to build new Central Government Offices on the Tamar site, it is more difficult to accept the lack of tax concessions for taxpayers in a recovering economy.

However the Financial Secretary has resisted calls from various sectors of the community for tax relief such as increases in personal allowances for

Salaries Tax payers and group loss relief for Profits Tax payers. In the latter case the Financial Secretary appears to have been misinformed regarding the need for such relief, which has been successfully introduced in Singapore without any significant tax avoidance issues.

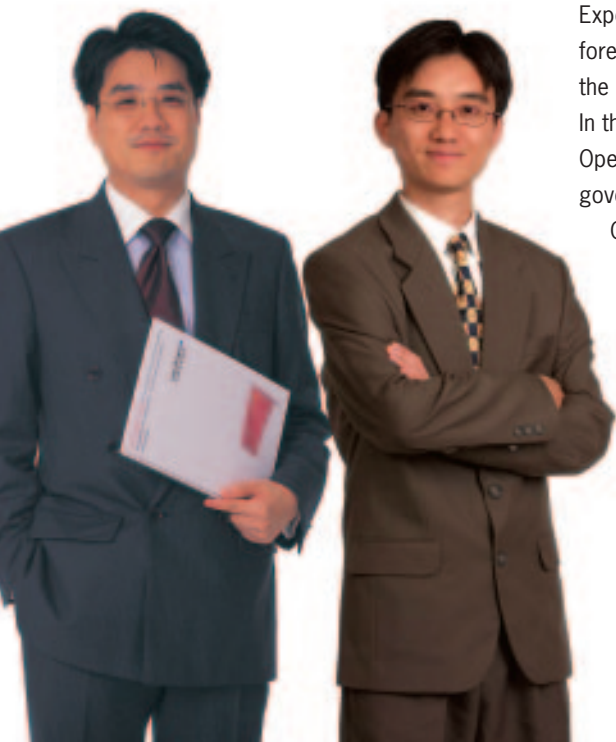
The Financial Secretary also referred to Hong Kong's narrow tax base which is susceptible to downturns in the economy and indicated that a Goods and Services Tax (GST) could be an option to broaden this narrow tax base.

The government will launch a consultation process on GST in the middle of 2006 which will take approximately nine months. At the end of this period a report will be prepared for the government's further consideration. In anticipation of the consultation process, this issue of tax talk contains an article on the background to the debate on the introduction of GST in Hong Kong.

"Green Taxes" was one of the Financial Secretary's catch phrases in the budget and we include an article on the government proposal for these taxes. We also review current developments in rental refunds for Salaries Tax purposes.

The second quarter of 2006 signals the commencement of the tax filing season for 2005/06. Details of the tax filing deadlines are set out in our Tax Notes Issue 15. Please contact us if you have not received your copy of these Tax Notes.

Michael To, Senior Tax Manager (left) and **Anthony Chan**, Tax Manager (right) of Grant Thornton



Goods and Services Tax

In his recent 2006 budget speech the Financial Secretary referred to the problem of Hong Kong's narrow tax base stating:

"The existing structure of government revenue is less than healthy. We need revenue items which are less sensitive to the ups and downs of economic cycles to offset the volatility of the others. Widespread experience overseas has demonstrated that a Goods and Services Tax (GST) can achieve this purpose. I believe that it is the civic responsibility of Hong Kong people to contribute an affordable amount of tax."

The Financial Secretary then announced that a public consultation period would be launched in the middle of 2006 lasting for approximately nine months to examine the detailed implications of GST stating:

"I will follow the principle of maintaining our low and simple tax regime...We intend, inter alia, to provide (GST) refunds to visitors and allow importers to defer payment to relieve pressures on their cash flow. To reduce the erosion of people's purchasing power, we will also propose relief and compensatory measures, including an increase in the level of (welfare) payments and reduction of other taxes."

The question of the introduction of GST in Hong Kong has been the subject of discussion since the establishment of the Advisory Committee on New Broad-based Taxes in May 2000. The Advisory Committee was set up at the instigation of

the then Financial Secretary, in the face of consecutive years of budget deficits, to consider alternatives to Hong Kong's narrow tax base.

The Advisory Committee reported in March 2002. As part of their review they considered a wide range of possible measures to broaden Hong Kong's tax base using eight widely accepted principles of a "good tax system". Applying these eight tests the Advisory Committee indicated that of all the options surveyed by them GST was the only one which fitted the primary criteria of being broadly based and highly revenue productive even when the tax rate is set at a level which, compared with other economies, is low.

The Advisory Committee indicated that if introduced in Hong Kong GST should be at a low rate 3% to 5% providing a revenue yield of between HK\$18 billion and HK\$30 billion.

In the four years since the Advisory Committee reported to the Government GST has been the subject of much discussion in Hong Kong and the International Monetary Fund (IMF) has provided further information and advice on the implementation of GST but no concerted action has been taken on this matter, and Hong Kong's tax base remains narrow. The Tax Force on a Review of Public Finances which reported in February 2002, indicated that Hong Kong has an ongoing and persistent structural fiscal problem. Despite that it must have been a temptation

for the Financial Secretary to take no action in a period of prosperity, but he has decided to renew the debate on GST.

The Advisory Committee concluded that GST even at a low rate of 3% would broaden the tax base, consistent with overseas trends to move towards a greater reliance on consumption taxes with less reliance on taxes on income and property. GST would also address the revenue requirements without jeopardising Hong Kong's low tax status and international competitiveness and provide a sustainable tax base in the future. They stated "It was the only option that provides a comprehensive solution to all the issues covered by this tax study and as set out in the study brief".

As part of its review the Advisory Committee met with the Fiscal Affairs Department of the IMF which recommended GST in Hong Kong should:

- contain few exemptions, zero ratings, or special concessions; and
- have a low single rate in the range of 3% to 5%.

The IMF also recommended the following features for a GST in Hong Kong:

- zero rated items - exports (including international transportation) – financial services (other than services consumed domestically for which explicit fees are charged)
- exempt items – residential rent, sales of residential property (other than newly constructed residential property)

Rent...or a cash allowance?



- small business concessions – high GST registration threshold for small businesses – optional registration for GST available for small businesses, that is businesses whose annual turnover falls below the registration ratio
- tourist refund scheme – GST refunds available to tourists for goods purchased in Hong Kong and taken overseas when they depart.

Typically the introduction of GST is accompanied by a reduction in direct taxes. However, this raises particular problems in Hong Kong due to Hong Kong's narrow tax base as many members of the public do not pay any direct taxes. Accordingly to his budget speech the Financial Secretary referred to measures to counteract the erosion of people's purchasing power.

The success or failure of any GST regime will depend upon the detail of the legislation and the manner in which it is implemented. A lengthy consultation period is to be welcomed, provided the government then makes an early decision on whether to introduce GST.

Typically the period between a decision to introduce GST and its actual implementation will be approximately three years. Therefore even if the consultation period were to end in March 2007 and a decision taken immediately to introduce GST it is unlikely that the GST will be implemented in Hong Kong before 1 April 2010.

For Salaries Tax purposes "Rent" paid by an employee as set out in section 9(1A) of the Inland Revenue Ordinance (IRO) is not restricted to payments under a legally binding landlord and tenant relationship where the tenant is the employee.

Hong Kong Salaries Tax is charged on an individual in respect of his or her income arising in or derived from Hong Kong from any office or employment. Included in the definition of income for this purpose are "perquisites" or benefits-in-kind if there are received as a reward for services.

The IRO specifies the Salaries Tax treatment where an employer provides rent free or subsidised accommodation to an employee.

Section 9(1A)(a) IRO reads:

".....where an employer or an associated corporation –

- pays all or part of the rent payable by the employee; or
- refunds all or part of the rent paid by the employee,

such payment or refund shall be deemed not to be income" of the employee for Salaries Tax purposes.

Where the employee receives a housing or rental reimbursement in accordance with the requirements of Section 9(1A) IRO the cost to the employer of providing the benefit is ignored for the purpose of calculating the employee's Salaries Tax liability. Instead the employee is deemed to have received a taxable benefit calculated by reference to the rental value of the accommodation.

The rental value is usually calculated as a percentage of the employee's other assessable income. The percentage for hotel accommodation is 4% for one room, 8% for two rooms and 10% for more than two rooms. The percentage for a house or flat is 10%.

However, if the requirements of the IRO are not met then the employer's cost of providing the housing or rental refund is treated as a cash allowance which is fully subject to Salaries Tax in the hands of the employee.

In the past the Inland Revenue Department (IRD) has sought to argue that in order for there to be "rent" paid by the employee under Section 9(1A) IRO there must be a legally binding landlord and tenant relationship between the owner of the property and the employee. The IRD has denied the application of Section 9(1A) IRO in cases where the employee's spouse rather than the employee has entered into the tenancy agreement, notwithstanding that the employee has paid the rental under the tenancy agreement and had this refunded by the employer.

However, the Board of Review has held that the IRD's interpretation of Section 9(1A) IRO placed too restrictive an interpretation on the concept of rent and has held that it can be sufficient that the employee has paid consideration for the use of the premises involved. Claims under Section 9(1A) IRO cannot be denied by the IRD simply because there is no landlord/tenant relationship between the landlord of the

“Green Taxes”



premises and the employee.

But where there is no such relationship it is still necessary to have a nexus between the payment by the employee and the employee's use of the property for which the rent is paid. That is, the employee must be using the premises as his own accommodation and Section 9(1A) IRO therefore can apply to situations where the employee's spouse or private company is the named tenant in a rental agreement.

Further clarification has been provided in the recent case of *Yau Wah Yau v CIR*, where the taxpayer was successful. It was held that the absence of a formal stamped tenancy agreement did not prevent sums payable by an employee to the owner of the accommodation used by the employee from qualifying as “rent” paid for the purposes of Section 9(1A) IRO.

Further details of the requirement for control of housing benefits and the reporting obligations for employers and employees can be found in our Tax Notes Issue 2.

In his 2006 Budget Speech the Financial Secretary once again referred to his commitment to impose “Green Taxes” in accordance with the Government's “Polluter Pays” policy.

But what exactly are “Green taxes”?

The term is generally used to refer to taxes imposed on specific items of consumption on environmental protection grounds.

Because of the specific and particular environmental goals that they seek to achieve, the scope of “green taxes” can range from very narrow (such as a tax on tyres or plastic bags) to extremely broad (such as a tax on gas or electricity consumption).

The use of “Green Taxes” to pursue environmental protection objectives involves considerations which may go much further than fiscal requirements, and thus involve considerations other than the raising of

revenue for government. As a result the question of “Green Taxes” is usually considered to be outside the ongoing debate on Hong Kong's narrow tax base.

In Hong Kong the Secretary for the Environment, Transport and Works will introduce the Product Eco-responsibility Bill later in 2006 to provide a legal framework for producer responsibility schemes. The Financial Secretary has announced that products to be regulated will include tyres and plastic bags.

The Environmental Transport and Works Bureau (ETWB) plans to levy a fee on tyres and to require the industry to be responsible for their recovery and recycling.

In the longer term the ETWB intends to introduce legislation prohibiting the free distribution of plastic bags and to levy a tax to deter their use. In the interim the ETWB will seek to agree a plastic bag reduction target with major supermarket chains.

Grant Thornton 均富會計師行

13th Floor, Gloucester Tower, The Landmark, 11 Pedder Street, Central, Hong Kong
T +852 2218 3000
F +852 2218 3500
E info@gthk.com.hk
W www.gthk.com.hk

The Hong Kong member of Grant Thornton International

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If you have any comments or require further information please contact:

Paul Chow
T +852 2218 3188
E paul.chow@gthk.com.hk

Gary James
T +852 2218 3137
E gary.james@gthk.com.hk

David Southwood
T +852 2218 3103
E david.southwood@gthk.com.hk

Brenda Cheung
T +852 2218 3136
E brenda.cheung@gthk.com.hk

Published by Grant Thornton
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