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Abstract

The Hong Kong tax system is generally regarded as relatively simple and favourable to the taxpayer compared to that of many industrialised nations. In view of the growing importance of Asian-Pacific economies, a familiarity with the basic tenets of different countries' tax systems is a necessity. Hong Kong provides valuable lessons and examples.

Keywords

Hong Kong, tax systems

THE HONG KONG TAX SYSTEM—AN OVERVIEW



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The Hong Kong tax system is generally regarded as relatively simple and favourable to the taxpayer compared to that of many industrialised nations. In view of the growing importance of Asian-Pacific economies, a familiarity with the basic tenets of different countries' tax systems is a necessity. Hong Kong provides valuable lessons and examples.

Hong Kong has often been characterised as a low tax country, a tax haven. Indeed the Australian authorities have nominated Hong Kong amongst others as such in both the (repealed as of 1 July 1990) legislation as to tax screening arrangements¹ and the draft bill concerning Taxation of Foreign Source Income.²

Despite its apparently low tax status, Hong Kong has consistently had revenue surpluses (twenty-three of the twenty-eight years from 1960 to 1988).³ In 1988/89 alone the surplus was some \$16.8 billion.⁴ Whilst there have been some suggestions as to the introduction of a wholesale sales tax, ostensibly to widen the tax base to cope with the strains of major infrastructural projects totalling some \$147 billion over the next ten years, there have been few changes of substance to the tax system in recent years.⁵ Indeed one of the highlights of the tax system is its relative stability and the paucity of amending legislation.

1 *Banking (Foreign Exchange) Regulations; Taxation Administration Act.*

2 See Taxation of Foreign Source Income Draft Bill, June 1990 AGPS.

3 Tikku Kaushal, 'The Proposed Wholesale Sales Tax: Is It Worth The Effort?' *The New Gazette*, December 1989, pp 43-46.

4 *Hong Kong Annual Digest of Statistics 1989*, Census and Statistics Department, p 121 ('Hong Kong Statistics'). All references to \$ are to Hong Kong dollars.

5 Tikku Kaushal, 'The Proposed Wholesale Sales Tax: Is It Worth The Effort?' *The New Gazette*, December 1989, p 44.

The aim of this paper is to give a general overview of the Hong Kong tax system. The purpose in doing so is twofold:

- 1 To provide to those who deal with Hong Kong from afar an understanding of its tax system and the way in which it works.
- 2 To highlight that a tax system need not be inordinately complex, convoluted and hampered by almost continual amendment and revision for it to be effective.

The overview of necessity will be brief, but hopefully will go some way in achieving these goals.⁶

The system in general

Hong Kong does not have an integrated system of tax legislation or method of assessment. There are, despite its reputation as a low tax country, a myriad of taxes—hotel accommodation tax, entertainments tax, betting and sweeps tax, motor vehicle taxes to name a few which will not be considered in this paper.

The paper will instead concentrate on the Inland Revenue Ordinance ('IRO') with its separate profits, property, salaries and interest taxes, the Estate Duty Ordinance ('EDO') and the Stamp Duty Ordinance ('SDO').

Salaries tax

Importance of revenue

In an economy where unemployment is virtually non-existent (1.4% in 1988) and which boasts a workforce of some 2.78 million,⁷ one would expect salaries tax to be a significant contributor to general revenue. Certainly it is the case that it is salaries, property and profits tax combined that contribute the lion's share to general revenue, some 46% (HK\$29.7 billion) of gross recurrent and capital account revenue for the 1988/89 financial year.⁸ Yet it is estimated that only one in four of the workforce pays any salaries tax.⁹ This may be a function of the so-called cash economy. It may also be a function of the fact that many, being self-employed, would be liable to profits rather than salaries tax.

There have been suggestions that the salaries tax system is in need of reform as it is dependent on too narrow a base. Supporting this view are estimates that some 50,000 taxpayers contribute 50% of the total salaries tax revenue.¹⁰

6 Commentaries on Hong Kong tax law are comparatively expansive compared to the balance of Hong Kong jurisprudence. For a more detailed exposition of the Hong Kong tax system see: Flux D, *Hong Kong Taxation: Law and Practice, 1989-90 edition* (The Chinese University Press); Young Arthur, *Taxation in Hong Kong* (1989 Longman); Willoughby P, *Hong Kong Revenue Law* (Matthew Bender & Co Inc).

7 *Hong Kong Annual Digest of Statistics 1989*, Census and Statistics Department p 31.

8 *Ibid* 121.

9 Tikku Kaushal, 'The Proposed Wholesale Sales Tax: Is It Worth The Effort?' *The New Gazette*, December 1989, pp 43-46.

10 *Ibid*.

Territorial basis

Salaries tax is charged on account of a person's income arising in or derived from Hong Kong from any office or employment of profit or from any pension.¹¹ The legislation gives little guidance as to what constitutes 'arising in or derived from Hong Kong'. The Commissioner of Inland Revenue ('CIR') has indicated that in general only the following facts will be relevant in determining (in the absence of statutory intervention) the location of employment (and hence the source of income derived from the employment):

- 1 Where the employment contract was negotiated, entered into and is enforceable.
- 2 Whether the employer is resident outside Hong Kong.
- 3 Whether the employee is paid outside Hong Kong.¹²

If an employee is found to have his employment located in Hong Kong, all income from that employment is subject to salaries tax. It matters not where the employment contract is performed. There are two exceptions to this rule:

(a) The 60-day rule

An employee who renders all services in connection with his employment outside Hong Kong is not subject to salaries tax.¹³ Up to sixty days in any year of assessment can be spent in Hong Kong without losing the benefit of this exemption.¹⁴

(b) Foreign tax rule

The income of an employee derived from services rendered outside Hong Kong which is subject in that place to tax of a similar nature as Hong Kong salaries tax and upon which tax has been paid in that place, is exempt from Hong Kong salaries tax.¹⁵

By way of contrast, if the employment is found to be located outside Hong Kong, income from such employment is exempt from Hong Kong salaries tax. There is one general exception to this rule—all income derived from services rendered in Hong Kong is taxable in Hong Kong.¹⁶ If income is not specifically referable to service rendered in Hong Kong, a proportion of the income (including leave pay) for the year is made assessable by reference to the number of days spent in and outside Hong Kong.

There are special provisions for those whose employment is likely to take them outside Hong Kong on a regular basis (eg aircraft and ship personnel).¹⁷

11 Inland Revenue Ordinance, Chapter 112, Laws of Hong Kong ('IRO') s 8(1).

12 Inland Revenue Department Interpretation and Practice Note No 10.

13 IRO s 8(1A)(b)(ii).

14 IRO s 8(1B).

15 IRO s 8(1A)(c).

16 IRO s 8(1A)(a).

17 IRO s 8(2)(j).

What income is assessable?

Assessable is all income from any office or employment,¹⁸ which is defined as including:

- (a) Any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite or allowance derived from the employer or others.
- (b) The employer's contribution to certain pension funds.
- (c) The rental value (deemed to be 10% of the employee's other income less any contribution to rent made by the employee) of a place of residence provided totally or partially rent-free by the employer or an associated corporation.
- (d) Gains from the exercise or the relinquishment of share options if such options were obtained as an employee.¹⁹

Specifically excluded (amongst others) are:

- (a) The value of holiday warrants.²⁰
- (b) Salaries paid to a person by that person's spouse or by a partnership in which that person's spouse is a partner (the rationale for this exclusion is that such salaries are not allowable deductions against the tax on profits of that business which pays the salaries).²¹

What of fringe benefits? Until recently it had long been accepted that fringe benefits were not taxable in the hands of the employee provided:

- (a) The liabilities being assumed by the employer were not contractually the liability of the employee.
- (b) The benefits were not in monies worth, that is not capable of being converted into money in the hands of the employee.²²

From the point of view of an employee, the structure of the remuneration package is consequently important. It is less so for an employer, as the benefits are deductible no matter how they are provided.²³

*Glynn's case*²⁴ has recently cast some doubt on these longstanding views. In *Glynn* the Privy Council held that the payment of the school fees of a daughter of the taxpayer, for which the employer had agreed to be primarily liable, amounted to a taxable perquisite. Their Lordships thought there was 'no difference between a debt of the taxpayer discharged by an employer pursuant to the contract of service and money paid for the benefit of an employee by his employer pursuant to the contract of service'.²⁵ Both were taxable.

18 IRO s 8(1)(a).

19 IRO s 9(1) and 9(2).

20 IRO s 9(1)(a).

21 IRO s 8(2)(k) and s 17(2).

22 See, eg, *Tennant v Smith* [1892] AC 150 and *Wilkins (Inspector of Taxes) v Rogerson* [1961] 1 All ER 358.

23 IRO s 16(1).

24 *Glynn v Commission of Inland Revenue* (1990) 1 HKRC 90-032.

25 (1990) 1 HKRC at 100,343.

The case was highly controversial through the many appeals leading to the final appeal. It prompted the Hong Kong Government to indicate that the decision had unexpected and unintended ramifications.²⁶ Following the Privy Council decision, legislation as promised was introduced and is presently awaiting the deliberations of the Legislative Council.²⁷

Deductions

Few deductions against assessable income are allowed. Those that are allowed are:

- (a) Expenses (other than of a domestic, private or capital nature) incurred wholly, exclusively and necessarily in the production of assessable income.²⁸
- (b) Depreciation on plant and machinery, the use of which is essential to the production of assessable income.²⁹
- (c) Losses brought forward from a previous year (rare for an employee).³⁰
- (d) Charitable donations (with an aggregate minimum of HK\$100 and a maximum of 10% of the claimant's assessable income).³¹

Assessment and collection

Those liable to salaries tax may be assessed either separately from other taxes or (in most cases),³² elect for personal assessment on their total income.³³ Personal assessment allows a taxpayer to aggregate assessments on account of property, profits and interest tax with those for salaries tax. Apart from not having to deal with each head of tax separately, an election for personal assessment may allow the taxpayer to utilise deductions or allowances against income from other sources which would otherwise not be possible under separate assessments.

The CIR issues returns to each employee, upon which assessments are made and final notices of assessment issued. In addition to the final notice, a notice as to provisional salaries tax (relating to the coming year) will issue. Provisional salaries tax is payable by two instalments timed such that salaries tax is effectively paid in arrears.

There is no pay-as-you-earn system of collection of salaries tax, though the CIR encourages taxpayers to invest in tax reserve certificates. Interest accrues on such certificates only if they are used to pay tax. Any certificates redeemed for any other purpose are redeemed free of any interest.³⁴

26 Inland Revenue Departmental Interpretation and Practice Note No 16.

27 Inland Revenue (Amendment) (No 3) Bill 1990, Hong Kong Government Gazette, 20 July 1990, p C771.

28 IRO s 12(1)(a).

29 IRO s 12(1)(b).

30 IRO s 12(1)(c) and 12A.

31 IRO s 12BA.

32 To be eligible to make the election one must be at least eighteen and permanently or temporarily resident in Hong Kong (or married to such a resident); IRO s 41(1).

33 IRO s 41(3).

34 Tax Reserve Certificates Ordinance, Chapter 289, Laws of Hong Kong.

Rates of tax

Salaries tax is the only tax under the IRO that is levied on a progressive basis. Rates range from 3% on the first \$10,000 of net chargeable income (that is net assessable income less charitable donations and personal allowances)³⁵ through to 25% of that portion of net chargeable income in excess of HK\$70,000.³⁶ Notwithstanding the progressive nature of the tax rates, there is an overriding limit such that salaries tax may not exceed 15% (the 'standard rate of tax') of net assessable income less charitable deductions (a reduction from 15.5% for the years of assessment prior to 1989/90).³⁷

Profits tax

Importance to revenue

With GDP growing at an average of nearly 16% per annum for the period 1979 to 1988,³⁸ in excess of 210,000 companies presently registered in Hong Kong and growing at the rate of some 15,000 per annum over the same period,³⁹ visitors to Hong Kong increasing 250% and expenditure by visitors increasing some 55% over the same ten year period,⁴⁰ one would expect profits tax to be a major contributor to general revenue.

What is perhaps surprising in a place where it seems almost everyone is conducting their own business, is that it is estimated that the top thirty companies in Hong Kong dominate profits tax payments, contributing some 20% of the total profits tax revenue in any year.⁴¹

Territorial basis

Like each of the other heads of taxation under the IRO, profits tax has a strong territorial basis. Profits tax generally is chargeable only in respect of a person's profits arising in or derived from Hong Kong from a trade, business or profession in Hong Kong.⁴²

Whether a person is carrying on a trade, business or profession in Hong Kong is a question of fact. It is conceivable (and not uncommon) for a person to derive income from Hong Kong without carrying on business there. The distinction between carrying on business with Hong Kong (or with Hong Kong people) and carrying on business in Hong Kong can be crucial in determining whether or not there is a liability to profits tax.

A person will not usually be said to be carrying on business in Hong Kong merely because that person's employees periodically visit Hong Kong for the purpose of marketing the employer's products. The extent

35 IRO s 12B.

36 IRO s 13(1) and Second Schedule.

37 IRO s 13(2).

38 *Hong Kong Annual Digest of Statistics 1989*, Census and Statistics Department, p 111 ('Hong Kong Statistics').

39 Ibid 283.

40 Ibid 162-163.

41 Above n 3 at 43-46.

42 IRO s 14.

of the employee's authority can be important. A permanent establishment (which the CIR regards as being liable to profits tax) does not include an agency unless the agent has and habitually exercises a general authority to negotiate and conclude contracts on behalf of his principal or has (in Hong Kong) a stock of merchandise from which he regularly fills orders on behalf of his principal.⁴³

'Business' is interpreted very widely. The definition, for example, makes clear that the mere leasing of premises by a corporation constitutes carrying on business (but curiously it is only subleasing by persons other than corporations that is expressly said to constitute the carrying on of business).⁴⁴

The question of the source of the profits is a vexed one, much litigated.⁴⁵ The courts have tended to follow what has become known as the operations test, that is one asks the question 'where do the operations take place from which the profits in substance arise?'⁴⁶ One consequence of this formulation of the test is that it is possible for businesses to be located in Hong Kong and yet have some (and, theoretically at least, all) of their profits free from Hong Kong profits tax on the ground that the profits are not considered as arising in Hong Kong.

One much criticised recent decision may indicate a change in attitude of the courts.⁴⁷ In *CIR v HK-TVB International Limited*, Godfrey J stated '... the time has come to make it clear that it is only where a taxpayer has established the existence of a profit-generating operation carried on by him outside Hong Kong that he can hope to escape the charge to profits tax'.⁴⁸

As one commentator has remarked, the implication is that if a business is based in Hong Kong, and it has no branch office or other permanent establishment outside Hong Kong, then it cannot argue that any of its income can have a non-Hong Kong source.⁴⁹ Such is contrary to the CIR's own published practice notes as regards the opposite but analogous situation of determining whether foreign-based businesses have a permanent establishment in Hong Kong due to the operations of agents.⁵⁰ In the absence of legislative intervention, the issue of source can be expected to continue to raise difficulties for advisers and taxpayers alike.

43 *Inland Revenue Rules* ('IRR') Rule 5(1).

44 IRO s 2(1).

45 See, eg, *Hong Kong and Whampoa Dock Company (No 2) v Commissioner of Inland Revenue* [1960] HKLR 166; *Bank of India v Commissioner of Inland Revenue* (1990) 1 HKRC 90-029 and the cases in notes 46-47 cited below.

46 *Sinolink Overseas Ltd v Commissioner of Inland Revenue* (1985) 2 HKTC 127, 130.

47 *CIR v HK-TVB International Limited* unreported High Court, 9 April 1990; for commentary on and criticism of this decision see Kaushai Tikku 'Case Report' *The New Gazette*, June 1990, pp 46-47; Ahern W, 'Tax Legislation: Time For A Rethink' *The New Gazette*, July 1990, p 3.

48 *Ibid.*

49 *Ibid.*

50 *Inland Revenue Rules* ('IRR') Rule 5(1).

Certain receipts are deemed to be chargeable with profits tax. These include:

- (a) Payments for the use in Hong Kong of cinema or television films, sound recordings and the like.⁵¹
- (b) Payments for the right to use (even if not in fact used) in Hong Kong intellectual property (patents, trademarks etc).⁵²
- (c) Rentals and like payments for the right to use movable property in Hong Kong.⁵³
- (d) Interest and gains from the redemption or presentment of certain certificates of deposit and bills of exchange derived in Hong Kong by a person in respect of that person's trade, profession or business.⁵⁴

Special rules apply for financial institutions,⁵⁵ mutual insurance corporations,⁵⁶ clubs, trade associations and the like⁵⁷ and certain resident shipowners and aircraft owners.⁵⁸

Persons

Those liable to profits tax include individuals, corporations, partnerships, trustees and any body of persons.⁵⁹ Partnerships are assessed as entities separate from the constituent partners. The corollary is that individual partners are not (unless they have made an election for personal assessment)⁶⁰ separately assessed on account of their respective shares in the profits of the partnership. Tax is levied against the partnership and it is left to the partners to apportion liability amongst themselves.

Whilst trustees are specifically included in the definition of 'person' and profits tax is chargeable on a 'person', there is no specific authority in the IRO for the levying of assessments on trustees. There is some doubt as to whether the appropriate method of dealing with profits earned by a trustee is to assess the trustee or to assess, in some way, the beneficial owner of the trust property.⁶¹

Assessable profits

Not all profits derived in Hong Kong from a business carried on in Hong Kong are chargeable to profits tax. Profits tax does not extend to profits arising from the sale of capital assets.⁶² This exclusion is narrowly construed and can have surprising results. For there to be a sale, there must first be an asset to sell. Consequently, as the granting of seats on a stock exchange by the Exchange itself (not a transfer by one holder to

51 IRO s 15(1)(a).

52 IRO s 15(1)(b).

53 IRO s 15(1)(d).

54 IRO s 15(1)(f), (g), (j) and (k).

55 IRO s 15(1)(i).

56 IRO s 23AA.

57 IRO s 24.

58 IRO s 23B.

59 IRO s 2(1).

60 See above 'Salaries Tax—Assessment and Collection'.

61 Above n 7.

62 IRO s 14.

another person) is not a sale, the consideration received (admittedly capital in nature) not being on account of a sale, is assessable in the hands of the recipient.⁶³ The exception also raises the question (much litigated in Hong Kong as in other jurisdictions), as to what constitutes capital receipts as opposed to other taxable receipts.

Deductions

All outgoings and expenses are deducted from profits chargeable to profits tax to the extent to which they are incurred in the production of profits.⁶⁴ A number of items are expressly made deductible but the list is not exhaustive.⁶⁵ There are also detailed provisions relating to deductions on account of depreciation.⁶⁶

Some encouragement for research and development is given by making deductible certain payments to approved research institutes or on account of research⁶⁷ and certain payments to approved educational institutions.⁶⁸ Losses may be carried forward indefinitely to be set off against assessable profits.⁶⁹

Basis period

The period for which profits tax is usually assessed is the year of assessment; that is, the year commencing 1 April in each year.⁷⁰ The CIR may, if satisfied that the accounts of a trade, profession or business carried on in Hong Kong are made up to some day other than that matching the year of assessment, direct that profits be assessed on the basis of the accounting period.⁷¹

Assessment and collection of tax

In common with other heads of tax, there is a system of provisional profits tax notices and final assessments. Final assessments are issued in reply to returns submitted by taxpayers and become the basis of estimating the quantum of provisional profits tax for the following year.

Rates of tax

Profits tax is charged at a flat rate of:

- (a) 16.5% in the case of a corporation.
- (b) 15% in all other cases.⁷²

63 *CIR v Far East Exchange Limited* (1979) HKTC 1036 (Privy Council).

64 IRO s 16(1).

65 IRO s 16(1)(a) to (h).

66 IRO Part VI.

67 IRO s 16B.

68 IRO s 16C.

69 IRO s 19C.

70 IRO s 18B(1).

71 IRO s 18B(2).

72 IRO s 14.

Property tax

Importance to revenue

Despite its name, property tax is not a tax on capital but rather upon the income an owner can expect to receive on account of ownership of real property in Hong Kong. The contribution of property tax to general revenue has increased as the base upon which the tax is assessed has been widened.

Territorial basis

Property tax until recently affected only certain land and buildings in Hong Kong. Land in the New Territories was progressively added to that already subject to the tax until as of 1 April all land in Hong Kong was made subject to the tax.⁷³

What owners?

An owner includes a person holding directly from the Crown, a life tenant, mortgagee in possession and an executor of the estate of an owner.⁷⁴ It is possible for there to be separate owners (each subject to property tax) of the land and of the buildings upon which they are built.⁷⁵

Assessable value

Property tax is calculated by reference to the net assessable value of land and buildings.⁷⁶ Net assessable value is the property's assessable value allowing for certain deductions and allowances.⁷⁷ The assessable value of land or buildings is the consideration in money or money's worth payable in a year of assessment to, or on account of, the owner in respect of the use of that land or buildings.⁷⁸ Consideration need only be payable not paid, though a deduction is allowed on account of consideration which is shown to be irrecoverable.⁷⁹ Any subsequent recovery is subject to inclusion.⁸⁰

No deduction against assessable value is allowed on account of expenses actually incurred, though a 20% notional deduction on account of repairs and outgoings is allowed.⁸¹ Rates if payable (and paid) by the owner (unusual as most Hong Kong leases cast the obligation upon the tenant) are the only other allowable deduction.⁸²

This results in an artificial situation because the net income from a property may bear little resemblance to the net assessable value. There is some relief for those who are qualified to elect for personal assessment

73 IRO s 5(1).

74 IRO s 2(1).

75 IRO s 5(1)(b).

76 IRO s 5(1).

77 IRO s 5(1A).

78 IRO s 5B(2). Different formulae apply for years of assessment prior to that commencing 1 April 1983.

79 IRO s 7C(1).

80 IRO s 7C(2).

81 IRO s 5(1A)(b)(ii).

82 IRO s 5(1A)(b)(i).

as it is then possible to deduct, for example, interest against taxable income.⁸³

Exclusions

Government and consular premises are not subject to property tax.⁸⁴

A corporation carrying on business in Hong Kong may apply for an exemption from property tax on the basis that the property in question is occupied or used by it for the purpose of producing the corporation's profits which themselves would be subject to profits tax.⁸⁵ If an exemption is not sought a set off (equal to the property tax payable) against profits tax is allowed.⁸⁶

Owner-occupied property used exclusively for residential purposes is excluded entirely if so utilised for the whole year,⁸⁷ or excluded on a proportional basis if not.⁸⁸ Land and buildings owned and occupied by clubs, trade bodies and clans (not carrying on business) are exempt.⁸⁹ Further, a refund is available to owners who can satisfy the Commissioner that the land or building in question has not been 'put to beneficial use' during any part of the year of assessment.⁹⁰

Assessment and collection

In each year the CIR (unless the taxpayer has elected for personal assessment) issues a provisional property tax assessment⁹¹ for the following year together with a final assessment for the preceding year. The final assessment will have been based upon a return as to assessable value submitted by the taxpayer.⁹²

The final assessment for a year and the provisional assessment for the following year are usually payable together late in the calendar year during the period to which the provisional assessment relates, meaning that, unlike salaries tax, property tax is not paid in arrears.

Rates of property tax

Property tax is levied at a flat rate of 15% of the net assessable value for the year of assessment.⁹³

Interest tax

Interest tax was repealed in Hong Kong effective from 1 April 1989.⁹⁴ Its demise was not the result of calls, similar to those heard in the recent past in Australia, for an exemption from tax on interest derived from savings.

83 IRO s 42(1).

84 Consular Relations Ordinance, Chapter 259, Laws of Hong Kong.

85 IRO s 5(2).

86 IRO s 25.

87 IRO s 5(3)(a).

88 IRO s 5(3)(b).

89 IRO s 5(3)(d).

90 IRO s 7(2) and 7A.

91 See generally IRO, Part XC.

92 See generally IRO, Part IX.

93 IRO s 5(1) and First Schedule.

94 IRO Part V—Interest tax repealed by Ordinance No 43 of 1989.

Despite an apparently wide definition of interest (including certain profits associated with annuities, bills of exchange and similar instruments), interest tax had little practical effect because of the wide range of exemptions. These included:

- (a) Interest payable to licensed banks and corporations carrying on trade or business in Hong Kong (in each case subject to interest rate ceilings which in practice were seldom breached).
- (b) Interest payable by licensed banks and specified public utilities (again subject to interest rate ceilings rarely breached).
- (c) Interest paid to registered moneylenders in the ordinary course of their business.
- (d) Interest paid on foreign and Hong Kong currency deposits with financial institutions carrying on business in Hong Kong.

Interest exempt from interest tax would, in appropriate cases, be subject to profits tax in the hands of the recipient. Only interest arising in or derived from Hong Kong was subject to interest tax. It was collected by withholdings at source at the rate of 15.5%.

Estimates as to the loss of revenue resulting from the abolition of interest tax are speculative. The bill which led to the repeal of interest tax also dealt with the reduction by .5% of the profits and standard rate of tax and the increase of certain allowances. The explanatory memorandum which accompanied the bill estimated that whilst the abolition of interest tax would result in total staff savings of some \$2 million over two years, the implementation of the amendments would result in a loss to general revenue of some \$1,100 million in 1989/90.⁹⁵

Anti-avoidance and tax relief

Mention should be made of the anti-avoidance provisions of the IRO, of which there are both specific and general measures.

Shams

An assessor who is of the opinion that a transaction which reduces the amount of tax payable by any person is artificial or fictitious or that any disposition is not given effect to may issue an assessment disregarding such transaction or disposition.⁹⁶

Transactions designed to avoid liability

Hong Kong also introduced, in 1986, a provision modelled on Part IVA of the Australian Income Tax Assessment Act.⁹⁷ Despite the extremely wide terms used, there is little precedent in Hong Kong (or elsewhere for that matter) on the operation of such a provision. The CIR has indicated, however, that it is intended that the provisions will be applied to 'strike down blatant or contrived tax avoidance arrangements, but

⁹⁵ Explanatory Memorandum, Inland Revenue (Amendment) (No 2) Bill, 1989. Hong Kong Government Gazette, 31 March 1989, p C329.

⁹⁶ IRO s 61.

⁹⁷ IRO s 61A.

should not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs'.⁹⁸ Specific guidelines have been offered by the CIR as to the applicability of this anti-avoidance provision to leveraged leasing arrangements.⁹⁹

Other provisions

The Ordinance also contains provisions with transfer pricing and the sale of loss companies.¹⁰⁰

Fiscal nullity

Whilst not authoritatively determined, it appears that the doctrine of fiscal nullity has no application to taxes chargeable under the IRO.¹⁰¹

Tax relief

Hong Kong is not the signatory to any Double Taxation Treaty (though the IRO contemplates that such treaties may be entered into).¹⁰²

There is limited Commonwealth income tax relief where income tax is payable under the laws of specified Commonwealth countries (including Australia but excluding New Zealand, Canada and the United Kingdom), as well as in Hong Kong on the same income. The relief is given in the form of a credit (the calculation of which differs for residents and non-residents of Hong Kong) against the Hong Kong tax payable.¹⁰³

Estate duty

Importance to revenue

Estate duty is a relatively minor contributor to general revenue. Its narrow base will ensure that it remains so. The duty contributed less than .7% (HK\$446.8 million) of gross recurrent and capital account revenue in the 1988/89 financial year. By way of comparison, the air passenger departure tax, has for the last two financial years, contributed some 50% more than estate duty.¹⁰⁴

Territorial basis

In essence, estate duty is a tax calculated by reference to the capital of any person who holds assets in Hong Kong at the time of death.¹⁰⁵ It is relevant to note that estate duty is not concerned with issues of residence, domicile or nationality. The sole issue is the situs of the property of the deceased at the time of death.

⁹⁸ Inland Revenue Departmental Interpretation and Practice Note No 15.

⁹⁹ Ibid.

¹⁰⁰ IRO ss 20 and 61B.

¹⁰¹ Board of Review Decision D 52/86.

¹⁰² IRO s 49.

¹⁰³ IRO s 45.

¹⁰⁴ *Hong Kong Annual Digest of Statistics 1989*, Census and Statistics Department, p 21 ('Hong Kong Statistics').

¹⁰⁵ Estate Duty Ordinance, Chapter 111, Laws of Hong Kong ('EDO') s 5.

Assessable property

All property situated in Hong Kong at the time of the deceased's death is *prima facie* assessable. Deemed to be included are gifts unless:

- (i) Made to specified charities.¹⁰⁶
- (ii) Bona fide made more than three years prior to death where the donee has immediately taken and retained possession (to the exclusion of the donor) of the benefit of that gift.¹⁰⁷
- (iii) Made in contemplation of marriage.¹⁰⁸
- (iv) Not exceeding \$100,000 for any one donee.¹⁰⁹

Allowances against the value of the estate are available for:

- (a) Funeral expenses incurred in Hong Kong (subject to a statutory limit).¹¹⁰
- (b) Debts and encumbrances bona fide incurred in Hong Kong or secured against Hong Kong property for full value for the deceased's own use and benefit (but not if the deceased has a right of reimbursement from any person).¹¹¹

Not included is the matrimonial home, provided it was owned by the deceased (or the deceased and spouse), occupied by the deceased (or the deceased and family), and it passes on death (by will or an intestacy to or for the benefit of the spouse).¹¹²

Controlled company

An important category of assets to be included in an estate is that of certain assets held by a controlled company. Assets held by a controlled company will be included in the estate liable to duty if:

- (a) The deceased at any time made a transfer of property to the controlled company.
- (b) Benefits accrued to the deceased from the controlled company within three years of death.
- (c) The controlled company owns assets in Hong Kong.¹¹³

The property transferred by the deceased to the controlled company need not be the Hong Kong assets.

A controlled company is a corporation (wherever incorporated) as to which not more than five people (for these purposes a person is aggregated with relatives, nominees, and partners),¹¹⁴ are in a position to:

- (a) Control the company's affairs.

106 EDO s 6(7).

107 EDO s 6(1)(c).

108 Ibid.

109 Ibid.

110 EDO s 13(1).

111 EDO s 13(3) and (4).

112 EDO s 10A.

113 EDO s 35(1).

114 EDO s 34(3).

- (b) Acquire the majority of the issued share capital of the company.
- (c) Receive more than half of the profits.
- (d) Receive more than half of any distribution of capital or funds upon a liquidation of the company.¹¹⁵

Specifically excluded from being a controlled company are subsidiaries (being companies whose shares are controlled by a company or companies themselves not controlled companies) and companies in which the public is substantially interested (being listed companies in which not less than 25% of the voting power is held by the public).¹¹⁶

The value to be added to the deceased's estate by virtue of there being a controlled company is that sum which bears the same proportion to the controlled company's net Hong Kong assets as the aggregate of benefits accrued to the deceased from the controlled company during the last three accounting years immediately prior to death, bears to the aggregate net income of the controlled company for the same period.¹¹⁷

Situs of property

Situs of the deceased's property is all important in determining whether estate duty is payable in Hong Kong. When determining situs regard must be had to general principles of private international law. Most forms of property have their logical situs. For example:

- (a) Real property is situated where it is.
- (b) Registered shares are situated where the register is kept.
- (c) Choses in action are situated where they can be enforced (the exception being specialties, in which case situs is generally determined by the location of the deed).

Such emphasis on situs at times places great focus on what appear to be fortuitous circumstances. Thus in *Kwok Chi Leong Karl v Commissioner of Estate Duty*,¹¹⁸ the Privy Court confirmed that in the case of a promissory note expressed to be non-transferable and payable only upon presentment in Liberia situs was located, for the purposes of the Estate Duty Ordinance, at the place in which it could be enforced (ie Liberia) notwithstanding:

- (a) The promissory note was created the day before the deceased's death.
- (b) The consideration for the promissory note was a substantial part of the deceased's then property.
- (c) The issuer of the note was owned and controlled by the deceased's relatives.
- (d) The issuer conducted no business other than the acquisition of the deceased's property and the issue of the promissory note.

¹¹⁵ EDO s 34(2).

¹¹⁶ EDO s 34(1).

¹¹⁷ EDO s 35(2).

¹¹⁸ (1989) 1 HKRC 90,002; [1988] 1 WLR 1035.

Relief

Some relief from the imposition of estate duty can be obtained in cases where, in any five year period, estate duty becomes payable on the same property twice.¹¹⁹

Rates of duty; collection

No estate duty is payable if the assessable estate is valued at not more than \$2 million. Thereafter, a progressive scale is applied with a maximum of 18% for an estate valued in excess of \$5 million.¹²⁰

The duty constitutes a first charge on the property of the estate in respect of which estate duty is leviable.¹²¹ No probate or letters of administration may be issued until the duty has been paid or the executor has made suitable allowance for payment.¹²²

Anti-avoidance

There are no general anti-avoidance provisions in the Estate Duty Ordinance. Hong Kong courts have not had an opportunity to consider whether the doctrine of fiscal nullity is applicable in Hong Kong, though the Privy Court in *Kwok* intimated that, had it not been constrained by the apparent failure of the Commissioner of Estate Duty to argue the issue, the doctrine may have been applied in the circumstances of that case.¹²³

Stamp duty

Importance to revenue

Despite the relatively narrow basis of its imposition, stamp duty is the second largest source of revenue for the Hong Kong Government, bringing in some 7.74% (HK\$5.094 billion) of gross recurrent and capital account revenue in the 1988/89 financial year.¹²⁴

Territorial basis

Stamp duty is a tax levied on instruments not transactions. Unlike many jurisdictions' statutes, the Hong Kong Stamp Duty Ordinance contains no elaborate provisions as to nexus or deemed nexus. Instead 'every instrument, wherever executed, specified in the First Schedule shall be chargeable' with stamp duty.¹²⁵

Heads of duty

There are four heads of duty, namely instruments relating to:

- (a) Immovable property in Hong Kong (covering both conveyances and leases).

119 EDO s 31.

120 EDO 17th Schedule.

121 EDO s 18(1).

122 EDO s 15(1).

123 (1989) 1 HKRC 90,002, 100,249.

124 *Hong Kong Annual Digest of Statistics 1989*, Census and Statistics Department Hong Kong, p 121.

125 Stamp Duty Ordinance, Chapter 117, Laws of Hong Kong ('SDO'), s 4(1).

- (b) Hong Kong stock.
- (c) Hong Kong bearer instruments.
- (d) Duplicates and counterparts of instruments otherwise chargeable.

Immovable property

Immovable property is defined as meaning:

- (a) Land whether covered by water or not.
- (b) Any estate, right, interest or easement in or over any land.
- (c) Things attached to land or permanently fastened to anything attached to land.¹²⁶

Not all instruments concerning immovable property in Hong Kong are liable to duty. There are two categories of instrument; conveyances on sale and leases.

Conveyances on sale

A conveyance is defined as including a surrender (significant when one remembers that a large portion of land in Hong Kong is held pursuant to a myriad of long term leases) and court orders whereby immovable property is transferred or vested in another person.¹²⁷ Not all conveyances are conveyances on sale. Excluded, for example, are conveyances by way of mortgage.

Conveyances of immovable property by way of gift or at an undervalue are chargeable with duty as conveyances on sale. The amount of the duty in such cases is calculated by reference to the market value of the property conveyed.¹²⁸

Agreements for the sale of any equitable estate or interest in immovable property are dutiable as if they were conveyances on sale of that estate or interest.¹²⁹ If the agreement is stamped, the conveyance itself will not be dutiable.¹³⁰

There are limited exemptions available as regards conveyances on sale amongst associated corporations (companies in which a holding company owns at least 90% of the issued share capital or companies one of which holds the same percentage in the other), though there are anti-avoidance mechanisms to preclude companies forming and abandoning associations for the purpose of obtaining relief from duty.¹³¹

Rate of duty; collection

Ad valorem duty on conveyances on sale range from a nominal \$20 where the consideration does not exceed \$250,000 to 2.75% of the consideration if greater than \$1,655,181.¹³² Duty is payable within thirty

¹²⁶ Interpretation and General Clauses Ordinance, Chapter 1, Laws of Hong Kong, s 3.

¹²⁷ SDO s 2(1).

¹²⁸ SDO s 27.

¹²⁹ SDO s 26(1).

¹³⁰ SDO s 26(3).

¹³¹ SDO s 45.

¹³² SDO First Schedule Head 1.

days of execution of the instrument and is denoted by way of impressed stamp.¹³³ Whilst the Ordinance provides that duty is recoverable from any party to the instrument, it is traditionally paid by the assignee.¹³⁴

Leases

Leases and agreements for leases¹³⁵ of immovable property in Hong Kong are similarly subject to ad valorem duty. Specifically excluded from being dutiable are leases granted by way of security.¹³⁶ In calculating the consideration upon which duty is calculated, no regard is had to penal rates, premiums or key money.¹³⁷ The premium paid, whilst not subject to lease duty, is subject to conveyance duty.¹³⁸

Rate of duty

Duty for leases is calculated by reference to the yearly or average rent payable and the premium (if any paid). As to rent, the rates range from 0.25% of the rent payable over the term (if less than one year) to 1% of the yearly or average yearly rent (if greater than one year). Duty on premium is calculated at the highest conveyance rate of 2.75%.¹³⁹

Duty is payable within thirty days after execution of the instrument and is usually shared equally between landlord and tenant (though recoverable from all executing parties).¹⁴⁰

Hong Kong stock

Hong Kong stock is stock the transfer of which is required to be registered in Hong Kong.¹⁴¹ Stock is widely defined as including shares, stocks, debentures, bonds or notes of or issued by any body (corporate or unincorporated), units under unit trust schemes, depository receipts of stock and rights to subscribe for or to be allotted stock.¹⁴² Specifically excluded are bills of exchange, promissory notes, certificates of deposit¹⁴³ and loan capital which is not funded debt or is incapable of being listed on a stock exchange.¹⁴⁴

Transfers of the beneficial interest in stock (eg, by way of declaration of trust or a foreclosure order) are subject to the same duty as if they had been an ordinary sale of the legal and beneficial interests.¹⁴⁵

Transfers of any other kind (for example the acquisition of the bare legal title) are subject to only nominal duty.¹⁴⁶

133 SDO First Schedule Head 1, para B.

134 SDO First Schedule, Head 1, para C.

135 SDO s 16(2).

136 SDO s 2(1).

137 SDO s 16(1).

138 SDO First Schedule Head 1(1) (Note 1) and Head 1(2)(a).

139 SDO First Schedule Head 1(2).

140 SDO First Schedule Head 1(2), para C.

141 SDO s 2(1).

142 SDO s 2(1).

143 As defined in IRO s 2(1).

144 SDO s 2(1).

145 SDO 27(4).

146 SDO 27(5).

With the exception of stock borrowings and stock returns effected by approved brokers in accordance with the rules and practices of the Unified Exchange,¹⁴⁷ and certain dealings relating to unit trust schemes,¹⁴⁸ all transfers on sale of stock must be accompanied by a contract note.¹⁴⁹

Rates of duty

Instruments of transfers of stock in respect of which a contract note is made out are subject to a nominal \$5 fee.¹⁵⁰ Contract notes are subject to duty at the rate of:

- (a) 0.6% of the consideration or market values whichever is the higher.¹⁵¹
- (b) A flat \$5 if it relates to a jobbing contract.¹⁵²

Duty as regards Hong Kong stock is payable within various time limits ranging from the same date as the instrument to seven days after execution (in the case of transactions effected in Hong Kong) and thirty days (if effected outside Hong Kong).

Duty is usually noted by impressed stamp, though there is provision for stamping by approved persons by means of adhesive stamps and franking machines.¹⁵³

Issue of share capital

Whilst not strictly an example of stamp duty, note should be made (whilst considering shares) of the fee of .6% levied upon the issue of share capital.¹⁵⁴

Hong Kong bearer instruments

A Hong Kong bearer instrument is one which has been issued:

- (a) In Hong Kong or
- (b) Elsewhere by or on behalf of a body (corporate or unincorporated) formed or established in Hong Kong.¹⁵⁵

A bearer instrument is an instrument to bearer by delivery of which stock can be transferred but does not include an instrument relating to stock consisting of a loan expressed in a currency other than Hong Kong dollars (unless the loan may be repaid in Hong Kong dollars).¹⁵⁶

147 SDO s 19(11).

148 SDO s 19(1A).

149 SDO s 19(1).

150 SDO First Schedule Head 2(4).

151 SDO First Schedule Head 2(1).

152 SDO First Schedule Head 2(3).

153 SDO s 5(2) and 7.

154 Companies Ordinance, Chapter 32 Laws of Hong Kong, s 304 and Eighth Schedule.

155 SDO s 2(1).

156 SDO s 2(1).

Rate of duty

Duty is payable before issue of the instrument at a rate of 3% of the market value of the bearer instrument on issue. The duty is recoverable from the issuer and any person who acts as the agent of the issuer for the purposes of the issue.¹⁵⁷

Duplicates and counterparts

Obviously not a significant revenue earner, this duty is levied at a flat \$5 where the original instrument has been stamped. If the original has not been stamped, the duplicate is stamped as if it were an original document.¹⁵⁸

Consequences of failing to stamp

Instruments chargeable with stamp duty but not duly stamped may not be received in evidence in any proceedings (other than criminal proceedings or any civil proceedings commenced by the Collector of Stamp Duty to recover stamp duty or impose any penalty).¹⁵⁹ Such instruments also may not be filed or registered by any body corporate or public officer.¹⁶⁰ This prohibition, coupled with a prohibition upon any person claiming payment of any dividend or interest on Hong Kong stock (and upon any person playing such moneys), prevents unregistered transferees of stock from enjoying the benefits of the stock.¹⁶¹

Late stamping of instruments can result in penalty duty of a maximum of ten times the duty to be imposed.¹⁶²

Anti-avoidance

In the absence of any general anti-avoidance provisions in the Stamp Duty Ordinance, one questions whether the doctrine of fiscal nullity would apply as regards Hong Kong stamp duty. Whilst the doctrine has been applied in an English stamp duty case,¹⁶³ and the question of its application to stamp duty left open in Australia,¹⁶⁴ there has been no determinative consideration of the doctrine as regards Hong Kong stamp duty.¹⁶⁵

Conclusion

The Hong Kong tax system is notable for its strong territorial basis and the relative simplicity of its legislative and administrative framework, though it is to be conceded that there is much in the apparently

157 SDO First Schedule Head 3.

158 SDO First Schedule Head 4.

159 SDO s 15(1).

160 SDO s 15(2).

161 SDO s 21.

162 SDO s 9(1).

163 *Ingram v Inland Revenue Commissions* [1986] Ch 585.

164 *Peko-Wallsend Operations Ltd v Commission of Trade Taxation (WA)* (1989) 89 ATC 4569; *Commissioner of Stamps (Victoria) v Ashwick (Victoria) No 4 Pty Ltd* (1987) ATC 5064.

165 But note the obiter comments of the Privy Council in *Kwok Chi Leung Karl v Commissioner of Estate Duty* (1989) 1 HKRC 90,022 as to the doctrine's application to estate duty.

straightforward legislation to exercise the imagination and ingenuity of advisers, taxpayers and the courts alike. Hong Kong itself is renowned for its free economy and healthy surpluses. It is perhaps for others to assess whether its tax system is in any way either a function or a cause of such a vibrant and resilient economy.