

Taxation of Financial Intermediation Activities in Hong Kong

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Abstract

This paper discusses issues related to the taxation of financial intermediation in Hong Kong in the context of Hong Kong's position as a major regional financial centre. It first provides some background analysis as to the definition of financial intermediation and identification of the providers of financial services. This is then followed by a discussion of the principles of taxation applicable to financial intermediation, including a comparison of income taxes to consumption taxes. Some specific issues relating to taxation of financial intermediation, such as income and cost recognition, are also canvassed. The paper continues with a description of the current taxation of financial activities in Hong Kong, and a comparison of taxation of these activities in Singapore, Malaysia and Taiwan. The paper then concludes with a discussion of tax policy options for Hong Kong, particularly with respect to income taxation of financial income, and with some reference to Stamp Duty and to VAT as it potentially could affect financial services.

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I. Introduction

The purpose of this paper is to evaluate the effects of the structure of the Hong Kong tax system on financial intermediation activities in Hong Kong. Hong Kong is a major financial centre for investment and related activities in Asia. The vibrancy of its financial sector has been a significant contributor to economic growth and jobs, as most of its manufacturing industry has shifted to Mainland China. At the same time, other financial centres in Southeast Asia, especially Singapore, have been growing in competition with Hong Kong. Thus, taxation of financial activities can have a significant impact on the growth and competitiveness of the Hong Kong economy.

Taxes are an important part of any modern economy as they help finance public goods and services. In this paper, we do not concern ourselves with the overall burden of taxation or with the expenditures made by governments with the tax revenues raised to finance them. Instead, we focus on the structure of taxes, but only in regard to the taxation of financial activity in Hong Kong.

Hong Kong, unlike many other developed countries, has adhered to the principle of territorial income taxation whereby only income earned in Hong Kong is subject to Hong Kong tax. Residents are not subject to tax on income earned offshore. Moreover, Hong Kong, unlike most of its neighbours, has carefully avoided the utilisation of targeted tax preferences in order to keep its tax base broad and its rate of tax low. This has resulted in Hong Kong having one of the simplest and most efficient tax systems in the world. The tax system is also relatively competitive by international standards in that Hong Kong rates for income-based taxes in the range of 15-16% are among the lowest in the world's taxing jurisdictions.

This is not to say that issues that are often confronted by any government in designing an effective tax structure do not affect the Hong Kong tax system. Two specific concerns that have been raised with respect to the Hong Kong tax system relate to the taxation of financial activities. The first of these is competitiveness and the second is the impact of the tax structure in distorting capital markets.

The competitiveness issue arises from a concern that the position of Hong Kong as the major regional financial centre for Asia could be challenged by other financial centres like Singapore, Malaysia and Taiwan. Based upon the territoriality principle used by Hong Kong for income taxation, financial income is only taxed in Hong Kong if the income is earned from a source in Hong Kong, thereby exempting any income earned from foreign sources. The exemption of foreign-source income provides substantial benefits to investors and businesses that make Hong Kong a centre for conducting investments in other countries in the region. Moreover, compared to Singapore and other Southeast Asian countries, the simplicity of the Hong Kong's tax system is a major benefit to taxpayers since the economic burden of complying with the tax system is minimised. On the other hand, interest and trading income earned by Hong Kong financial institutions from some foreign activities is subject to a tax rate of 16% while in Singapore financial income earned by financial institutions from qualifying sources may be subject to a concessionary rate of 10%. In addition, unlike Hong Kong, Singapore and some other countries in the region have extensive networks of bilateral tax treaties, which provide some assurance to investors that they will be subject to protection from onerous taxation and not subject to discrimination under domestic law. Thus, concerns arise as to the ability of Hong Kong to maintain its dominance as a regional financial centre.

The tax system also distorts financial activities in Hong Kong. To avoid paying tax on income earned in Hong Kong, investors and businesses may organise their affairs so that some financial income is earned from sources in tax haven jurisdictions, such as the Cayman Islands. There is also some preferential treatment given to certain forms of investment income such as bank deposits, stocks and debt securities. Moreover, some interest expense incurred on debt borrowed offshore may not be deductible for earning profits in Hong Kong, though this is not generally the case with interest on borrowing from or by Hong Kong financial institutions. Thus, there can be a significant incentive for Hong Kong borrowers to channel funds through the banking system rather than borrow directly from abroad. These distortions in the tax system have given rise to some concern about the lack of development of debt markets in Hong Kong. Given the exemption of offshore interest from taxation for many non-financial lenders and the limitations on deduction for interest incurred on debt, Hong Kong borrowers might find it less favourable to borrow internally than to raise money offshore. It is not clear that this practice is of serious consequence to Hong Kong since the cost of capital for investment is reduced overall. However, Hong Kong wishes to create strong capital markets and the lack of a domestic debt market is perceived as inhibiting some of its growth. We are not in a position to evaluate whether it is important to have a strong domestic debt market in Hong Kong. We are only able to discuss the tax distortions that impact on financial activities.

This paper surveys the issues related to the taxation of financial intermediation and related activities in Hong Kong. It begins in Section II with some background in defining financial intermediation activity. This is followed by a discussion in Section III on the principles involved in taxing financial activities. Section IV provides an analysis of the taxation of financial services in Hong Kong. Section V compares the Hong Kong tax system with some other countries. Section VI concludes with a discussion of options for reform of the Hong Kong tax system, particularly with respect to the income tax, Stamp Duties and value-added tax as it potentially affects financial activities.

II. Background

In order to provide some focus for our discussion on taxation, it is useful to first define financial intermediation as a business activity and describe who are the providers of financial services. This information will be useful for later discussion of tax effects on the conduct of financial intermediation in Hong Kong.

A. What is Financial Intermediation?

Financial intermediation is a significant share of industrial activity for many modern day economies. In Hong Kong, for example, finance, insurance, real estate and business services account for about 25% of GDP. Excluding business services, the sector accounts for roughly 10% of the labour force.¹ These estimates, however, do not include the financial activities undertaken by non-financial institutions and households, which can also be significant.

¹ *Hong Kong Monthly Digest of Statistics*, September 2000. See Table 12.5 and 2.5 respectively.

But how should financial intermediation be described as a business activity? Financial intermediation is undertaken to assist lenders and borrowers of money to transact among each other. There are at least four particular services that can be provided:

Payment system: Financial intermediaries facilitate the exchange of goods and services in the economy. Financial intermediaries provide a cheap means of carrying out money transactions since a purchaser is able to deposit funds in an account that can be drawn by bank order, cheque or direct deposit to satisfy the legal claim of a vendor for payment. Financial intermediaries also facilitate market exchange by creating a means of payment through credit and debit cards.

Mobilising savings for investments: Another role of financial intermediation is to match the users and suppliers of funds. Through financial markets, lenders supply financial capital that is desired by borrowers who need financial resources to invest in capital projects.

Risk management: Financial intermediation allows investors to reduce the cost of risk by pooling funds invested in projects of different risk characteristics. Borrowers benefit from risk diversification by ultimately borrowing at a lower cost of funds.

Reducing information costs: Financial intermediaries reduce the cost of information in financial markets. Through the monitoring of businesses, including a watchful eye of corporate management to improve governance, the financial intermediary reduces the scope for managerial actions to shirk from the profit objectives of the owners. Further, intermediaries reduce the investors' cost of research needed to judge the quality of the firm's investment plans.

Financial services therefore include an array of products provided by suppliers. These include providing a payment system, investment counselling, trading securities, foreign exchange and financial derivatives (swaps, futures, and options), selling insurance and leasing, guaranteeing financial payments, and lending finance for the purchase of business capital (fixed assets and inventory) and consumer durables (primarily owner-occupied housing and automobiles).

Specifically, the income received from financial intermediation includes:

- dividends from equities and interest on loans and debt instruments;
- gains on the sale of property, both real (structures, machinery, land and inventory) and securities;
- fees explicitly charged for services such as transactions in foreign exchange, underwriting fees, credit, bank drafts, and leasing of property;
- income from financial derivatives, which provide returns based on the returns of underlying securities. Financial derivatives include interest rate, currency and other swaps, options and futures contracts for foreign exchange and commodities. Income from financial derivatives includes fees and the return on financial derivative assets held by the intermediary.

As will become more apparent later in our discussion of tax issues, it is important, at this juncture, to define conceptually the value of financial intermediation. Given the array of products and services provided, it is not a simple exercise to measure financial intermediation activities since there is often no explicit fee charged for the services when borrowers are receiving the funds provided by lenders through intermediaries. For typical loans provided by intermediaries, the “fee” for financial intermediation is the spread between the lending rate charged to the borrowers and the interest paid to depositors. For other services, an explicit fee might be charged such as in the case of underwriting the distribution of shares or guaranteeing repayment of loans. Thus, to measure the value of financial intermediation in the economy, it is necessary to add interest revenues received from loans and fees from services and to subtract the interest paid on deposits and other liabilities and fees paid to other financial service providers. The net amount is “value-added” contributed by financial intermediation, which are the resources paid to labour and real capital used in the financial intermediation process. Real capital includes structures, land, inventories and machinery such as automated tellers and computers.

The conceptualisation of financial intermediation is important in delineating the difference between trading and property income to measure income for tax purposes. Intermediaries earn business income (trading profits) from financial transactions because they require resources (labour and real capital) to undertake financial transactions on behalf of lenders and borrowers. Thus, the spread - the difference between lending and borrowing costs net of wages and salaries and the cost of borrowed funds - is the return to shareholders’ capital used by traders in the financial intermediation process. On the other hand, property income earned by households and firms arises from financial portfolio transactions that require few or no resources (labour or real capital) to carry out the transactions. Thus, there is little or no explicit value of financial intermediation with respect to property transactions. Households and businesses might earn income from their portfolio transactions but such income is compensation for patience (delaying the purchase of goods and services) and risk inherent with investments. It is not compensation with respect to time or resources incurred to earn property income.

Obviously, this distinction between trading and property transactions is not clear-cut. Investors, no matter how small, might use time (with an opportunity cost of foregone wages) and real capital to undertake their financial transactions. However, the amount of real resources expended on financial intermediation is relatively small compared to other activities of the investor. On the other hand, moneylenders and traders expend most of their time on financial intermediation activities and the return received is more than just the cost of patience and risk but also the time and capital used in the intermediation process. In terms of tax policy, this distinction will be important.

B. Who are the Financial Service Providers?

Financial service providers are often classified as two types: financial intermediaries and direct finance institutions (Dobson and Jacquet [1998]). Financial intermediaries include commercial banks, savings institutions (“near banks”) and non-bank institutions including insurance, investment (including mutual funds or unit trusts), contractual savings (pension or provident funds), finance, credit and leasing companies. Direct finance institutions include brokerages and securities firms that underwrite the sale of corporate securities and buy or sell shares, bonds and financial derivatives.

The distinction between banks and non-banks is increasingly blurred as governments have deregulated the financial industry in many countries. The critical difference is that banks participate in the payment system by taking direct deposits from households, firms and government. In Hong Kong, there is a three-tier system of deposit taking institutions (authorised banks). Licensed banks, by far the dominant group, are the only institutions that can operate current and savings accounts, taking deposits of any size, and pay or collect cheques drawn by or paid in by customers. Restricted license banks are primarily engaged in merchant banking and capital market activities, taking deposits of at least HK \$500,000. Deposit-taking institutions, owned or associated with banks, are engaged in specialised activities such as consumer finance and securities and may take deposits of HK \$100,000 with an original term of at least three months.

As discussed below, an important distinction for tax purposes is whether a particular corporation operates as a financial institution or not (financial institutions are generally authorised banks). Also as discussed below, the trading profit of financial institutions includes income from sources outside of Hong Kong derived through its business in Hong Kong. This treatment does not apply to other financial service providers that are not deposit-taking institutions.

The deposit-taking institutions dominate capital flows in Hong Kong. Using the external factor income flows taken from Gross National Product data², we compute the share of capital income inflows and outflows attributed to the banking sector in 1999 (Table 1). Banks account for almost 43% of capital income inflows and over 51% of capital income outflows (direct, portfolio and other investment income). They particularly dominate the category of “other investment income”, which includes income derived from financial claims on and liabilities to non-residents.

2 *Hong Kong Monthly Digest of Statistics*, September 2000, Table 12.5.

Table 1: Factor Income Flows Estimated for 1999

(excluding salaries)

	INFLOWS		OUTFLOWS	
	\$HK Billion	% of Total	\$HK Billion	% of Total
<u>Banking</u>				
- Direct	9.6	2.6	71.1	20.9
- Portfolio	17.5	4.8	4.2	1.2
- Other	129.5	35.3	99.4	29.4
<u>SUBTOTAL</u>	156.6	42.7	174.7	51.5
<u>Others</u>				
- Direct	123.8	32.8	132.9	39.2
- Portfolio	73.5	20.0	22.3	6.6
- Other	12.9	3.5	9.5	2.7
<u>SUBTOTAL</u>	210.2	57.3	164.7	48.5
<u>TOTAL</u>	366.8	100.0	339.4	100.0

Notes:

- Direct refers to investments in which the investor has control or a lasting interest. It includes reinvested earnings, equities and other capital.
- Portfolio refers to investments in non-resident equity and debt securities with an ownership interest of less than 10%.
- Other refers to investments made by non-residents that are neither direct nor portfolio investment.
- Others refer to households, government units, non-profit institutions and companies other than banking.

Source: *Hong Kong Monthly Digest of Statistics, September 2000, Table 12.5, Census and Statistics Department, Hong Kong Special Administrative Region, People's Republic of China.*

The dominance of banking in Hong Kong is also reflected in the ratio of outstanding bank loans to outstanding bonds. The ratio of bonds to bank lending in Hong Kong is 26% compared to 143% and 304% in Japan and the United States respectively.³ Thus, banking institutions are especially dominant in debt financing in Hong Kong.

³ Source: Lau and Chan [2000].

III. Taxation Principles with Respect to Financial Intermediation

Before describing the Hong Kong tax system, it would be worthwhile to review several taxation issues relating to financial services. We begin with a review of general issues to be followed by a discussion of specific issues in relation to income taxation of financial intermediation. This will be followed by a brief discussion of the importance of open-economy and tax competition issues for the conduct of tax policy.

A. General Issues

Based on our survey of the tax system in Hong Kong, we have found that it is useful to review several important principles related to taxation. This includes the distinction between income and consumption taxes, the underlying role of withholding taxes on capital income in a tax system and the role of bilateral tax treaties.

1. Income versus Consumption Taxes

To understand how the Hong Kong tax system relates to principles of taxation, it would be useful to outline two basic concepts of taxation that will be a basis for further discussion below. The two concepts are related to income and consumption taxation.⁴

A principle often used as a basis for the structure of taxation is the ability of a person to pay taxes. An interpretation of “ability to pay” is that taxes should apply to a person’s annual income. The Haig-Simons approach is that a person would pay tax on the value of consumption plus net accretion in wealth. This would be equivalent to employment earnings (wages, salaries and other supplementary income) and capital income (dividends, interest, rents and capital gains), measured as income is accrued.⁵

4 See Bradford [1984] for a lucid treatment of the issues.

5 Accrual implies that the income is earned whether or not the cash has been received. For example, income is subject to tax so long as the taxpayer has invoiced for payment for goods and services sold even if no payment has been received. An accrued capital gain is the increase in the market value of assets whether or not the asset has been sold.

The alternative is to tax individuals on their consumption, which could operate as a direct tax on individuals just like the annual income tax. Consumption is equal to a person's earnings net of savings (if there are "dissavings" or withdrawals of principal and accumulated interest from accounts, such amounts are taxed). Effectively, a consumption tax would exempt the return to savings required to compensate the investor to postpone consumption to future dates. Unlike consumption taxation, income taxation on an annual basis makes savers worse-off compared to consumers. For instance, suppose there are two persons with equal lifetime earnings from work, but one consumes all earnings in each period while the other saves. The consumer pays tax only once on earnings (since there is no interest income earned from savings) while the saver pays tax twice - once when income is earned and a second time when the savings are invested in accounts that earn taxable interest. Even though lifetime earnings are the same for the two individuals, the income tax applies more heavily on savers. On the other hand, consumption taxes only apply equally on consumers and savers. Both pay tax on earnings but the savers can deduct amounts from the tax base and pay tax only on current consumption. However, when the saver withdraws principal and interest from the account to consume in later years, the saver will pay, in present value terms, the same amount of tax as the consumer. Alternatively, the saver may not be given a deduction for saved earnings from the tax base. But if there is no tax on dissavings or income earned in later years, the saver effectively has prepaid taxes on savings. Income would therefore be exempt. This puts consumers and savers on the same footing. Box A provides an example of the differential impact of consumption and income taxes on the taxes paid by persons over time.

Box A: Comparing Income and Consumption Taxes

The important difference between income and consumption taxes is the former results in the taxation of income earned from capital while the latter exempts such income. To understand this point, consider two individuals with identical earnings over time (earnings such as salaries and supplementary benefits) but with different savings patterns. To keep the example simple, we only consider the person living for two periods.

Each individual earns HK \$100,000 in each period. Individual C (the consumer) saves no income. Individual S (the saver) saves \$30,000 for the future, receiving in the second period income based on an interest rate of 10%. The tax rate on income is assumed to be 15%.

Under an income tax, C, who has no savings, pays tax of \$15,000 on \$100,000 in each of the two periods. The total tax paid over time is \$30,000. However, once taking into account the time value of money, taxes paid in the first period are more costly to the individual compared to taxes that are postponed to the future. Thus, to compare the amount of taxes paid, we need to discount future amounts to the current period, using one plus the rate of interest as a measure of comparing one dollar of current to one dollar of future values to arrive at the present value of taxes. The present value of taxes in period 1 of taxes paid during the two periods is approximately equal to \$28,636.

For S, who saves \$30,000, income taxes paid in the first period are \$15,000. In the second period, income is equal to both earnings of \$100,000 plus interest income of \$3,000 (\$3,000 is the income earned on capital investment yielding a return of 10%). Thus, the saver pays tax in the second period equal to \$15,450. S pays total tax equal to \$30,450, which is \$450 more than C. On a present value basis, S pays tax equal to \$29,045.¹

The key point is that under an income tax, savers pay more tax than consumers do. Consumers pay tax only once on their earnings. Savers pay taxes twice on their earnings, including once on the return on investments derived from their earnings. Putting it in consumption terms, future consumption is more highly taxed than current consumption under an income tax.

Now let us consider a consumption tax. One version of the consumption tax is to apply taxes on earnings net of savings (any "dissavings" or withdrawals of principal and interest from accounts would therefore be fully taxed). Since C has no savings, his tax at a 15% rate is the same: \$30,000 in the two periods, or on a present value basis \$28,636. For S, however, the calculation of tax is a bit more complicated. In the first period, the consumption base is \$70,000 (\$100,000 minus \$30,000 in savings). In the second period, the consumption base is \$133,000 (\$100,000 plus \$33,000 in withdrawals of principal and accumulated interest from the savings account). The tax paid in period 1 is therefore \$10,500 (15% of \$70,000) and in period 2 is \$19,950 (15% of \$133,000). The total tax paid by S is \$30,450 but more heavily weighted to the future when there is dissaving. However, once allowing for the time value of money to be included in calculating taxes paid overtime, the present value of taxes is \$28,636, exactly identical to the present value of taxes paid by C.

An alternative approach to the consumption tax is the exempt-yield method. Savings are not deductible from the tax base in the first period. However, any withdrawals from savings accounts are exempt. In effect, the tax on saved earnings is an early payment for future taxes on consumption. Under the exempt-yield approach, C pays the same tax as in the other cases: \$30,000 over the two periods or, in present value terms, \$28,636. S also pays the same amount of tax - \$15,000 in each period and, in present value terms, \$28,636.

Thus, no matter what savings decisions are made, two individuals will be subject to the same amount of tax when the return on savings is exempt. The exempt-yield approach is therefore equivalent to a consumption approach.

¹ For this present value calculation, we use the after-tax discount rate of 1.1% to compare with the previous case and ones below.

This distinction between income and consumption taxation is quite relevant in understanding Hong Kong's tax system. As described in detail below, Hong Kong taxpayers do not pay tax on dividends, interest and capital gains, except financial institutions, which pay tax on interest. In this respect, the Hong Kong personal tax system is close to the "consumption tax" principle of taxation for its direct tax.

However, the Hong Kong tax system diverges from the consumption tax system in two ways. First, a consumption tax would apply to all earnings whether earned in Hong Kong or abroad. Because Hong Kong's tax system exempts the foreign-source earnings of taxpayers, the Hong Kong income tax could not be a full-fledged consumption tax since consumption derived from foreign earnings is not taxed. Second, taxes in Hong Kong apply to corporate profits. Yet, under a consumption tax system, taxes would not apply to the profits earned by shareholders. Instead, to capture the earnings of individuals left in the corporation when dividends and other capital returns are exempt, a corporate tax would apply to the "cash flow" of corporations. Cash flow would be the returns earned from the sale of goods and services net of the wage and salary cost of labour and purchases of non-capital and capital goods from other businesses.

The main alternative approach to a direct consumption tax on individuals and corporations is a value-added tax (VAT) that would be collected by businesses on goods and services sold to consumers. Businesses charge tax on the sale of goods and services and claim a credit for taxes charged on inputs purchased from other businesses. Exports are generally not taxed and a tax is imposed at the border on imported goods and services. In principle, the tax on goods and services sold net of the rebate of taxes on purchased inputs is equivalent to a "cash flow tax" without the deductibility of wages and salaries paid to workers. While a VAT could be levied on a destination basis, given that the Hong Kong tax system applies to income only earned from domestic sources, it should be noted that a VAT could instead be structured as a production or source basis tax by taxing exports and exempting imports when entering the country.

2. Withholding Taxes

Many governments apply withholding taxes on income - dividends, interest, royalties and other service payments - paid to non-residents.⁶ There are generally two reasons for applying withholding taxes. First, they help protect tax revenues if non-residents choose to withdraw income in the form of interest and other charges that are deductible from the corporate income tax base. Second, given that some countries like the United States, the United Kingdom and Japan, allow their taxpayers to credit such taxes against income taxes payable on foreign income in the home jurisdiction⁷, the withholding tax results in a transfer of revenue from the foreign government to the host country.

6 Some governments also apply withholding taxes on income earned by residents. This will occur when there are administrative problems in collecting taxes paid by individuals on their income (such as taxpayer compliance with registration and filing). We will not concern ourselves with withholding taxes on residents.

7 The crediting is limited by the amount of home tax payable on foreign income.

Although withholding tax may be desirable to protect and improve the efficiency of the revenue base, there are important arguments that weigh against the use of such taxes. First, the withholding tax is equivalent to a tariff on the use of capital or services that are imported. It can affect business efficiency at the international level since the tax is only paid when cross-border transactions are involved. Withholding taxes are thus avoided by a taxpayer investing in the domestic economy. Second, there may be no or little crediting of withholding taxes against foreign taxes. In part, this may arise if withholding taxes apply to income, which is repatriated to countries such as the Netherlands that exempt foreign-source income of taxpayers. More importantly, even if such taxes are credited, there may be little tax on net income to credit withholding taxes that apply to income gross of expenses. This is particularly the case for financial service providers that are unable to credit withholding tax on gross interest against corporate income tax payable to the home country on their net foreign-source income. If crediting is not possible, the lender must charge a higher cost of funds to offset the tax. If the country is relatively small, the ultimate incidence of the withholding tax is to fall on the borrower.⁸ If the tax is fully shifted forward onto the borrower, the harm to capital market efficiency could dominate the value of tax revenue to the government.

Generally, Hong Kong has not applied withholding taxes on non-residents. Given the importance of financial services in Hong Kong, this approach is consistent with the view that such withholding taxes would unlikely be credited against foreign taxes, thereby imposing a significant cost on the economy in terms of capital market efficiency.

3. Role of Tax Treaties

Bilateral income tax conventions or tax treaties are an important part of the international tax system. Such tax treaties are important to investors for two reasons. First, they provide protection against discriminatory practices that governments may pursue by favouring domestic investors through tax policy. Second, the treaties may provide tax benefits such as the avoidance of double taxation of income by home and host countries, or lower rates of tax. At the same time, governments may benefit from tax treaties by providing greater certainty to foreign investors about tax rules and, with exchange of information, improving compliance with the tax system.

Hong Kong has several tax treaties, but only of limited scale. The Hong Kong tax treaty with the People's Republic of China provides for an exemption of international aviation, shipping and land transport income from tax in the PRC. Other Hong Kong enterprises are exempt from PRC tax unless they have a permanent establishment (Hong Kong provides a foreign tax credit in this case). There are also limited treaties with the United States for shipping income and Belgium, Canada, Germany, Israel, Korea, Mauritius, the Netherlands, New Zealand and the United Kingdom for aviation income.

⁸ Some evidence of such shifting onto borrowers may be found in Brean [1977] and Huizinga [1994].

Concerns have been expressed that the lack of a treaty network could affect the use of Hong Kong as a financial centre. Although Hong Kong already has a low corporate income tax rate and no withholding taxes on interest and dividends, several other countries, including Ireland, Singapore and Taiwan offer low tax rates for financial income with a treaty network. However, Hong Kong, once considered a tax haven, would need to offer an attractive package to entice other countries to enter into a tax treaty with it. This would be difficult given the absence of withholding taxes although exchange of information and certainty from discriminatory practices against foreigners might provide some basis for discussion.

B. Issues Related to Income Taxation of Financial Activities

There are a number of specific issues related to the income taxation of financial activities that do not apply to other activities. These issues are related to the recognition of income and costs, the treatment of trading and portfolio income and integration of corporate and personal income taxes. Each of these issues is discussed below.

1. Recognition of Income and Costs

Given that most income earned by financial intermediaries is financial, the most salient issues that arise from a tax policy viewpoint are related to the tax treatment of interest, dividends and capital gains and related costs, including the distinction between trading (business) and portfolio (capital) income. The latter is left to discussion in the next section.

Generally, income tax systems tax interest income with a deduction given for interest expense, often on an accrual basis. If the interest is less than what would be normally charged (such as a zero-coupon bond), the taxpayer would adjust the cost basis of the asset and income to reflect the interest that would be paid if fully charged on an accrual basis. Financial businesses are entitled as well to a deduction for loan losses or bad or doubtful debts. Some countries only allow financial businesses to write off actual loan losses and bad debts as they occur. Others may permit financial businesses to deduct funds put in reserve to cover the amount of anticipated loan losses or doubtful debts, subject to a maximum based on a percentage of the loans or debt held. If the allowable deduction is more than the actual cost of loan losses or doubtful debts, there is a mismatch between the reporting of income and costs over time.

Dividends received from other corporations by a financial institution are usually not subject to tax. The underlying principle is that the dividends are already subject to tax when a company distributes income from after-tax profits. An additional tax on dividends received by financial institutions would only serve to tax doubly such income.⁹

9 In some cases, a corporation's distributions of income have not borne tax. Therefore, with an exemption given to the financial institution, there could be an advantage to lend funds that earn tax-free dividends rather than hold debt of which its interest is fully taxable. Some countries have curtailed tax planning of this form by imposing a minimum tax on dividend distributions to ensure that some amount of corporate tax is paid on profit distributions.

Capital gains are treated separately than other sources of income since tax is paid only when assets are sold as opposed to taxing such gains on an accrual basis, subject to the application of mark-to-market taxation in some systems. Capital gains are often given preferential treatment by exempting all or part of the gain from taxation or assessing a lower rate of tax on the gain. The logic of lower tax on capital gains is twofold. First, capital gains reflect anticipated changes to after-tax profits so there is an implicit tax already on the gain (similar to dividends). Second, since assets may be held for lengthy periods, capital gains in whole or in part reflect appreciation in the general price level. On the other hand, investors postpone taxes paid on gains by holding assets for longer periods rather than disposing them (this has been referred to as the “lock-in effect”). Further, investors can borrow funds to purchase assets with capital gains - income and expenses are mismatched as the income is earned after the expense has been incurred. Capital losses are often restricted to be written off against capital gains since taxpayers would otherwise time capital losses to shelter income from taxation. However, many countries permit capital losses to be written off against capital gains over time, similar to other non-capital losses. We also note that gains and losses of financial businesses from financial activities are often treated as ordinary trading income and not allowed the special treatment accorded to capital gains and losses.

As mentioned, Hong Kong largely exempts interest, capital gains and dividends earned by taxpayers, except in the case of financial businesses earning interest, which is fully taxed. As discussed in detail below, deductions for interest expenses are also restricted, except in the case of certain financial businesses.

The differential treatment of income, especially capital gains and interest, could give rise to the development of financial derivatives that provide tax benefits by differences in the recognition of income and expenses or with timing of receipts and expenses. For example, a return on stocks can be mimicked by a combination of a zero-coupon bond and call and put options. If the bond return is fully taxable while call and put options are treated as capital gains or losses at differential rates, then taxpayers could exploit these differences to increase cost deductions and reduce income recognition in order that tax payments can be minimised. This issue gives rise to considerable complexity in tax law since financial products with different income characteristics can give rise to different tax treatment. The use of full income treatment combined with “mark-to-market” rules whereby a taxpayer (primarily financial traders) must include market value changes in a portfolio as income reduces some of the complexity involved with the recognition of income and costs associated with various financial products.

2. Trading versus Portfolio Income

Typically, income tax systems distinguish between trading and portfolio financial income. As discussed above, portfolio (or property) income earned by taxpayers is a return on capital that compensates for the postponement of current consumption and assumption of risk. Trading income, which is a form of business income, is a return to capital and the labour of persons engaged in the process of financial intermediation. The distinction is an important one in that the financial trader is usually fully taxed on all forms of their income, including capital gains (losses are fully deductible). As discussed above, governments sometimes apply mark-to-market rules for financial traders who pay tax on both income and the change in the value of all securities and financial derivatives held in a portfolio.

As discussed above and to be discussed in more detail below, Hong Kong exempts most portfolio income from taxation. On the other hand, interest income earned by financial businesses is fully taxed. One could argue that it is appropriate to tax financial businesses since the profits are compensation for their work effort and real capital employed in financial intermediation, as discussed above.¹⁰ On this basis, capital expenditure should be expensed currently.

3. Integration of the Personal Income Tax with the Corporate Income Tax

One of the common issues that is dealt with in tax policy is whether a corporate income tax is at all needed as part of the overall tax system. There are three common arguments given for corporate income taxation.¹¹ The first is that the corporate tax serves as a backstop to the personal income tax because individuals could otherwise avoid payment of personal taxes by leaving their income in the untaxed corporation. The second is that the corporate tax is a withholding tax on income accruing to non-residents because the host country is entitled to a share of such income. The third is that the corporate income tax is a surrogate for a benefit tax on corporations that receive value from the provision of public goods and services such as infrastructure and education.

The first rationale for the corporate income tax raises important tax policy issues in terms of how the corporate income tax is integrated with the personal tax. When individuals receive dividends from a corporation, the distributions are already reduced by the corporate tax. Similarly, when a person sells corporate stock, the capital gain, reflecting the after tax profitability of the corporation, is similarly reduced by the corporate tax. Thus, both dividends and capital gains have already been subject to tax at the corporate level before personal tax is applied.

10 The Meade Report [1978] examines a consumption tax treatment in which financial flows of income would be included in the tax base. Taxpayers would deduct investments in assets from and add debt liabilities to the tax base and pay tax on financial income and repayment and principal and deduct the repayment of interest and principal on borrowed finance. If assets are equal to liabilities, the financial trader would pay tax on financial income net of expenses which would be the return to financial intermediation.

11 See, for example, the discussion contained in Canada's report of the Technical Committee on Business Taxation [1998].

On the other hand, corporate income paid out in the form of salary, interest, royalties or other charges that are deductible from corporate income are not subject to tax at the corporate level. This income is therefore only taxable at the level of the recipient. If such income is subject to the same rate of tax as dividends and capital gains at the personal level, the tax system will favour the payment of interest and other deductible charges since dividends and capital gains will bear higher taxes at the corporate and individual level.

In order that the tax system does not impair capital market efficiency, there is a case to be made that personal taxes on dividends and capital gains should be adjusted to recognise that corporate taxes have already been paid prior to the receipt of income by the investor. In order to accomplish this, tax systems often either exempt, in whole or part, dividends and capital gains from personal tax or provide a tax credit to shareholders in recognition of corporate taxes paid prior to the receipt of dividends. Moreover, an “equalisation” tax is often applied on payment of dividends to ensure that corporate level tax relating to the dividends has been paid.

Weighed against integrating corporate and personal taxes on dividends and capital gains are the other two rationales for applying a corporate tax. If the corporate tax is meant to be a withholding tax on foreign income that is not subject to tax in the host country, there is less need to integrate personal and corporate tax for domestic shareholders.¹² Further, if the corporate tax is meant to be a form of benefit taxation, integration of corporate and personal taxes is unnecessary since the corporate tax is a payment for the benefits received from public goods and services. Although these two arguments would go against the necessity of integrating corporate and personal taxes, integration is still needed to reduce the distortions arising from differential taxes imposed on income earned at the corporate and personal level.

Hong Kong has to a large extent an integrated corporate and personal income tax system. The corporate tax rate is close to the top personal tax rate. Dividends and capital gains are exempt. Thus, for high income taxpayers, the tax on dividends from domestic taxable corporations and capital gains on their shares is approximately equal to the tax rate applied to salaries, wages and rental income, although any economic rents from holding assets, such as goodwill, may not be fully taxed under the profits tax. Furthermore, interest expense is largely non-deductible when the interest is not taxed in the hands of the lender. If such interest were deductible from the profit tax, taxpayers could avoid profit taxes by leveraging the company with shareholder debt. However, as discussed below, the Hong Kong tax system disallows the deductibility of interest when money is borrowed from taxpayers who are exempt from tax on the interest.

¹² One could go further and argue that, in a small open economy, adjustments to personal taxes for domestic shareholders would only be a subsidy for domestic savings since international markets determine the cost of funds for a multinational corporation. Thus, any tax credit or exemption for dividends at the individual level would not affect the cost of funds of the corporation. This argument, however, does not recognise that tax-planning opportunities will still arise for shareholders within a country. Also, there is considerable evidence that economies are open but not small in equity markets (see McKenzie and Thompson [1997]).

C. Tax Competition Issues

Given the importance of international capital flows for Hong Kong, tax policy issues cannot be evaluated without some consideration of tax competition issues. Tax competition¹³ arises from two sources. One form of tax competition arises from governments being concerned about the loss of a tax base to a low tax jurisdiction (“tax base flight”). A second form of tax competition arises from governments deliberately raising taxes in order to make non-residents pay for public goods and services that benefit primarily residents (“tax exportation”). The former leads to lower tax burdens while the latter leads to higher tax burdens. If a country faces considerable international competition for its goods and services, the ability to export taxes is compromised so that the main form of tax competition arises from “tax base flight”.

How should a country respond to tax competition? One view is that the best response to tax competition is to choose a tax system that is neutral among industrial activities, with internationally competitive tax rates and a broad tax base. This approach, already used by Hong Kong, would mean that entrepreneurs would pursue economically viable business opportunities without being unduly influenced by the tax system. The other approach is to match by industry or form of activity concessions provided by other countries for their industries. This could potentially make a tax system less neutral, impairing efficiency of the economy.

Given the importance of financial services to Hong Kong and the competitiveness of international markets for financial intermediation, tax competition resulting in a loss of tax base is of paramount concern. The question that will be apparent later in our discussion of the Hong Kong tax system is whether Hong Kong could best respond to tax competition by providing preferential treatment where needed or rather make changes to the tax structure maintaining an approach of neutrality with internationally competitive tax rates.

¹³ Mintz and Tulkens [1986] define tax competition as a process by which governments compete with their tax strategies. While it is often viewed that tax competition leads to lower tax levels, this is not always the case when governments export taxes on non-residents.

IV. Taxation of Financial Intermediation in Hong Kong

A. Description of the Hong Kong Tax System

Income tax, as well as other taxes, are levied in the Hong Kong Special Administrative Region (SAR) under the authority of The Sino-British Joint Declaration on the Question of Hong Kong of 1985, and The Basic Law of the Hong Kong SAR, enacted in 1990. The law specifically providing for the imposition of income tax in Hong Kong is the Inland Revenue Ordinance (IRO). Income tax is levied under the IRO in Hong Kong on a territorial basis; that is, only income or profits which arise in or are derived from Hong Kong are subject to tax. Generally, residents and non-residents who carry on the same activities will have the same tax liabilities under such a system. This territorial-based income tax is levied under the IRO as three different taxes: Property Tax, Salaries Tax and Profits Tax. Any other type of income, profit or gain not specifically charged under one of these taxes, such as capital gains, or any income or profits from foreign sources is not subject to income tax in Hong Kong. Although each of these three taxes is normally assessed separately, a taxpayer may choose instead to have all assessable income dealt with in a single personal assessment. Current rates for these taxes are as follows: 15% for Property Tax; 16% for corporations and 15% for individuals for Profits Tax; and progressive rates generally reaching a maximum of 15% for Salaries Tax. As Salaries Tax does not directly impact the subject matter of this paper, only Profits Tax and Property Tax will be described in more detail below.

The Profits Tax is the main tax on the carrying on of business activities in Hong Kong. Generally, profits arising in or derived from Hong Kong from the carrying on of a trade, profession or business in Hong Kong are liable to Profits Tax. In certain cases, as discussed below, income or profit from sources outside Hong Kong is deemed to arise from a source in Hong Kong. Non-residents carrying on these activities are taxed on the same basis as residents.

Profits Tax is a tax on net income, subject to the specific provisions of the IRO relating to enumerated inclusions and deductions or allowances for costs. Conduct of a trade or business is defined to include “an adventure and concern in the nature of trade”. However, as in the United Kingdom and other jurisdictions that derive their tax law from the U.K., income from the conduct of a trade or business does not include capital gains (nor do trade or business losses include capital losses). The determination of what constitutes income from a trade or business, in particular as compared to capital gains, is a question of fact in each case, the determination of which depends on a traditional analysis based on objectively ascertained intention as reflected by particular factors. Dividends received from a domestic Hong Kong corporation which is chargeable to Profits Tax are excluded from assessable Profits Tax of the recipient, while dividends from corporations outside Hong Kong are not subject to tax because they do not have a Hong Kong source. Interest is only taxable in Hong Kong within the context of the general application of Profits Tax. Accordingly, subject to special source rules discussed below, interest will not generally be subject to tax in Hong Kong unless it relates to a trade or business carried on in Hong Kong.

Because of the territorial limitation on taxation, which is the basis of Profits Tax, the question of location of source of income or profit has become a most important one in the Hong Kong tax system. Generally, the determination of source is a question of fact in each case, based on consideration of a number of factors. As a result, there has traditionally been some lack of clarity in the case law on this subject. However, the decision of the Privy Council in the case of *Commissioner of Inland Revenue v. Hang Seng Bank Ltd.* [1991] 1 A.C. 306 went some way toward clarifying the analysis to be used for determination of the location of source for this purpose. In that case, the Privy Council emphasised that in making a determination of source a court must look to see what the taxpayer has done to earn the particular item of income or profit and where those functions were carried out. The Hong Kong Inland Revenue Department (IRD) has issued Department Interpretation and Practice Note DIPN-21 (most recently reissued in March of 1998) in order to provide its views on the question of location of source of profit for purposes of Profits Tax. These views are discussed in more detail below with particular reference to financial and related activities. One important general point, however, which IRD makes in DIPN-21, is that, while it does accept the apportionment of a particular source of income or profit as between a Hong Kong source and foreign sources in certain circumstances, it does not consider that this approach has wide application. Where apportionment is accepted, it is stated by the IRD that, unless there are compelling circumstances to the contrary, such apportionment should be carried out on a 50/50 basis. Moreover, expenses of a business that relate to the earning of profits apportioned to both a Hong Kong and foreign source are to be apportioned to reduce such income in the same ratio as it is apportioned.

The IRO provides for unilateral relief from double taxation in two ways: first, a deduction from income is allowed with respect to certain items of income specifically included in Hong Kong source income chargeable to Profits Tax; and second, a tax credit is provided in limited circumstances where ordered by the Chief Executive in Council. As discussed above, Hong Kong is not a party to any bilateral income tax treaty other than its treaty with the PRC that provides general relief from double taxation.

Property Tax is levied on the net assessable value of land and buildings situated in Hong Kong using as the base the rental amount payable to the owner for use in the year of assessment. Only very limited deductions are allowed from this base, including bad debts, property taxes and a general fixed allowance of 20% of such rentals for costs. Where land or buildings are used for the purpose of earning income or profits of the owner chargeable to Profits Tax, the owner can credit the amount of Property Tax paid with respect to that property against such Profits Tax. A corporation, which can demonstrate to the satisfaction of the IRD that it would be entitled to this Property Tax credit may apply for an exemption from Property Tax.

An individual who is a permanent or temporary resident of Hong Kong may elect to aggregate all sources of income or profit subject to tax under the IRO to determine liability to tax on the basis of the total of all such income and profit. This allows, for example, the use of business losses against total income for a particular year.

Other taxes levied in Hong Kong include Betting Duty, Estate Duty, and Stamp Duties and tax on hotel accommodation. Stamp Duty is levied under the Stamp Duty Ordinance, and generally is required to be paid with respect to documents evidencing transactions relating to immovable property, stocks and bearer instruments. However, Stamp Duty is not chargeable with respect to most transactions involving debt instruments. Transactions relating to stock borrowing or to hedging by stock futures market makers are exempt, and there is no Stamp Duty on foreign exchange transactions. These other taxes do not have any material impact on financial activities.

Hong Kong does not levy any gross basis or similar withholding taxes (except that Profits Tax can apply on a special basis with respect to certain royalty payments to non-residents). Nor does Hong Kong levy any broad-based sales or consumption tax such as retail sales tax or VAT. However, it is understood that consideration is being given to the possibility of introduction in Hong Kong of a broad based consumption tax, such as VAT, to be levied at a relatively low rate of say 3%. It should be noted that even if levied at such a relatively low rate, a VAT could have important implications for financial activities, in that it could become a significant added cost depending upon the treatment of financial services and their inputs. Most countries generally exempt financial services under a VAT. This means that financial service providers do not charge VAT on their sales (such as loans to consumers and businesses), but neither can they claim a tax credit for any VAT paid by them on purchases for the business. The unrecoverable tax on business inputs of financial institutions is an additional cost that must be either shifted to the customer or borne by the financial institution.

The composition of tax revenues assessed in Hong Kong is provided in Table 2. By far, the most important source of tax revenue is the Profits Tax, which accounts for over three-eighths of the HK \$100 billion in annual tax revenue. Earnings and profit taxes are three-quarters of total receipts. Stamp Duties, which have been declining over time with rate reductions, are currently about 10% of revenues.

Table 2: Composition of Tax Revenue in Hong Kong

	1998-99 HK\$ Billion	Average 1995-99 Percentage Share
Profits Tax		
- Corporations	37.7	37.7
- Unincorporated Business	7.6	5.0
Salaries Tax	25.1	23.9
Interest Tax	0.0	0.0
Property Tax	1.3	1.3
Personal Assessment	4.1	3.2
Total Earnings and Profits Tax	75.7	71.2
Estate Duty	1.2	1.2
Stamp Duty	10.1	15.4
Betting Duty	12.2	10.6
Business Registration	1.3	1.1
Hotel Accommodation	0.2	0.4
Total Tax Revenue	100.9	100.0

Source: Inland Revenue

A further breakdown of the Profits Tax is provided in Table 3, according to amounts raised by individual sectors of the economy. Banking accounts for almost one-fifth of tax revenues. Finance, real estate and insurance account for a further third of tax revenues. Thus, combined - banking, finance, insurance and real estate - account for almost one-half of Profits Tax revenues raised in Hong Kong.

Table 3: Composition of the Profits Tax (1999)

	Average 1996-99 Percentage Share (%)
Manufacturing	8.5
Public Utilities	7.5
Banking	18.2
Finance, Insurance and Real Estate	31.8
Distribution	17.7
Other Services	16.3

Source: Inland Revenue

Accordingly, the taxation issues related to efficiency and competitiveness of financial intermediation in Hong Kong have a significant impact on the fiscal position of the Hong Kong government.

B. Taxation of Financial Activities in Hong Kong

As can be seen from the above description of Hong Kong's tax system, business activities such as those involved in financial intermediation will be subject to taxation in Hong Kong to the extent that such activities result in income or profits that arise in or are derived from Hong Kong. While such activities will be subject to the generally applicable rules set out in the IRO as described above, special considerations apply in at least three areas: determination of location of source of income, special treatment of some sources of interest income, and the treatment of funding costs. Also, some financial transactions may be subject to Stamp Duty.

The determination of location of source of income or profit from financial activities can be a particularly difficult exercise, which depends on the facts and circumstances of each situation. In the *Hang Seng Bank* case the Privy Council confirmed that, while determining the gross profit from a particular transaction is always a question of fact, the general guiding principle involves examination of what the taxpayer has done to earn the profit; and that, generally, profit from the rendering of services arises where the services are rendered and profit from dealings in securities arises where the contracts of purchase and sale are made. Accordingly, in that case, the Privy Council decided that the profits from the purchase and sale of certificates of deposit by the Bank on markets in London and Singapore through instructions to agents provided by the Bank in Hong Kong arose outside of Hong Kong, even though the Bank carried on business only in Hong Kong. This meant that profits from a business carried on in Hong Kong could arise from sources both in Hong Kong and outside of Hong Kong, depending on the nature of the activities involved.

The IRO now contains specific statutory provisions that deem certain amounts relating to financial activities of financial institutions to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong, even though the transactions are effected outside Hong Kong. The first of these provisions, which deals with interest, was added to the law in 1978, prior to the years in question in the *Hang Seng Bank* case. However, the second of these appears to have been added in 1986 in direct response to the circumstances of the case. The amounts deemed by these provisions to be Hong Kong source income are described as follows:

- sums not otherwise chargeable to Profits Tax received by or accrued to a financial institution by way of interest which arises through or from the carrying on by the financial institution of its business in Hong Kong, notwithstanding that the moneys in respect of which the interest is received or accrues are made available outside Hong Kong (section 15(1)(i));

- sums not otherwise chargeable to Profits Tax received by or accrued to a financial institution by way of gains or profits arising through or from the carrying on by the financial institution of its business in Hong Kong from the sale or other disposal or on the redemption on maturity or presentment of a certificate of deposit or bill of exchange notwithstanding that the moneys laid out for the acquisition of the certificate or bill were made available outside Hong Kong; or the sale, disposal or redemption is effected outside Hong Kong (section 15(1)(l)).

The IRD has set out in DIPN-21 a number of guidelines that it uses for determining the source of items of income of financial institutions in view of the specific provisions of the IRO and taking into account the decision in the *Hang Seng Bank* case. The main thrust of these guidelines is that for interest and related fee income to be considered to arise outside of Hong Kong, it must relate to loans to parties outside of Hong Kong that are initiated, negotiated, approved and documented by an “associated party” outside of Hong Kong - that is, the funds must be raised and loaned direct to the borrower by a “non-resident such as a branch, subsidiary or head office” located outside of Hong Kong (though the transaction may be in the name of the Hong Kong financial institution). As for interest from offshore loans funded by a Hong Kong financial institution, 50% of this income is considered to be from a source in Hong Kong if all other activities are those of an associated party outside of Hong Kong, while similar treatment is given to interest from offshore loans where such activities occur in Hong Kong but funding is from a non-resident associated party. In all other cases interest earned by a Hong Kong financial institution is considered to arise from a source in Hong Kong. DIPN-21 states that the source of the profit from guarantee or underwriting fees will depend on the facts of each case, but that a principal consideration is whether the risk under the guarantee or underwriting commitment is evaluated and is to be borne by the Hong Kong financial institution. Finally, DIPN-21 emphasises that the IRD takes a serious view of “schemes and devices” which seek to “book” profits of a business carried on in Hong Kong to a source outside of Hong Kong, and notes that in order to provide certainty it will provide advance rulings on the locality of profits.

The IRO also contains some specific concessions relating to taxation of interest and profits from redemption or sale of certain debt instruments. In particular, section 26A provides that interest on and profits from sale or redemption of debt obligations issued by the Exchange Fund or Hong Kong dollar denominated debt instruments issued by certain multilateral agencies (such as the World Bank or the Asian Development Bank) will be exempt from charge to Profits Tax. In addition, interest on deposits with an authorised institution (including banks and other deposit-taking institutions under the Banking Ordinance) is exempt from Profits Tax.

In 1996, section 14A of the IRO was introduced to charge tax at only one-half of the otherwise applicable rate on assessable profits in the form of interest on or gain or profit from sale or other disposal (including redemption) of certain debt instruments issued by private sector borrowers, statutory bodies and government-owned corporations, referred to as “qualifying debt instruments”; for this purpose a “qualifying debt instrument” is defined as a debt instrument cleared by the CMU and issued to the public in Hong Kong by a person with a minimum credit rating acceptable to the Monetary Authority, for a term of not less than five years, issued in minimum denominations of not less than HK \$50,000. The policy intent of this provision is to encourage the growth of a domestic Hong Kong dollar debt market for local business issuers and thereby lessen their reliance on bank financing.

The deductibility of interest for the purposes of determining the amount of income subject to Profits Tax is a somewhat involved question. In general, interest and associated expenses, in order to be deductible, must be an expense incurred by the taxpayer for the purpose of producing profits chargeable to Profits Tax. Thus the interest expense of an individual investor not carrying on a trade or business is not deductible. Where this purpose test for deductibility of interest is met, deduction is limited further by a set of specific rules contained in section 16(2) of the IRO to the following situations:

1. where the money has been borrowed by a financial institution;
2. where the money is borrowed in certain circumstances by a public utility company;
3. where the money has been borrowed from a person other than from a financial institution or an overseas financial institution and the interest payable is chargeable to Profits Tax;
4. where the money has been borrowed from a financial institution or overseas financial institution and the repayment of principal and interest is not secured or guaranteed in whole or in part by an instrument or undertaking from the borrower or an associate of the borrower against a deposit made with that or any other financial institution or overseas financial institution where any sums payable by way of interest on the deposit are not chargeable to tax under the IRO;
5. where the money has been borrowed from a non-associated lender to finance capital expenditure on depreciable machinery or equipment or for the purchase of trading stock the profits from which are chargeable to Profits Tax;
6. where the interest is payable by a corporation on a debenture listed on the stock exchange in Hong Kong or any other stock exchange recognised by the Commissioner of Inland Revenue, or another marketable instrument issued bona fide in the conduct of a business (or under a special arrangement relating to the Protection of Investors Ordinance);
7. where the interest is payable by a corporation on money borrowed from an associated corporation that has funded the loan from proceeds of an issue of debentures or other instruments referred to in 6 above.

Presumably, for the purposes of Profits Tax a taxpayer will only receive the benefit of a deduction of interest payable on funding used to acquire a “qualifying debt instrument” to the extent of one-half where that interest is otherwise deductible for such purposes, because the deduction would first reduce income from the “qualifying debt instrument” which is recognised fully but then taxed on a net basis at one-half rates. The IRO contains appropriate adjustment provisions to deal with the set-off of losses from qualifying debt instruments against normal trading income.

It is understood that proposals have been put forward in the Inland Revenue (Amendment) Bill 2000 to add further limitations to the deductibility of interest under the provisions of section 16(2) of the IRO, by requiring with respect to the situations described in items 4, 5 and 6 above that no holder of any part of the debt or other person entitled to interest thereon may be the borrower itself or an associate of the borrower. The apparent purpose of these proposals is to counter certain tax planning arrangements that utilise so-called “back-to-back” debt obligations. However, it is also understood that concerns have been expressed that these amendments could further restrict the availability of deduction of interest in a number of legitimate situations.

In conclusion, it may be observed that the method of taxation of financial income in Hong Kong generally discourages the conduct of financial activities, and in particular lending, in Hong Kong. This results primarily from the relatively strict application of a territorial basis of taxation, which inherently provides a lower taxation burden where transactions may be accomplished outside of Hong Kong in low tax or no tax jurisdictions, and which leaves a considerable amount of uncertainty as to the correct results in particular factual situations. A further factor contributing to potential economic distortions in this sector is the variety of levels of taxation for profits from various otherwise taxable debt obligations, which ranges from full exemption for certain instruments such as Exchange Fund obligations, to half rates for qualifying debt instruments to full taxation for others. Certain other types of problems arise with hedging and derivative transactions, because with the limitations on both inclusion and deduction of financial income and costs in the Hong Kong tax system it may prove very difficult or impossible to balance the nature of the income tax treatment on two different parts or “legs” of a transaction without arranging for both parts to take place offshore. Of course, concern as to taxation of financial activity in Hong Kong may be lessened where a multi-national financial institution is able to credit any Hong Kong Profits Tax against tax liability in another jurisdiction.

V. Other Regional Jurisdictions

A. Singapore

Singapore is looking to establish itself as a leading regional financial centre. While obviously many non-tax factors enter into this assessment, the competitiveness of the Singapore tax system is an important element. Singapore levies income tax under the authority of the Income Tax Act. This tax depends upon a territorial basis and a receipts basis. Both individuals and corporations who are resident in Singapore are taxed on income accruing in or derived from Singapore and on amounts received in Singapore. Amounts so received include amounts of foreign-source income remitted to or brought into Singapore or amounts applied for certain purposes related to Singapore. Non-resident and temporarily resident individuals are not taxable on foreign-source income received in Singapore; similarly, non-resident corporations with a permanent establishment in Singapore are subject to Singapore income tax on all Singapore-source income and foreign-source income received in Singapore, while a non-resident corporation without a permanent establishment in Singapore is only taxed on Singapore-source income. Income tax is levied under the Income Tax Act in Singapore at a statutory corporate income tax rate of 25.5% (being reduced by a further point in 2001). A graduated rate system rising to a top rate of 28% applies for resident individuals, with special rules for non-resident individuals. Questions of source are decided on the facts of each situation taking into account the usual relevant factors. The computation of assessable income follows familiar lines (subject to the exemptions and concessions referred to below). However, it may be noted that interest cost is generally deductible in computing income subject to tax under the Income Tax Act so long as it is incurred in the production of assessable income; this is so, even if such interest is paid to a non-resident except where paid by a person outside Singapore to another person outside Singapore without tax being withheld. Interest earned by Singapore taxpayers is taxable subject to the general requirements of source and receipt. Interest is considered to derive from a source in Singapore if the relevant agreement is executed in Singapore or if the loan is advanced by the lender to the borrower in Singapore. Certain exemptions from tax on interest are discussed below.

Withholding of tax at the standard rate is required for certain payments by a Singapore resident or permanent establishment to non-residents of Singapore on items such as interest, commissions and fees related to any indebtedness considered to be derived from sources in Singapore, and royalties, rental and leasing income considered to be derived from sources in Singapore. However, this withholding is not a final tax obligation and only constitutes a payment against liability for net income tax otherwise exigible under the Income Tax Act, except that payments of rent on movable property, interest or royalties are subject to a final withholding tax levied at a rate of 15% subject to reduction by tax treaty. To give effect to its imputation system for corporate income tax integration, Singapore also levies an equalisation tax based upon the prevailing corporate tax rate on payment of dividends by resident corporations unless sufficient corporate tax has been paid to “frank” the dividend; taxable shareholders are then required to bring into income a grossed-up amount reflecting corporate tax paid and may claim a tax credit for that amount. Special rules provide for tax-free flow through of dividends from foreign sources. Generally, capital gains are not taxable in Singapore, except for gains on real property and on shares of a corporation that has a substantial direct or indirect investment in real property. The distinction between gain and loss on account of capital and trading income is drawn in a familiar fashion based on objectively ascertained intention using certain factors. Singapore is a party to a number of bilateral income tax treaties, including those with some major developed countries, including Japan, the U.K., Germany, France, the Netherlands and Canada. These treaties resemble the general framework of the OECD Model Income Tax Convention, though Singapore tries to negotiate tax-sparing provisions to preserve the effects of its tax incentive arrangements.

Singapore also levies Property Tax on the annual value of land and buildings, Estate Duty and Stamp Duties (but only on documentation relating to stocks, shares and immovable property). A broad-based value-added tax called Goods and Services Tax was introduced in Singapore in 1994 at the rate of 3%. Financial services are generally exempt from this tax and inputs related to these services are not recoverable. Stamp Duties are also levied, but only on stocks, shares and immovable property.

Even though the Singapore income tax system levies tax at significant rates, it is more favourable to certain business activities than at first appears because of panoply of specific incentives and concessions, which reduce these rates in particular circumstances. The Singapore tax incentives and concessions that are important with respect to financial activities include the following:

- a reduced income tax rate of 10% paid by financial institutions on profits from their Asian Currency Units (ACU) from qualifying offshore transactions;
- an exemption from tax on income from syndication and underwriting of offshore loan arrangements where certain activities occur in Singapore that is derived by an ACU of a financial institution or an Approved Securities Company;
- a reduced income tax rate of 10% on interest and debt trading profits of approved traders; and an exemption from tax on fee income for arranging placement of debt securities in Singapore;

- a reduced income tax rate of 10% on income from a Finance and Treasury Centre from approved activities, including international treasury management and corporate finance;
- an exemption from income tax for income from certain foreign currency denominated securities listed on the Singapore Stock Exchange earned by ACUs or Approved Securities Companies;
- exemption from tax on interest for certain approved bank deposits, Asian Dollar Bonds, certain commodity margin accounts and certain approved loans that promote or enhance economic or technological development in Singapore held by non-residents, and post office savings bank interest.

B. Malaysia

The federal government of Malaysia imposes income tax on resident individuals on the basis of income derived or accruing from a source in Malaysia or income received in Malaysia from a source outside Malaysia by a resident of Malaysia (subject to available exemptions). Corporations resident in Malaysia are liable to tax on income from sources in Malaysia; however, banks, insurance companies and certain transportation companies that are resident in Malaysia are taxed on income from all sources in or outside of Malaysia, without reference to receipt. Income subject to tax in Malaysia is not itemised in the law but is considered to be a broad category based on traditional case law. Income subject to tax does not generally include capital gains, except that gains from disposal of real property situated in Malaysia (and the shares of certain real property holding companies), other than the private residence of an individual, are liable to tax under the Real Property Gains Tax Act; this tax is imposed on a declining rate scale depending on the length of time the real property has been held, with rates varying from 30% to 5% for corporations and from 3% to 0% for individuals. Malaysia has an imputation system for taxing domestic income earned by resident corporations. Under this system resident corporations may deduct and pay equalisation tax on dividends paid from domestic source income using the corporate tax rate as applied to a grossed-up dividend. Where equalisation tax payable by a corporation in a year is less than the corporate income tax liability of the corporation, the excess corporate income tax may be carried forward to be used in the following year against liability for equalisation tax on future dividends, while if it exceeds corporate income tax liability, the corporation must account for the difference to the tax authority. Resident shareholders then pay income tax on the gross amount of dividends received from resident corporations with a tax credit for the equalisation tax. While dividends from foreign-source income are generally exempt from the imputation regime and may be received by shareholders without tax, this exemption does not apply to foreign-source dividends of banks insurance companies and certain transportation companies.

Resident individuals pay income tax on a progressive rate basis with the top marginal rate of 29%. Non-resident individuals generally pay income tax at the flat rate of 29%. Resident and non-resident corporations pay income tax at the rate of 28%. Malaysia also levies a gross basis withholding tax on the following payments made to non-resident corporations: 15% on interest derived in Malaysia; 10% on royalties derived in Malaysia; 10% on technical, management and similar service fees; 10% on rentals for the use of movable property.

The location of source of income is determined under applicable Malaysian law according to general principles, except that certain items - including dividends or interest on securities that form part of the trading stock of a business - are deemed to be derived from Malaysia. Generally the source of interest is considered to be the place where the money being loaned is advanced. Interest from a loan granted in the course of carrying on a money-lending business in Malaysia is also deemed to be derived from Malaysia. Interest paid on money used for the production of gross income is generally deductible, except that interest paid to a non-resident is only deductible if withholding tax has been paid thereon. There appears to be some uncertainty caused by the administrative approach to apportionment of interest expense as between various sources. In addition interest is treated as derived from Malaysia if any of the following conditions is satisfied: the interest is payable by the federal or a state government; the interest is payable by a resident and the proceeds of the debt are being used for the production of Malaysia-source income or the debt is secured on property in Malaysia; the interest is charged as an expense against any Malaysia-source income.

A number of exemptions from income tax are also provided for interest income, including interest on certain debt of domestic governments or public authorities and interest from bonds issued by corporations rated by Malaysian rating authorities or from various deposits with domestic financial institutions that is received by individuals.

The Malaysian income tax system has many special tax incentive arrangements, including “pioneer” status partial tax holidays for five years. There are favourable tax regimes for a number of financial and related activities, including for fund management companies. There is also a special 10% tax rate available for five years for operational headquarters which carry on the business in Malaysia of providing services to offices and related parties outside of Malaysia; the approved services for qualification for this include treasury and fund management services where funds are obtained outside Malaysia.

A tax incentive arrangement of particular interest is the Labuan International Offshore Financial Centre. Labuan is a Malaysian federal territory which encourages the establishment of financial service businesses by financial institutions (other than Malaysian Banks or Insurance Companies) which are not allowed to conduct business in Malaysian currency or with Malaysian residents, except under certain circumstances. Generally, to qualify for status as an offshore bank or offshore investment bank, a financial institution must be a well-established bank of international standing and must meet capital requirements. Special secrecy laws also apply. A similar regime applies for offshore insurance companies. These activities are subject to income tax of 3% on net profits unless an election is made to pay a fixed tax of MYR 20,000 per annum. These activities are also exempt from withholding tax and from Stamp Duties.

Malaysia provides unilateral relief from double taxation for resident taxpayers through a foreign tax credit on a source by source basis (limited to 50% of foreign tax incurred). Malaysia has also entered into some bilateral income tax treaties which generally follow the form of the OECD model convention; however, Malaysia attempts to preserve the benefits of its wide ranging tax incentive arrangements through tax-sparing provisions in its treaties.

Malaysia also levies Stamp Duties on a range of legal documents including some banking transactions. Malaysia does not levy a value-added tax but does apply both a single stage sales tax on goods and a separate service tax on certain delineated services, which includes insurance services but does not generally include other services of a financial nature. Service tax payable by a service provider is recoverable from customers.

C. Taiwan

Taiwan levies two forms of income tax: the Consolidated Income Tax, which is levied on stated types of income including income from profit-seeking enterprises of a resident or non-resident individual from sources within Taiwan; and the Profit-Seeking Consolidated Income Tax. Where a non-resident individual has income from Taiwan sources subject to tax, this tax is withheld and remitted at source. Domestic profit-seeking enterprises (that is those with a head office in Taiwan) pay tax on all of their income from sources inside or outside of Taiwan; while foreign profit-seeking enterprises are subject to tax only on their Taiwan-source income. However, if such a foreign enterprise has no fixed place of business or business agent in Taiwan, it is only subject to withholding tax. Domestic enterprises pay income tax at a graduated rate that reaches 25% on income over 100,000 Taiwan Dollars. A foreign profit-seeking enterprise with a fixed place of business or business agent in Taiwan is taxed on a similar basis on its Taiwan-source income. Withholding tax on certain items of Taiwan-source income earned by other foreign profit-seeking enterprises is levied at rates varying from 15% to 25%. Taiwan-source income generally includes capital gains on Taiwan-situated property. Income subject to income tax (other than withholding tax) is generally net income determined by allowing for deductions and allowances for ordinary and necessary expenses relating to the earning of that income. Interest, though generally allowed as a deduction if it meets this test, is disallowed as a deduction if it is paid on loans from sources outside Taiwan unless the Taiwan foreign exchange authority has approved the loan. Taiwan has an imputation system for taxation of shareholders of domestic profit-seeking enterprises. This system allows resident individual recipients of dividends from such corporations to offset their personal income tax liability by the actual amount of underlying income tax paid by the enterprise on the profits that are distributed. Dividends paid by such an enterprise to non-residents are subject to withholding tax at 20% or 25%.

Financial institutions are generally not subject to special income tax rules (an exception appears to be special low rates of tax on foreign futures transactions), though certain exemptions from withholding tax are available.

Taiwan levies Stamp Duty on certain instruments, though it appears that no Stamp Duties are exigible with respect to loans or debt securities. Taiwan also imposes both a value-added tax, the General Business Tax, levied at a general rate of 5% applicable to most goods and services; and a business turnover tax on gross revenue, levied at a 3% rate on banking, insurance, trust and investment businesses.

D. Tax Competition

To understand Hong Kong's tax competitiveness for financial activities in relation to Singapore, Malaysia and Taiwan, we sum up the major differences in the tax regimes in Table 4. Hong Kong has the lowest corporate tax rate and the lowest withholding taxes, especially on interest income. However, the other three countries do have a number of exemptions, tax holidays and reduced tax rates for selective activities. Further, unlike Singapore, Malaysia and Taiwan, Hong Kong does not have a sales tax that affects financial activities. Hong Kong does impose Stamp Duty, though in Hong Kong and the other jurisdictions Stamp Duty is generally not an issue with respect to debt-based activity. Another advantage for Hong Kong is that it does not use exchange controls, unlike Malaysia and Taiwan. However, the lack of bilateral tax treaties is a disadvantage for Hong Kong, unlike Singapore and Malaysia which have extensive tax treaty systems.

In Table 4, we also provide the range of possible effective tax rates on the cost of financial intermediation¹⁴ in the four countries. In the absence of special preferences under the corporate and withholding tax regimes in the other three countries, Hong Kong provides the most tax competitive regime for financial activities. With special low-tax corporate and withholding regimes in Singapore, Taiwan and Malaysia (but sales tax still applied to financial transactions), Hong Kong international financial activities can be somewhat more highly taxed than similar financial activities in the other three countries.

14 The estimate of the effective tax rate on the cost of financial intermediation is based on the model in McKenzie, Mintz and Scharf [1997]. We calculate the effective tax rate on capital and business inputs used in the financial intermediation process. Depreciation is ignored for capital. Withholding taxes on interest income is assumed to affect the cost of borrowed funds. It is assumed real capital is one-third of the cost of financial intermediation, the rest being labour costs, which are assumed to be unaffected by taxes since the taxes lower the wage paid to workers. VAT, which treats financial intermediation as exempt, and turnover sales taxes are assumed to raise the cost of business inputs by the amount of the tax. The effective tax rate is estimated as: $T = (1+ak)(1+wi)(1+s) - 1$. Note that k is the effective tax rate on capital (as a percentage of the net return on capital), w is the withholding tax on interest income i , and s is the VAT (exempt activities) or turnover tax rate. The nominal interest rate is assumed to be 9%.

TABLE 4: Tax Competitiveness of Financial Intermediary Activities in Hong Kong

	Hong Kong	Singapore	Malaysia	Taiwan
Profits Tax Rate	16%	25.5%	28%	25%
Withholding Tax Rates on Interest	0%	7-15%	10-15%	10-20%
Stamp Duties	Yes	Yes	Yes	Yes
General Sales Tax	None	VAT at 3%	Turnover at 3%	VAT at 5% Financial revenue tax at 3%
Exchange Controls	No	No	Yes	Yes
Effective Tax Rate				
- High	6.0%	22.5%	26.9%	31.0%
- Low	6.0%	3.0%	3.0%	9.0%

Notes:

1. “High” effective tax rate assumes applicability of general profit tax rate, withholding tax on interest income and sales tax.
2. “Low” effective tax rate assumes tax preferences apply for corporate tax (often zero-rate) and no withholding tax on interest by exemption.
3. Withholding tax rates are the most general rates applicable by treaty for financial institutions, assuming no special exemptions apply.
4. Stamp Duties in Singapore and Taiwan primarily apply to immovable property.
5. Taiwan, in addition to VAT, levies a 3% turnover tax on certain financial activities.

VI. Options for Reform

When evaluating reforms of a tax system, it is important to outline the criteria to judge the success of the reforms. Typically, three criteria should be considered:

- *Efficiency:* A tax system should be efficient in the sense that it does not distort the allocation of resources that is best achieved by markets. For a business tax system to be efficient, tax burdens should be similar for activities so that businesses will invest in projects for economic reasons, rather than for the purpose of reducing taxes. Only if there is a failure in markets to achieve a socially acceptable level of activity, should tax burdens be adjusted to influence activities. For example, if some activities lead to too much pollution, then environmental taxes should be imposed to correct the misallocation of resources resulting from pollution-generating activities.
- *Equity:* Taxes should be assessed so that they are fair or equitable. Equity is of two forms. Horizontal equity implies that the tax burdens should be similar for taxpayers with similar resources. Vertical equity implies that the tax burden should be less on those with less ability to pay. For business taxes, the most equitable tax is one in which tax burdens are similar for business activities, since businesses are owned by taxpayers with different ability to pay. If taxes are assessed to reduce taxes for those with lower incomes, it is best to use individual, not business, taxes to accomplish distributive objectives.
- *Minimising complexity:* To collect taxes, taxpayers must expend resources to comply with the system. Governments bear costs to administer the system. Taxes that are simpler to operate save compliance and administrative costs for the economy.

As an objective, tax competitiveness with respect to financial activities in Hong Kong should not be the overriding issue for government. Other objectives including efficiency, fairness and simplicity are equally compelling, if not more important goals, when designing a tax structure. When a tax system is efficient and relatively simple to comply with, there are significant resource savings for the economy in that the economic and compliance costs are reduced. That in itself is an important competitiveness advantage for Hong Kong.

A. Taxation Models

The Hong Kong income tax system as described above represents an approach to taxation that, from a tax policy perspective, should not in broad terms be viewed as detracting unduly from economic efficiency, while at the same time the system raises sufficient revenue to fund public expenditures. The tax system operates with relatively low rates and a base generally restricted to employment income and business profits. Of course, the territorial nature of the system - the taxation of only Hong Kong sources of income - creates some tax disincentive for activity in Hong Kong. One area where the Hong Kong income tax system does appear to have the potential to create significant economic distortions is that of financial activity. In particular, the system appears to create relative disincentives for certain financial investments and for the conduct of certain financial activities in Hong Kong. This result is a function of the relatively fragmented and therefore potentially distortionary treatment of financial income and costs.

More specifically, the Hong Kong income tax system creates many different tax results for earning similar types of income and incurring similar costs related to financial income. Most telling is the treatment of interest income and interest expense. As described above, interest income will be exempt if derived from sources outside Hong Kong (subject to the special sourcing rules in the IRO). Interest will be exempt if earned from a source in Hong Kong by an individual or corporation not in the course of carrying on a trade or business. It will be taxable fully if derived from a source in Hong Kong earned in the course of carrying on a trade or business. But, Hong Kong source interest is exempt as a result of being interest paid on certain government or multilateral authority debt instruments or on interest on certain bank deposits received by persons who are not financial institutions, and is taxable at one-half rates where it is interest on a “qualifying debt instrument”.

As for the deductibility of interest expense, the situation is also fragmented. Interest expense is deductible in computing income for purposes of the IRO for financial institutions but only to the extent it relates to a cost of earning Hong Kong source taxable income. On the other hand, for non-financial institutions interest on debt incurred to earn Hong Kong source taxable income is generally not deductible, except where the borrowing is from a financial institution or an overseas financial institution and the repayment of principal is not secured on a deposit earning non-Hong Kong source interest. Interest may also be deductible if the borrowing is from a non-associated lender to finance capital expenditure or inventory or where the borrowing is by a corporation by way of the issue of publicly traded debentures. Proposed changes to these restrictive rules in the Inland Revenue (Amendment) Bill 2000 put further restrictions on the deduction of interest with respect to certain perceived tax avoidance arrangements. In summary, it should be recognised that, while some of these special limits on inclusion and deduction of financial income and cost are based on the territorial nature of the Hong Kong income tax system and others are attempts to deal with economic policy or avoidance concerns, the total result is a system that will distort economic activity in various directions, including in particular the disincentive to have activities that produce income located in Hong Kong.

The review of the tax systems of Singapore, Malaysia and Taiwan indicates how these countries, mostly through specific incentive measures, are competing to develop financial intermediation activities within their jurisdiction. This obviously can have adverse effects on the economic development of Hong Kong. While the approach taken by some of these jurisdictions - particularly the myriad of detailed special incentive schemes available in Singapore and Labuan (Malaysia) - may not be recommended in isolation as good tax policy, it is clear that Hong Kong should at least consider whether there are any changes that could be made within the context of its income tax system that would reduce economic distortions and therefore increase productive activity. The following discussion reviews this question with reference to the treatment of financial income and costs.

There are three models derived from tax policy theory that may be relevant in order to provide a background for the discussion of options for change available to the Hong Kong tax system.

The first of these models is a comprehensive income tax. This means, in this context, a system that attempts to levy a tax on all forms of economic income of all taxpayers. While the comprehensive income tax could be considered in a territorial taxation system, it is more customarily thought of as comprehensive both in terms of types of income and location of sources of income. The general advantage of such a system from the point of view of fairness is open to debate (see the discussion of consumption tax), and its effect on overall economic activity levels can be negative. However, a comprehensive income tax does have the advantage of minimising distortions caused by different treatment of different sources of income and different costs. In particular, it would normally be thought of as a system that would tax all interest and related financial income (from all sources or, as in Hong Kong, from domestic sources) in the same manner. All costs, such as interest expense, involved in earning such income would be deductible in the same manner.

The second of these taxation models is a variation of the comprehensive income tax system. That is, this model uses the comprehensive income tax system as a base but elaborates on it with specific exemption or rate reduction provisions that are intended to act as incentives for chosen types of activity. Assuming the same revenues are raised, this approach would mean that the rate would be higher and the tax base narrower compared to the comprehensive income tax approach outlined above. Examples of this approach are readily apparent in the income tax systems of Singapore and Malaysia, such as the special income tax incentives provided for certain offshore financial activities. This model when put into practice often appears very effective in generating the intended activity, though it raises other serious questions, as discussed below.

The third taxation model to be considered represents a departure from traditional income taxation. As discussed above in Section II, this is based upon the idea that income over time of individuals is equal to two components representing the possible use of income: consumption and savings. It then proceeds to the conclusion that it is both fairer (in the sense of eliminating tax at two different times) and less economically distortionary to tax only the consumption component of income, and not to tax income from savings. While one approach is to construct a tax on the consumption base as a comprehensive direct tax that resembles an income tax by exempting income from savings, it is more common to implement a consumption tax by levying a destination based multi-stage sales tax, such as VAT. The consumption tax in its pure form should allow great efficiency in the operation of financial markets and activities so long as financial service is not treated as an act of consumption. This can be achieved by zero-rating financial services - that is, a refund is given for taxes levied on inputs used in providing financial services. However, in view of some of the difficulties presented by the nature of financial services, the common approach to imposing consumption taxes in the form of VAT often results in the creation of some distortion in the area of financial intermediation, because these activities are treated as "exempt" rather than "zero-rated". This means that while there is no tax levied on the provision of the financial service itself, the financial service provider is unable to recover its cost of the tax paid on its non-financial inputs. The distortionary impact of VAT on financial services is, of course, the case that applies to Singapore and Taiwan.

B. Options for Consideration

The three taxation models described above can be used as a basis for a delineation of options to be considered for reform of the Hong Kong income tax system as it relates to the treatment of financial income and costs. However, as this is an exercise limited to this particular area, these options will not be described in a pure form, but rather the options are intended as possible adaptations of the existing Hong Kong tax system.

Indeed, there are some very basic and useful elements of the existing Hong Kong system, which in all of the circumstances should be maintained to the greatest extent possible. These elements are low rates, territorial source base and simplicity of compliance and administration. The options as discussed below do not take account in detail of the effect each would have on revenue collection, though it is recognised that each could lead to a substantial revenue loss, as a large proportion of Profits Tax collections is attributable to the financial industry. We are not in a position to evaluate the revenue impacts from the options. Even if we were able to do so, consideration should still be given to recouping the loss by reducing expenditures or by increasing reliance on other tax bases.

These options are as follows:

1. *Comprehensive income tax approach with a reduced Profits Tax rate:* The Profits Tax can be broadened by eliminating current exemptions for interest on Exchange Fund debt, multilateral agency debt and other specified debt and eliminate half-rate treatment for interest on qualifying debt instruments. The Profits Tax rate would be reduced to 10%, a rate that would be competitive with special preferences offered elsewhere as in Singapore. Limitations on the deduction of interest as an expense would also be modified to allow all interest incurred in earning income chargeable to Profits Tax to be deductible (subject to necessary anti-avoidance rules relating to source). While this approach does not come very close to a pure comprehensive income tax, it seeks to remove some of the distortions within the context of current Hong Kong income tax by moving very modestly in that direction.
2. *Selective tax preferences:* The Profits Tax base would be narrowed and the rate would be unchanged. Specific exemptions from tax would be provided for income earned by offshore financial entities which would be allowed to operate in Hong Kong within very restrictive conditions. The exemption would apply to activities that are related only to earning income that is currently exempt or which would become exempt at the same time by lessening or removing the application of the expanded source rules in section 15 of the IRO for this purpose. This approach may result in significant exempt activity within Hong Kong, some of which is incremental. However, it may pose serious drawbacks in terms of failing to provide substantial enough benefits to participants compared to a location such as Singapore. At the same time, some currently taxable income would be shifted to related offshore activities, resulting in a leakage of revenues into this exempt regime.

3. *A consumption tax approach:* The base of the Profits Tax would be narrowed by exempting all interest and related financial income (including trading income and related derivatives income). All interest and related expense would be disallowed as a deduction in computing income. The Profits Tax rate would not be lowered. As an offset for the deduction of interest expense incurred to invest in fixed assets and inventory, amounts paid for these items could be expensed on a current basis for the purpose of computing Profits Tax (the sale of such assets would be fully taxed). This approach, which may at first appear as a further narrowing of income taxation for special purposes, can instead be viewed as a move toward a consumption tax base with its many benefits.

C. Recommendations

Based on our review and comparison of the taxation of financial activities in Hong Kong and other regional jurisdictions, we would begin with the conclusion that the Hong Kong tax system, taken by itself, is not overly unfavourable for financial activities from a tax policy perspective. Accordingly, we do not feel that there is an overriding necessity to make substantial changes to the system. However, given the importance of financial activities for the Hong Kong economy, combined with the competition in this area and the significant tax initiatives taken by other regional jurisdictions such as Singapore and Malaysia, our overall recommendation would be for Hong Kong to consider implementing the third option described above: moving the Hong Kong tax base closer to the consumption base. This would involve exempting all interest and related financial income from Profits Tax and disallowing interest and related expense as deductions for that purpose. The resulting Hong Kong income tax system would be efficient, fair, simple and competitive.

Efficiency and fairness is arguably achieved by exempting the return on savings from tax since it puts taxpayers, no matter their desire to accumulate savings for future consumption, on the same basis (see Box A's example). However, by exempting financial trading income, the consumption tax could result in the exemption of consumption derived from the earnings received from financial trading activities when such earnings are paid in the form of interest and other capital income rather than salaries. For some financial trading activities, such as banking, it is usually the case that most earnings received by traders are a return to capital rather than work effort or entrepreneurship. On the other hand, for small financial traders, a substantial part of their earnings are a return to their effort and therefore support their consumption.

A consumption tax approach would therefore imply that the financial sector, which is a significant contributor to public revenues, could be exempt, or at least substantially relieved, from taxation. Leaving aside the revenue and political issues associated with the exemption, it might be viewed that the tax system is no longer fair since the financial industry would be exempt from taxation while other industries pay tax. However, this argument is inappropriate in an evaluation of tax policy considerations. Fairness is achieved when individual taxpayers of similar resources pay the same rate of tax. If there is a desire to have similar tax burdens on individuals, regardless of their consumption/savings decisions, there is no reason to believe that fairness is best achieved by taxing financial activities that directly impact on the savings decisions of individuals. In other words, the taxation of businesses under the income tax is not relevant to the fairness issue except to the extent that it is required to tax individuals fairly.

The above observation - that consumption derived from financial activities may be exempt - has led to several proposals being made to tax the financial income in excess of the required return on capital. The Meade Report suggested taxing financial businesses on their real and financial cash flows - the difference between revenues and current and capital expenditures. Financial revenues would include financial income, repayment of loans by the financial trades and borrowings of debt. Expenditures would include investments in financial assets, interest expenses and repayment of debt. If the increase in financial assets is equal to the increase in financial debt liabilities, then financial income would be equal to the spread between financial asset returns and the cost of debt finance and other expenditure incurred in the financial intermediary process.

An alternative approach for financial activities is to tax income in excess of the “normal” return on capital - “normal” being the return required by investors to hold capital in the firm. A tax on the “above-normal” would require the firm to deduct a cost of equity finance from profits in addition to the normal deductions given in the tax system. The deduction would be equal to the beginning year value of equity invested in the financial firm multiplied by a prescribed rate of interest.¹⁵ Any losses incurred by businesses would be carried forward by a rate of interest to preserve their value.

Both approaches to taxing financial trading income could be limited to financial institutions. There are a number of issues involved with defining the appropriate tax base that would require careful consideration. However, the main point is that there are technical solutions that could be considered if it were deemed important to tax the earning component of financial trading income, in excess of the return to capital.

Implementation Issues with the Consumption Tax Approach

There are several implications that would need to be considered in full if the consumption tax approach is to be followed:

- *Revenue implications:* Losses in government revenues are anticipated with this option. Thus, the government may wish to phase in exemptions over time. For example, an immediate exemption could be given for those debt instruments that are only half exempted now. Further exemptions could be provided as other tax measures or expenditure savings provide fiscal room.
- *Anti-avoidance rules:* Hong Kong already disallows interest expense deductions when monies are borrowed from exempt taxpayers. The option being suggested would exempt financial traders from taxation as well. Since financial traders could receive as remuneration exempt financial income rather than salary income, then anti-avoidance rules would be needed to ensure that the income paid as compensation for a financial trader’s work effort is taxable.

¹⁵ This approach is used for taxing closely-held companies and unincorporated businesses in the “dual income” tax systems of Scandinavia. Croatia, which had a full-fledged consumption tax, also provided a deduction for the imputed cost of equity finance.

- *Transition:* Transition issues are primarily related to the deduction of interest on debt, which is somewhat facilitated given the current operation of the Hong Kong tax system. Presumably, only interest on new debt would be exempt and therefore, non-deductible for the borrower. Interest on old debt, of which interest might be taxable, would continue to be taxed and therefore, deductible as an expense by the borrower. However, as with any transition, there would be incentive for companies to convert old to new debt if the tax benefits are important. Transition arrangements may need to be considered for the tax treatment of old debt. If expenditures on fixed assets and inventories are to be expensed and disposals taxed, transition rules would need to apply to the depreciation and sale of old assets.
- *Expensing of capital purchases:* As mentioned above, a pure consumption tax with the disallowance of interest expense would also imply that the purchase of real capital (structures, machines, inventory and land) would be expensed and the disposal of real capital would be fully taxed.

If there is little desire to move to the full consumption tax approach, the government could consider, instead, a partial approach of providing more exemptions for savings income. It could, for example, provide a full rather than half-exemption for the income earned from qualifying debt securities. Interest expense incurred by businesses in issuing qualifying debt securities would therefore be non-deductible, rather than half-deductible as under the current rules.

Alternatives to the Consumption Tax Approach

It is our view that, if it is considered that action must be taken in this area, then the only other sensible approach to follow would be to move towards the comprehensive income tax option. This approach, involving base broadening and overall rate reduction of Profits Tax, would, however, require a substantial revision in the basis of income taxation in Hong Kong, without necessarily improving some of the distortions in the current tax system. Under this approach, most capital income earned in Hong Kong would need to be taxed and most interest would be deductible as well. But, given the territorial system, taxpayers in many circumstances could avoid taxation by holding assets offshore, as they currently do. Therefore, the comprehensive income tax approach would not encourage the growth of debt capital markets in Hong Kong, so long as financial activities can be shifted to low-taxed countries allowing Hong Kong residents to avoid the Hong Kong tax. Finally, we would not recommend the creation of special targeted tax incentives, such as those used in Singapore and Malaysia. These types of arrangements can be costly and complex, and often create disadvantageous economic distortions that can weigh against the resulting benefits.

D. Other Tax Issues

While we do not think that there are other aspects of the Hong Kong tax system apart from Profits Tax that are particularly significant with respect to the conduct of financial intermediation in Hong Kong, we would make the following observations.

- It would be generally desirable from a tax policy perspective to eliminate the application of Stamp Duty entirely, with the possible exception of its application to the transfer of immovable property situate in the jurisdiction. The recent move in the March 7, 2001 budget to reduce the Stamp Duty from 0.225% to 0.2% is appropriate when applied to securities. However, some thought might be given to maintaining Stamp Duties on real estate property, similar to land transfer taxes used in many industrialised economies.
- It might also provide more flexibility to large businesses if the Profits Tax were to provide some form of corporate consolidation or group relief, though we recognise that the increased complexity of such provisions may well not outweigh the benefits. Consolidation or group relief provides an opportunity for a corporate group to deduct losses incurred by a member company against the profits of another. The more liberal use of losses within the corporate group removes a bias against the corporations that cannot consolidate for regulatory or other reasons. It also provides greater relief to companies that tend to face greater risk, and potential losses, over time compared to more stable companies. One approach is to have full consolidation as in the United States, whereby the income, assets and liabilities of members of a corporate group would be consolidated and taxed as one person. An alternative approach is to provide group relief that allows the losses of a member in a corporate group to be transferred to another, as in the United Kingdom. To provide some form of group relief, a minimum degree of ownership would be required to determine which companies are members of the corporate group. There are a number of complexities that would need to be considered such as the impact of a change in control of firms on the use of losses within the group.
- Should Hong Kong implement a value-added tax on a destination basis, some consideration should be given to the tax treatment of financial services. One could zero-rate financial services on the grounds that services are not a form of direct consumption but instead enable individuals to earn a higher return on their savings. However, if financial services were exempt resulting in the non-recoverability of taxes on inputs, the VAT on financial services for international lending would need to be studied.

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