Taxation of Financial Intermediation Activities in Hong Kong

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Summary

This paper evaluates the effects of taxation on financial intermediary activities in Hong Kong. The paper does not focus on the overall burden of taxation in Hong Kong since tax revenues are necessary to finance public services. Instead, the paper concentrates on the structure of taxation as it affects financial intermediary activities in Hong Kong.

Hong Kong has adhered to the principle of territorial taxation whereby only income earned in Hong Kong is subject to Hong Kong tax. The tax system is relatively broad in application, with few targeted preferences, and tax assessed at a low rate. Two specific problems, however, are encountered with respect to the taxation of financial activities. The first is "competitiveness" in that Hong Kong is concerned that it should maintain its attractiveness as the primary regional financial centre in Asia. The second is the potential impact of taxes on financial intermediation in Hong Kong in that investors and businesses may organise their affairs so that some financial income is earned from sources in tax haven jurisdictions. Further, there are concerns that there are not sufficient incentives for taxpayers to borrow in Hong Kong debt markets, an issue partly addressed by exempting half of income from qualifying debt instruments.

The Hong Kong income tax is applied at a rate of 16% on corporate profits, up to 15% on salaries and 15% on other income. Taxpayers pay tax on income earned in Hong Kong, including profits from the carrying on of a trade, profession or business in Hong Kong. In certain cases, primarily for financial institutions, income or profit from sources outside Hong Kong is deemed to arise from a source in Hong Kong. Otherwise, foreign income is exempt from taxation. Non-residents are taxed on the same basis as residents. Except for financial institutions, Hong Kong residents generally do not pay tax on interest, capital gains and dividends on investments in Hong Kong. In order to protect the tax base from avoidance, an attribution is made to disallow the deduction of interest on borrowings from exempt taxpayers.

Other important features of the Hong Kong tax system include the following. There are no withholding taxes on income paid to non-residents. Neither is a consumption tax, such as a Value-Added Tax (VAT), imposed in Hong Kong. There is, however, a Stamp Duty that applies to financial (primarily stocks and bearer instruments) and immovable property transactions.

The paper reviews and compares the Hong Kong tax system with Singapore, Malaysia and Taiwan. It concludes that Hong Kong's tax treatment of financial intermediary activities is generally competitive with the above three countries as Hong Kong has lower effective tax rates on most financial activities. While there are some important tax advantages for foreign activities engaged by Singapore-based companies outside Singapore, the Hong Kong tax system generally provides a more competitive tax system. Compared to other countries, Hong Kong's corporate income tax rates are low, no VAT applies on business inputs used by financial intermediaries and the Stamp Duties are aimed primarily at equity markets. Further, unlike Malaysia and Taiwan, Hong Kong does not impose exchange controls.

As the paper discusses in detail, Hong Kong's income tax system contains features that are more consistent with an expenditure tax system. An expenditure tax, in principle, exempts the return on savings by taxing residents on worldwide earnings and exempting savings from taxation. Consistent with an expenditure tax approach, most Hong Kong taxpayers pay tax on their earnings, including trading profits, and pay no tax on capital income in the form of interest, dividends and capital gains. Further, certain interest expense related to exempt income cannot be deducted. Two important differences between the Hong Kong income tax and an expenditure tax system are the following. The first is that the return on investments may be subject to tax to the extent that such income is earned by financial institutions. The second is that Hong Kong residents pay tax only on earning sourced in Hong Kong not on earnings outside Hong Kong.

There are three directions that could be considered for tax reforms in Hong Kong. The first would be to move towards an annual income tax that would result in the full taxation of interest, capital gains and dividends (the latter two sources of income could remain exempt since such income is taxable at the corporate level). With additional revenues from taxing a wider base, Hong Kong could reduce income tax rates to maintain the same tax burden. The second approach would be to accept high tax rates but provide greater special preferences such as the half-exemption given for income from qualifying debt securities. The third would be to move more fully towards the consumption tax approach by exempting all taxpayers on interest and disallowing the deduction of interest expense (capital expenditures on tangible assets would be expensed rather than depreciated).

Although the paper questions the need for any major tax reform since the Hong Kong tax system is already efficient and competitive, it suggests that any reforms should move towards to the consumption tax approach. Thus, for example, a full exemption should be given for qualified debt securities (and a full disallowance of associated interest deductions for borrowers).

Further, Stamp Duties should be phased out with the exception of immovable property transactions. Corporate consolidation or group relief should be provided to allow a corporate group to make better use of losses. Finally, if Hong Kong considers the implementation of a VAT, special consideration should be given to the tax treatment of financial intermediaries to avoid taxes on business inputs used in the intermediary process.