

Hong Kong's system of income tax is outlined in the Inland Revenue Ordinance and its subsidiary legislation, the Inland Revenue Rules. Hong Kong also imposes stamp duty on instruments catering for the transfer of specific property primarily immovable property and Hong Kong stock (the legislation covering this is contained in the Stamp Duty Ordinance). The estates of people who died before February 10, 2006 were also subject to Estate Duty.

The structure of Hong Kong's tax system has always been based on three simple principles:

- The implementation of a comparatively low level of taxation, which nevertheless produces revenue for the Government.
- It is simple to understand.
- It is inexpensive to administer.

These principles were reinforced in the Basic Law of the Hong Kong Administrative Region of the People's Republic of China, in which Articles 106 to Article 108 provide that Hong Kong shall administer an independent tax system based on a historically low level of taxation yet strive to maintain a balanced budget.

The legislation is administered by the Inland Revenue Department. The system of assessment and objection is in the first instance the responsibility of the Inland Revenue Department, but at later stages of appeal it is the responsibility of Hong Kong's court system. To assist taxpayers, the Inland Revenue Department has published a series of Departmental Interpretation and Practice Notes ("DIPN"), covering a variety of subjects, which explain the Inland Revenue Department's interpretation of Hong Kong's tax legislation. Each DIPN clearly states the Inland Revenue Department's practice, whilst stating that this is not binding on the taxpayer and does not prevent a taxpayer from pursuing the appeals procedure.

Hong Kong's unique tax system has a number of characteristics that have been fundamental to its success:

- All of its types of income tax, namely profits tax, salaries tax and property tax, are assessed independently of each other, notwithstanding the fact that a taxpayer files a composite tax return.
- Spouses are regarded as separate individuals, but in given circumstances they may elect to aggregate their incomes and be assessed as a single person.

- Tax is levied not on the basis of the residence of the person, but rather according to the location of the source of the income earned by the person.
- There is no capital gains tax.
- There is no withholding tax on the payment of dividends and interest, although a form of Hong Kong tax may be withheld from the payment of specific royalties.

BUSINESS TAXATION PROFITS TAX

Scope of Tax

Profits tax is charged on every person carrying on a trade, profession or business in Hong Kong. It is charged in respect of profits of a revenue nature that arise in or are derived from Hong Kong in the year of assessment.

The determination of whether a given source of income is derived from Hong Kong is a question of fact that has been considered by the courts. It is now well recognised that one looks to see what the taxpayer has done to earn the profit in question and where he/she has done it. DIPN 21, revised in December 2009, considers the general rules for determining the location of numerous sources of income and reflects the Inland Revenue Department's interpretation of the relevant case decisions. These include but are not limited to:

<u>Activity</u>	<u>Location of the Source of Profit</u>
Provision of a service	– the place where the service is rendered
Manufacturing	– the place where the manufacturing is carried out
Letting of property	– the place where the property is located
Lending of money	– the place where the borrower is first able to exercise control over the funds
Dealing in commodities and securities	– the place where the contracts of purchase and sale are effected

However in practice, the Inland Revenue Department has adopted a more expansive view following Lord Jauncey's decision in HK-TVBI, in which he stated that "it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under section 14". This confusion has, to a certain extent, been addressed in the recent decision in ING Baring Securities (Hong Kong) Limited v CIR, where it was stated that the focus must be on establishing the geographical location of the taxpayer's

profit-producing transactions themselves as distinct from activities antecedent or incidental to those transactions.

Permitted Deductions

All expenses of a revenue nature incurred in earning profits chargeable to Hong Kong tax qualify as a deductible expense. Specific legislation applies to the deduction of interest expenses (the provisions are complex and are designed to mitigate the loss of revenue from schemes designed to reduce a person's assessable profits). The provisions mean that interest on loans payable to connected parties does not qualify as a deductible expense unless the recipient is subject to tax on the interest income. Other specific legislation deals with:

- The deductibility of bad and doubtful debts
- Repairs and renewals
- Intellectual property
- Contributions to retirement schemes
- Research and development expenditure
- Technical education
- Charitable donations
- Prescribed fixed assets
- Environmental protection machinery

Capital Expenditure

Relief in the form of depreciation allowances is available for the cost of capital expenditure on assets used for the purposes of earnings profits chargeable to tax. The relief available depends on the nature of the asset:

Plant and machinery	– Year 1, either 72%, 68% or 64% of the capital cost; thereafter 30%, 20% or 10% of the residual value
Computer equipment	– 100% in year 1
Industrial buildings	– Year 1, a total allowance of 24% (20% initial allowance and a 4% annual allowance) of the qualifying capital cost of construction; thereafter 4% of qualifying capital cost of construction
Commercial buildings	– 4% of qualifying expenditure

Special provisions apply to assets partly used for business purposes, and assets acquired by hire purchase and leveraged leasing. Depreciation allowances are also claimed back when the asset is sold for a price exceeding the tax written-down value, but are limited to the original cost of the asset. The acquisition cost of plant and machinery not acquired using hire purchase financing or partly used for non-qualifying purposes is pooled into three categories where the annual allowance is either 30%, 20% or 10% of the written-down value. A claw-back of depreciation allowances granted, known as a balancing charge, can only occur where the proceeds of sale (limited to the acquisition cost) exceed the tax written-down value of the pool.

Losses

Agreed tax losses incurred by a person may be carried forward indefinitely, irrespective of the nature of the trade or business conducted by the taxpayer. There are no provisions for the carry back of losses or for group relief. Anti-avoidance provisions are contained in the Inland Revenue Ordinance to prevent the sale of tax-loss companies purely for the benefit of the tax loss.

Debt/Equity Ratio: Thin Capitalisation

No formal rules are contained within the Inland Revenue Ordinance. However, due to the complex provisions denying relief for interest or loans between associated parties, there has been little need to implement such provisions.

Transfer Pricing

The Inland Revenue Ordinance does not contain any provisions under the title of “transfer pricing”, but Hong Kong’s anti-avoidance provisions and conditions for the deductibility of interest serve to mitigate any perceived tax loss through transfer pricing. Hong Kong has so far concluded 14 comprehensive double taxation treaties. Each treaty contains an exchange-of-information clause, so where there is cause for an adjustment due to the adoption of a transfer pricing scheme, the Inland Revenue Department has stated in DIPN Note 46 “Transfer Pricing” that it will adopt OECD principles.

Withholding Taxes

There is no withholding tax on the payment of dividends and interest. However, when a person carrying on business in Hong Kong pays a royalty to a person not subject to Hong Kong tax, the offshore party is deemed to have carried on business in Hong Kong and to be in receipt of Hong Kong-sourced profits. Depending on the circumstances, the deemed profit rate is 30% or 100%, giving a withholding tax rate of 4.95% or 16.5%.

Tax Treaties

Hong Kong has concluded 14 comprehensive double taxation treaties. Hong Kong’s treaties partners are:

Austria

Indonesia

The Netherlands

Belgium	Ireland	Thailand
Brunei	Kuwait	The United Kingdom
China	Liechtenstein	Vietnam
Hungary	Luxembourg	

Returns, Assessment and Payment of Tax

The Inland Revenue Department normally issues profits tax returns at the beginning of each financial year, i.e. April, with one month being the permitted time to file the completed return. However, a system of automatic extensions is in place such that the following deadlines apply;

Accounting period	Filing Deadline
• Ending in December	- August 15 of the following calendar year
• Between January 1 and March 31	- November 16 of the same calendar year
• Other dates	- One month after receipt of the return

The Inland Revenue Department will raise an assessment based on the return that has been filed, but in the absence of a return an estimated assessment will be raised. If the taxpayer is dissatisfied with the assessment, he/she may raise an objection in writing within one calendar month from the date of the assessment. The taxpayer may also apply for a holdover of the tax payable under an assessment (this must be done within 14 days of the date that the tax is payable).

Hong Kong operates a provisional basis of taxation, meaning that the annual assessment will assess the fiscal profits for the previous year of assessment and assess the provisional profits of the current year. Current-year profits are deemed to be the same as the previous year's final profits. The effect of this is to assess profits on a current-year basis.

Rate of Tax

The current rate of profits tax is 16.5% (2010 – 2011). There is no small companies rate of tax.

Employment of individuals

An individual is required to apply for and hold a work visa, unless he/she has the right of abode in Hong Kong (effectively, this means an individual who is a Hong Kong national or a person who has resided permanently in Hong Kong for a period of seven consecutive years and holds a Permanent Identity Card).

An employer is required to notify the Inland Revenue Department on the occasion of a person starting or leaving employment. Within three months of a person starting employment, the employer must notify the Inland Revenue Department of the individual's name and address, the date of commencement and the terms of employment.

When a person ceases employment, the employer must advise the Inland Revenue Department of the individual's departure at least one month prior to the departure date. If the individual is intending to leave Hong Kong, the employer must not pay the employee any remuneration without the Inland Revenue Department's consent.

It is mandatory for an employer to establish a retirement scheme in accordance with the Mandatory Provident Fund Scheme Ordinance.

Individuals are subject to Hong Kong salaries tax on their income from employment in respect of their income derived from a Hong Kong contract of employment. If the individual derives income from a non Hong Kong contract of employment the individual will be subject to salaries tax on a time apportionment basis. However, if an individual spends fewer than 60 days a year in Hong Kong, the individual will not be subject to salaries tax on employment income.

Where an employer provides accommodation to the employee or reimburses rent paid by the employee, Hong Kong provides a very beneficial basis of taxation. The amount assessed, the rental value, is equivalent to 10% of the individual's assessable income from the employment. Where the employer provides the individual with accommodation in a hotel, a reduced percentage applies.

Other tax-free benefits can be provided to the employee, either as a result of being specifically provided for in the Inland Revenue Ordinance or because the liability associated with the provision of the benefit is entirely that of the employer, i.e. there is no assumption by the employer of an employee's liability.

Each year, the employer is required to make an annual return to the Inland Revenue Department, with details of the names and addresses of all the employees receiving an annual income in excess of HK\$100,000. The individual is also required to file an annual salaries tax return within one month of the receipt of the return giving details of his/her assessable income. As with profits tax, Hong Kong operates a provisional salaries tax system that seeks to tax individuals on a current-year basis.

The Inland Revenue Ordinance provides for progressive rates of tax payable on the taxpayer's assessable income, i.e. his/her total Hong Kong-sourced assessable income less his/hers personal allowances and deduction, which are numerous. However, the total salaries tax payable cannot exceed 15% (2008/09) of the net assessable income before personal allowances.

Income from Property

Corporations in receipt of rental income from property located in Hong Kong will normally be subject to profits tax, however individuals not carrying on a business will be subject to property tax. This is a very simplified basis of taxation that limits deductions from rental income to government rates, bad debts and a statutory deduction of 20% of the assessable value to compensate the taxpayer for repairs and other outgoings.

Rates of Salaries Tax and Allowances 2009/10 and 2010/11

- Standard rate (applied to net assessable income, i.e. before personal allowances)
- 15%
- Progressive rates (applied to net chargeable income, i.e. after personal allowances)

First HK\$40,000	2%
Next HK\$40,000	7%
Next HK\$40,000	12%
Remainder	17%

- Personal allowances

Basic			HK\$108,000
Married			HK\$216,000
Single parent			HK\$108,000
Child (1st to 9th)		year of birth	HK\$100,000
		other years	HK\$50,000
Dependent parent/grandparent	(aged 60 years+)	basic	HK\$30,000
		additional	HK\$30,000
	(aged 55 – 59)	basic	HK\$15,000
		additional	HK\$15,000

Dependent brother/sister	HK\$30,000
Disabled parent	HK\$60,000
Deductions (maximum amount)	
Self-education expenses	HK\$60,000
Home loan interest (maximum 10 years of assessment)	HK\$100,000
Elderly residential care expenses	HK\$60,000
Contributions to recognised retirement schemes	HK\$12,000
Approved charitable donations	35% of assessable income