HOW SIMPLE CAN TAX LAW BE?: THE INSTRUCTIVE CASE OF HONG KONG

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INTRODUCTION

Hong Kong is famous for its low rates of tax. The territory’s tax system also seems to be well-known for being relatively simple. What seems to be under-appreciated, however, is just how simple it is.

Hong Kong’s system of income tax is provided for, still, by the Inland Revenue Ordinance 1947 (IRO). When it first became law, the Ordinance consisted of 90 sections, and occupied a total of 43 pages in the issue of the Hong Kong Government Gazette in which it was published. Since then it has been amended repeatedly (though far less often and far less extensively than the taxing statutes in other jurisdictions). Consequently, it is now much more complex than it was. Even so, it is still only about 200 pages all up—and it contains not only the substantive law but also the machinery for its administration: taxpayers’ obligations, the Commissioner’s powers, appeals procedures and so on.

It might be supposed that the successful operation of so skeletal a statute must depend upon a correspondingly comprehensive body of case law. It might be supposed, in other words, that the courts must have filled in the gaps left by the legislature. But this is not so. On the contrary, one of the most striking features of the case law which has grown up around the IRO is the number and size of the gaps in it.

The aim of this paper is to examine the law (that is, the IRO and the cases relevant to its interpretation); to examine, in particular, its simplicity; and to examine also the factors which appear to have made this simplicity possible. I explain the operation of the Ordinance as a whole, but concentrate on the taxation of business profits. More particularly still, I examine the way in which Hong Kong law distinguishes between trading profits and capital gains (crucial, because capital gains are not taxable at all) and between Hong Kong profits and offshore profits (also crucial, because offshore profits are likewise not taxable). The reasons for this emphasis are that the taxation of profits is both fiscally and politically important; the taxation of profits poses greater conceptual challenges than the taxation of other forms of income; and firms

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1 Pieces of primary legislation in colonial Hong Kong were called Ordinances, not Acts. This appears to have been the custom in British colonies not possessing responsible government. The practice has survived the return of the territory to Chinese rule in 1997.
(particularly those engaged in cross-border business) are commonly in a position to undertake more sophisticated tax planning measures than individuals. For these reasons, the complexity of most countries’ tax law is very largely attributable to the difficulties posed by the taxation of profits. The simplicity of this aspect of Hong Kong’s tax system is therefore especially instructive.

The paper is divided into three main parts. The first of these provides an overview of Hong Kong’s tax system. Particular attention is paid to a number of important respects in which the simplicity of Hong Kong tax law is almost incomprehensible, judged by the standards prevailing elsewhere in the developed world. The second part examines more closely the taxation of profits in Hong Kong. Again, particular attention is paid to a number of important respects in which Hong Kong tax law is very much simpler than the law of other developed jurisdictions. Finally, in the third part, I seek to explain what it is that has made this extraordinary simplicity possible. I examine a number of possible explanatory factors and conclude that one, the very low rates of tax, is the most important.

I AN OVERVIEW OF HONG KONG’S TAX SYSTEM

A Hong Kong’s System of Government and the ‘Fiscal Firewall’

It may be useful to begin with a brief account of Hong Kong’s system of government and its ‘fiscal firewall’. The colonial Hong Kong government was established in accordance with the British Imperial norm in the mid-nineteenth century. The system then established survived not only the following century-and-a-half of colonial rule, but also the return to Chinese rule in 1997; consequently, it remains basically intact today. Curiously, then, the only substantially populated place in the world whose government is still based on the mid-nineteenth century British colonial model is Hong Kong—a small but bustling and economically important corner of an emerging superpower whose central government still professes to be communist.

Since 1997, Hong Kong’s constitution has been contained in an instrument called the Basic Law. The Basic Law is itself subordinate to the Chinese constitution; for this reason, it is sometimes called Hong Kong’s ‘mini-constitution’. Prior to that date, the colony’s constitution was based on Letters Patent and Royal Instructions issued by the British government in the name of the Crown. The head of the government, called the Chief Executive (in the colonial period, the Governor) is effectively appointed by the Chinese Government in Beijing (previously the British Government in London). The incumbent, Tung Chee Hwa, has held the post since 1997. Tung is a multimillionaire shipping magnate. He was originally from Shanghai, was educated at Liverpool University in England, and is a long-term resident of Hong Kong. The members of the legislature (called the Legislative Council) are selected by an electoral process

especially designed to give the appearance of democracy whilst in fact effectively guaranteeing a body dominated by Beijing-friendly business interests.3

One of the more notable aspects of the Basic Law is that it provides for the complete separation of the tax systems and public finances of Hong Kong and the rest of China. This is sometimes referred to as the ‘fiscal firewall’. It is established by Articles 106 and 108 of the Basic Law. Article 106 provides as follows:

The Hong Kong Special Administrative Region shall have independent finances.

The Hong Kong Special Administrative Region shall use its financial revenues exclusively for its own purposes, and they shall not be handed over to the Central People’s Government.

The Central People’s Government shall not levy taxes in the Hong Kong Special Administrative Region.

Article 108 provides, insofar as is relevant, as follows: ‘The Hong Kong Special Administrative Region shall practise an independent taxation system.’

There would appear to be several methods by which the Central People’s Government could, if it wished, circumvent the spirit of these provisions without contravening them. For example, it could impose a tax on the exportation of water from the Mainland to Hong Kong, for the territory is heavily dependent on the Mainland for water. Electricity, gas, meat, vegetables and various other goods are also imported from the Mainland in large quantities, and all of these, too, would be reasonably expeditious subjects of taxation. It seems reasonable to suppose that, in the event of serious national need (eg, war over Taiwan?), the fiscal firewall would come down; and that the Central People’s Government would cease to deprive itself of the revenues it might raise in Hong Kong. To date, however, the Central People’s Government’s behaviour has been in this respect exemplary: it appears to have made no attempt whatever to extract revenues from Hong Kong, other than, of course, through normal commercial endeavour.4 Thus Hong Kong, by far the richest part of China, is the only part to make no contribution at all to the nation’s public finances.

B The History and Basic Structure of Hong Kong’s Tax System

Taxes on income were first introduced in Hong Kong by the War Revenue Ordinance 1940, as a means of financing a contribution to the British war effort. The colonial government proposed to establish an income tax of the kind it considered ‘normal’: that is, a single tax on the worldwide incomes of persons resident in the colony and also on income derived from the colony by persons resident elsewhere. But the government was dominated by the colonial business community, which was predictably opposed. Consequently, the system of taxation which was in fact established differed from this norm in two basic respects. First, there was no tax on income, as such, at all. Instead, there was a schedular system of three separate taxes on three different kinds of income:

3 See Ghai, above n 2.

4 The Basic Law contains notable Buchananite limitations on the Hong Kong government’s authority to levy taxes. See Michael Littlewood, ‘The Taxing and Spending Powers’ in Cooray et al, above n 2.
property tax was charged on rents derived from land and buildings; salaries tax on income from employment (and on various analogous forms of income, such as directors’ fees); and profits tax on the profits of business. These three taxes were not exhaustive; income of kinds not covered by them was untaxed. Second, each of these three taxes was confined to income derived from Hong Kong. Offshore income, in other words, was exempt from tax (whether taxed elsewhere or not). This system was revived after the war by the IRO, which remains in force today.

The IRO also added to the system a mechanism called ‘personal assessment’. This is essentially a ‘normal’ income tax—but a voluntary one, to which taxpayers can choose to submit themselves, if they wish, instead of paying the separate taxes on the several components of their incomes. Thus, the IRO gives each taxpayer a choice: she can pay the schedular taxes (property tax, salaries tax and profits tax) on the several components of her income; or she can elect to have them combined, and pay tax on the total.

C The Statute and the Cases

Judged by the standards of other developed jurisdictions, the case law that has grown up around Hong Kong’s IRO is disconcertingly incomplete. To provide a comprehensive account of the gaps would be tedious, but some examples might serve to give an idea of their nature and scale.

One illuminating instance is the tax treatment of dividends. The IRO provides that no tax is payable on dividends paid out of profits which have borne tax. The implication, one might think, is that dividends paid out of untaxed profits might be taxable (in some circumstances, at least). Curiously, though, Hong Kong’s Inland Revenue Department seems never even to have asserted that this might be so. At least, the law reports contain not a single case in which the department has sought to tax a dividend.

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5 Profits tax was (and is) charged on the profits of both incorporated and unincorporated firms. This is explained further below.

6 For example, interest was in some circumstances chargeable to profits tax, and in others not taxable at all. This remains the case today (though the circumstances in which interest is chargeable to profits tax are more extensive than in 1940).

7 In 1941, a fourth tax, interest tax, was added to the original three. It remained in force until 1989, when it was abolished. In some circumstances interest is chargeable to profits tax (in particular, when produced by the carrying on of a trade or business); in others it is simply exempt (for example, interest on bank deposits held by individuals). For a brief history of Hong Kong’s tax system, see Michael Littlewood, ‘Taxation without Representation: The History of Hong Kong’s Troublingly Successful Tax System (2002) British Tax Review 212.

8 A person electing personal assessment is taxed on the same income as would otherwise be chargeable to the schedular taxes (property tax, salaries tax and profits tax). That is, income which escapes the schedular taxes escapes personal assessment also. The difference between personal assessment and the schedular taxes lies not in what income is taxable, but in the method by which liability is calculated. Since personal assessment is elective, it can only decrease a person’s liability to tax, not increase it. See below n 40.


10 Since dividends are invariably not taxable, there is no need of either (1) a definition of ‘dividend’ or (2) rules providing for the tax treatment of distributions other than dividends.
Taxpayers, too, have been curiously unassertive. Like the department, they have chosen not to take points which (by the standards prevailing elsewhere in the developed world) seem clearly to be worth arguing. For example, the department maintains that neither an employee nor a self-employed person can deduct the cost of clothing.\(^{11}\) In the case of employees, the department’s position seems sound (though still debatable).\(^{12}\) In the case of self-employed persons, however, the authority for the department’s position is dubious in the extreme;\(^{13}\) yet no-one appears ever to have challenged it.

Thus, the prevailing interpretation of the IRO rests heavily on a kind of consensus, shared by taxpayers and the department and supported by only the sketchiest authority, or none at all. To some extent, this is no doubt true of all tax systems (and, indeed, law generally): some points, whilst arguable, are not worth taking. The point, however, is that the threshold at which an arguable point of tax law becomes one worth arguing seems to be very much higher in Hong Kong than elsewhere.

\(^{11}\) The department accepts that the cost of clothing is deductible if the clothing is of a sort that would not ordinarily be worn other than for the purpose of producing income. Examples include uniforms and costumes. But, the department’s position seems to be that clothing that might be worn for purposes other than producing income is not deductible (even if in fact worn exclusively in the course of producing income). The cost of clothing purchased by an employer for an employee, however, would seem to be deductible by the employer and not taxable to the employee, so long as provided to the employee on terms not permitting the benefit to be converted into cash.

\(^{12}\) Section 12 of the IRO provides that employees can deduct expenditure only if it is ‘wholly, exclusively and necessarily’ incurred in the production of taxable income. A similarly-worded provision was held by the House of Lords in *Mallalieu v Drummond* (1983) 2 AC 861 not to permit the deduction of expenditure incurred on clothing (conservatively-colored suits, and accoutrements) used by a barrister only when appearing in court. Decisions of the House of Lords are still regarded as highly persuasive in Hong Kong, but they are not binding.

\(^{13}\) Section 16 of the IRO provides that a self-employed person can deduct expenditure ‘to the extent that’ it is incurred in the production of taxable profits. The department’s view that this does not permit the deduction of expenditure on clothing seems, again, to be based on *Mallalieu v Drummond* (1983) STC 665 (above n 12). But the theory that *Drummond’s Case* is relevant to the interpretation of s 16 seems highly speculative, given the difference in the statutory wording, and in any event is entirely unsupported by authority.
D Property Tax

Property tax is imposed on rental income derived from land and buildings.\textsuperscript{14} It is charged at the flat ‘standard rate’, currently 16 per cent.\textsuperscript{15} There are no allowances. Consequently, the flat 16 per cent applies from the first dollar. The tax is imposed on gross rents, less 20 per cent.\textsuperscript{16} There is no provision for the deduction of landlords’ actual expenditure, which is therefore irrelevant. Thus, the statute effectively assumes that landlords invariably incur deductible expenditure equal to exactly 20 per cent of their rental receipts.\textsuperscript{17} Like the other taxes imposed by the IRO, property tax is based on the ‘source principle’. It is imposed only on income derived from property ‘situate in Hong Kong’.\textsuperscript{18} Income derived from offshore property, in other words, is exempt from tax (whether or not taxed in the jurisdiction in which the property is situated). Also, property tax is imposed only on landlords who are natural persons. Corporate landlords are taxed on their rental income, but they pay profits tax, not property tax.\textsuperscript{19} Property tax is provided for by Part II of the IRO. Part II is simple in the extreme: it consists of four sections of about half a page each. There is virtually no case law, because there has been virtually no litigation.

\textsuperscript{14} IRO s 5 and 5B. For a comprehensive analysis of Hong Kong tax law, see Peter Willoughby and Andrew Halkyard, \textit{Encyclopaedia of Hong Kong Taxation}, Butterworths, Hong Kong, loose leaf, which is the leading work on its subject. Virtually all privately held land in Hong Kong is leasehold. That is, it is held on lease from the government. (The only fee simple is the site on which stands the Anglican Cathedral, St Johns.) Consequently, when people speak of ‘land’ in Hong Kong, they are generally speaking of leases. This results in some difficulties in terminology. In particular, there is no real property or real estate in the territory (apart from St Johns). The word ‘land’ is also problematic, since what is in fact meant is generally buildings or parts of buildings.

\textsuperscript{15} IRO s 5 and Schedule 1.

\textsuperscript{16} IRO s 5.

\textsuperscript{17} This is obviously a very rough and ready approach to the taxation of rental income. It seems unlikely that such approximate equity would be tolerable at significantly higher rates of tax. Even at the relatively low rates at which tax is imposed in Hong Kong, the statutory 20 per cent deduction is presumably a significant cause of the notorious parsimony of Hong Kong’s landlords (for they get the 20 per cent deduction even if they spend less than that or nothing at all on maintaining their properties). It is worth noting also, however, that the system is simple not only from the landlord’s point of view, but from the revenue’s, too: since landlords’ expenditure is irrelevant, the only item on their tax returns requiring verification is the amount of rent. Once interest is included, landlords’ expenditure (in Hong Kong, as elsewhere) very commonly exceeds 20 per cent of rents received. In fact it commonly exceeds 100 per cent of rents. The absence of any provision allowing for the deduction of landlords’ actual expenditure can therefore be very harsh. Relief is commonly available, however, in the form of personal assessment. See below.

\textsuperscript{18} IRO s 5.

\textsuperscript{19} IRO s 2 (‘business’ defined to include the letting of ‘premises’ by a corporation), 5 and 25. Profits tax, unlike property tax, makes provision for the deduction of expenditure: IRO s 16. Thus, a corporate landlord can deduct its expenditure (to the extent that it is incurred in producing rents or other assessable profits and is of a revenue nature); and an unincorporated landlord can deduct 20 per cent of her rents, even if she in fact spends nothing. There is consequently very considerable scope for very simple tax planning. That this kind of thing is tolerable seems, again, to be a function of Hong Kong’s unusually low rates of tax. It is perhaps worth adding that the rules providing for the deductibility of expenditure for profits tax are almost entirely free of the kinds of restriction which are to be found in other developed jurisdictions. See Willoughby and Halkyard, above n 14.
E Salaries Tax

Salaries tax is provided for by Part III of the IRO, which consists of 12 sections, averaging a little under a page each. Salaries tax, then, is somewhat more complex than property tax, but still extraordinarily simple, judged by the standards of the rest of the developed world.

The tax is charged on income from employment, and also on analogous forms of income such as directors’ fees. There is a system of allowances which effectively exempt from tax the first part of the taxpayer’s income. The rest is taxed at progressive rates, currently 2 per cent, 8 per cent, 14 per cent, and 20 per cent. There is also, however, a provision limiting liability to the amount produced by applying the flat standard rate (16 per cent) to the whole of the relevant income, without the benefit of any allowances. There are thus two separate methods of calculating a person’s liability to salaries tax. The first is to subtract the allowances to which the individual’s circumstances entitle her; and to apply the progressive rates (2 per cent, 8 per cent, 14 per cent and 20 per cent) to the remainder. The second is to apply the flat standard rate to the whole of the assessable income, from the first dollar. The taxpayer gets the benefit of whichever calculation produces the lesser liability. The consequence of this is that incomes beneath a certain point (known colloquially as the ‘standard rate threshold’) are taxed at the progressive rates (because these produce a lower liability than would the flat standard rate); and incomes above that point are taxed at the flat standard rate (because, for incomes above the standard rate threshold, the progressive rates, culminating in a maximum of 20 per cent, produce a larger liability than the flat 16 per cent).

Judged by the standards of the rest of the world, the allowances are exceedingly generous: they are so high as to effectively exempt about two thirds of the workforce from tax altogether. (Salaries tax is thus aptly named: mere wages are not taxable in Hong Kong.) Moreover, very few taxpayers’ incomes exceed the standard rate threshold. Of those who pay tax, therefore, the overwhelming majority are taxed at the progressive rates rather than the flat standard rate; their total liability, in other words, is less than 16 per cent.

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20 IRO s 8(1).
21 IRO s 27 to 33.
22 IRO s 13 and 43 and Schedule 2. The first part of the taxpayer’s income is effectively exempted by the allowances to which her circumstances entitle her; the next HK$30 000 is taxable at 2 per cent; the next HK$30 000 at 8 per cent; the next HK$30 000 at 14 per cent; and the remainder at 20 per cent.
23 IRO s 13.
24 For example, a married couple with two children and an ordinary level of expenditure on home-mortgage interest is taxable only on income over HK$360 001 (about US$46 000) per year: Antony Leung (Hong Kong Financial Secretary), 2003/2004 Budget Speech, Supplement, Salaries Tax.
25 The standard rate threshold depends on the allowances to which the taxpayer’s circumstances entitle her. It therefore varies from taxpayer to taxpayer, depending on marital status, number of children and other dependents, etc. The standard rate threshold for a single person with no dependants is currently HK$770 000 (about US$99 000). For a typical Hong Kong household (which, according to the Hong
Salaries tax has given rise to more litigation than property tax. For example, there have been disputes over the distinction between employees (who are liable for salaries tax) and independent contractors (who are liable for profits tax).\(^{26}\) The distinction is significant, because the rules for deductibility for profits tax are far more generous.\(^{27}\) For instance, an independent contractor can deduct entertainment; an employee generally cannot. For present purposes, however, the most notable aspect of this feature of Hong Kong’s tax system is not the disputes, but that liability can vary very considerably depending on whether a person is an employee or a contractor. Elsewhere in the world, the legislature has typically resorted to considerable complexity of legislation to eliminate or at least ameliorate such inequities; in Hong Kong it has not.\(^{28}\)

Also notable is the tax treatment of persons deriving income from employment from outside Hong Kong. Salaries tax (like property tax and profits tax) is confined to income derived from Hong Kong.\(^{29}\) Offshore income, in other words, is simply not taxable. The IRO contains a number of rules for distinguishing between employment income derived from Hong Kong (which is taxable) and employment income derived from outside Hong Kong (which is not).\(^{30}\) These rules are more important in Hong Kong than similar rules in other jurisdictions, not only because offshore income is simply exempt from tax, but also because it is very common for Hong Kong residents to work both in Hong Kong and elsewhere.\(^{31}\) The Board of Review\(^ {32}\) has interpreted these in such a way as to favour non-residents;\(^ {33}\) and the Inland Revenue Department administers the IRO in accordance with this interpretation. The practical effect of this seems to be that Hong Kong’s tax system favours expatriates and discriminates against Hong Kong Chinese. Any taxpayer aggrieved by this practice would be entitled to appeal—but none has. This curious state of affairs might once have been dismissed as a

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\(^{26}\) See for example Hong Kong Inland Revenue Board of Review Decision no D 103/96. (The Board of Review is the tribunal charged with determining disputes between taxpayers and the Inland Revenue Department. Its establishment, membership and procedures are among the matters provided for by the IRO.)

\(^{27}\) Above n 12 and 13.

\(^{28}\) There is a provision, however, aimed at the use of companies to turn a person who would otherwise be an employee into an independent contractor. See IRO s 9A.

\(^{29}\) IRO s 8.

\(^{30}\) IRO s 8.

\(^{31}\) There are two main reasons for this. First, many American and European firms maintain their regional Asian headquarters in Hong Kong, and require extensive regional travel of their employees. Secondly, many Hong Kong firms (and Hong Kong subsidiaries of foreign firms) conduct various operations (notably manufacturing) in the Mainland of China, and require their employees to spend substantial periods in the Mainland.

\(^{32}\) Above n 26.

\(^{33}\) The IRO provides that income derived from services rendered during ‘visits’ to the territory of less than 60 days is exempt: s 8. The Board of Review (see above n 26) has interpreted this on the basis that a person can ‘visit’ Hong Kong only if she is not resident there; and, therefore, that residents cannot benefit from this rule. See D 11/84. In D 34/97, the Board expressed doubt as to this interpretation, but did not rule on the point. The legislature has shown no inclination to intervene.
distasteful relic of colonialism, but seven years after the resumption of Chinese rule this explanation is unconvincing. Rather, it seems that no-one adversely affected has yet found it worthwhile to challenge the Board’s very dubious interpretation in the courts. Once more, the unusually low rates of tax are presumably a significant factor in this calculation.

Another important feature of Hong Kong’s system of taxing income from employment is that there is no PAYE. That is, employers are not required to deduct at source the tax on the salaries they pay their employees. Instead, persons who are liable for salaries tax are simply required to discharge their liabilities themselves. Generally they are required to pay twice per year; and generally they meet this obligation either by mailing the department a cheque, or by presenting themselves at the department’s offices with a pile of banknotes. (The department operates cashiers’ booths for the purpose of accepting these payments.)

This aspect of Hong Kong’s tax system is especially instructive, because if other developed jurisdictions were to emulate it (that is, if they were to scrap their PAYE systems and require persons in employment to pay their own tax), it seems inevitable that many taxpayers would be unable or unwilling to pay. It seems reasonable to suppose also that the number of defaults would escalate to the point of producing significant losses in revenue. Law-abiding taxpayers would grow resentful of those not paying; and resentful also of the system itself. In short, the result would be chaos. Yet Hong Kong’s tax system operates well enough without PAYE. The reasons are that the rates of tax are very low; and the allowances are generous enough to exempt most of the workforce from tax altogether. Also, most of those obliged to pay tax own assets and so are worth suing if they default.

F Profits Tax (an Overview)

Profits tax is of course a tax on profits. It is imposed on both incorporated and unincorporated firms. Profits tax is provided for by Parts IV and VI of the IRO, which consist of about 70 sections in total, averaging a page or so each. Profits tax is thus considerably more complicated than property tax or salaries tax, but still much simpler than the taxes on profits to be found elsewhere in the developed world. Unincorporated firms (that is, mainly sole proprietorships and partnerships) are charged at the flat standard rate (16 per cent). There are no allowances. Consequently, tax is payable at 16 per cent from the first dollar, irrespective of the amount of profits; and irrespective of the personal circumstances of the firm’s proprietor or proprietors. In the case of a sole proprietor, he or she is of course liable for the whole of the tax. In the case of a partnership, the partners are liable for the tax in the same shares as they are entitled to the profits. No further tax is imposed on distributions.

34 IRO s 14(1).

35 The proprietors of unincorporated firms can commonly reduce their liability by electing personal assessment. See below n 40.
In the case of corporations, profits tax is charged at 17.5 per cent. No further tax is imposed on dividends. In other words, dividends are treated as distributions out of a taxed fund, and accordingly exempt. Notably, though, dividends are exempt from tax even if the profits out of which they are paid have not been taxed. As with unincorporated firms, the profits tax on corporations is a final liability. It is not subject to adjustment, either upwards or downwards, in light of shareholders’ total incomes or other circumstances. Nor is there any system of imputation (or integration): since dividends are simply exempt from tax, there is obviously neither any need nor any room for imputation. One of the more obvious advantages of very low rates of tax is thus that it makes feasible the extremely simple treatment of corporate profits. To put it another way, Hong Kong’s tax system appears to demonstrate that the so-called ‘problem’ of taxing corporate profits is entirely a function of relatively high rates of tax.

G Personal Assessment

In various common circumstances, Hong Kong’s schedular taxes (property tax, salaries tax and profits tax) are inequitable. Relief from some of the grosser inequities is available in the form of ‘personal assessment’. This, as I have indicated, is like a normal income tax, except that it is optional. Thus, instead of paying the schedular taxes on the separate components of her income (broadly rents, salary and profits), a taxpayer can elect personal assessment, and pay tax on the total. Personal assessment tax is charged at the same rates as salaries tax. That is, there are two ways of calculating it. The first is to take into account whichever of the allowances the taxpayer’s personal circumstances entitle her to; and to apply the progressive rates (2 per cent, 8 per cent, 14 per cent and 20 per cent) to the rest. The other is to apply the flat standard rate (16 per cent) to the taxpayer’s total

36 IRO s 14(2) and Schedule 8. A closely held company can generally reduce its liability to tax by employing its shareholders (or their family members). In all normal circumstances, the salaries will be deductible by the company and taxable to the employees, if at all, at a lower rate (and usually a much lower rate) than 17.5 per cent. See above n 20. In other developed jurisdictions, there are typically complex rules designed to restrict this sort of tax minimization. In Hong Kong there are none, other than the basic requirement that a salary is deductible only if incurred in the production of assessable profits; and this is liberally interpreted. See Willoughby and Halkyard, above n 14.

37 See above n 9. There are various common circumstances in which tax might not have been paid on the profit out of which a dividend is paid. For example, the profit might have been derived from outside Hong Kong; or it might be a capital gain. If the department were to assess dividends to tax in such circumstances, it would face issues such as whether a dividend paid out of an offshore profit is derived from the same place from which the profit was derived, or from the place where the company is resident, etc. The point remains that the department has in effect conceded all such arguments.

38 Most developed jurisdictions tax corporate profits at a rate which is lower than the highest rate applicable to personal income. Consequently, they have little choice but to tax dividends—for, if they did not, they would (1) lose very substantial revenues (the difference between the corporate rate and the personal rates on distributed corporate profits); (2) create a substantial inequity (in that corporate income would be taxed less heavily than income of other kinds); and (3) open up an attractive possibility for abuse (in that channelling income through a corporation would reduce the tax on it by the difference between the corporate rate of tax and the highest personal rate).

39 See above n 8.

40 IRO s 40B to 43. See also above n 20.
taxable income, without allowances. Liability is determined by whichever of these methods produces the lower figure.

Personal assessment alleviates the inequity of the schedular taxes in the following common circumstances. First, it is only by electing personal assessment that an individual taxpayer can set off a business loss against rental income or income from employment. The reason for this is simply that the schedular taxes make no provision for such set-offs. Second, most landlords and self-employed people gain by electing personal assessment. The reason is that property tax (payable by landlords) and profits tax (payable by self-employed people) are charged at the flat standard rate (16 per cent), without the benefit of any allowances, whereas personal assessment (like salaries tax) provides for generous allowances and is charged at progressive rates (if these result in a lesser liability than would the flat standard rate). Thus, personal assessment generally produces a lesser liability for individuals whose total taxable income is less than the standard rate threshold. Most landlords and self-employed people have incomes below the standard rate threshold; of these, almost all gain by electing personal assessment. Third, property tax makes no provision for the deduction of mortgage interest by landlords, whereas personal assessment does. Landlords commonly make the election for this reason.

H The Unnecessary Complexity of Hong Kong Tax Law

My aim in this paper is to examine the simplicity of Hong Kong tax law. But it is apposite to note also the possibility that it is in fact considerably more complex than it needs to be. The reason is that, as I have explained, there is in Hong Kong no tax on income as such at all but, rather, a schedular system of three separate taxes (property tax, salaries tax and profits tax), plus personal assessment. If, instead of this schedular system, there were a single tax on income as such, the legislation could be simplified considerably. It would likewise seem possible to eliminate various other causes of complexity. For example, the IRO provides for very generous allowances for capital expenditure. In particular, capital expenditure on plant and machinery qualifies for an ‘initial allowance’ (meaning an immediate write-off) of 60 per cent. Unsurprisingly, even the Hong Kong Government has found it necessary to add to the legislation rules to restrain the abuse of this provision; and, of course, such rules are necessarily complex. Compared to other jurisdictions’ tax systems, then, Hong Kong’s is very simple; but it could be simpler still.

41 Above n 23.
42 There are circumstances in which a person whose income is below the standard rate threshold would not gain by electing personal assessment. But such cases are unusual.
43 IRO proviso to s 42(1).
44 IRO s 37A.
II PROFITS TAX EXAMINED MORE CLOSELY

A The Charging Provision: Section 14(1)

The legislation providing for profits tax is extremely simple. The charging provision, s 14(1), is worded as follows:

Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate\(^{45}\) on every person\(^{48}\) carrying on a *trade, profession or business* in Hong Kong in respect of his assessable profits *arising in or derived from Hong Kong* for that year from such trade, profession or business (excluding profits arising from the sale of capital assets)\(^{46}\) as ascertained in accordance with this Part.\(^{47}\)

This wording imposes profits tax only where two basic conditions are satisfied. First, there must be a person (which, as will be seen, is defined to include a corporation)\(^{48}\) carrying on a ‘trade, profession or business’. Second, there must be profits ‘arising in or derived from Hong Kong’.\(^{49}\) These formulae are thus of fundamental importance. As will be seen, they give rise to some difficult issues. But, as will also be seen, Hong Kong’s courts have developed interpretations which, whilst sometimes controversial, have been entirely workable. Moreover, the government has been content to rely on the judicial interpretation of s 14(1); it has not attempted to resolve the difficulties by adding to the legislation or otherwise amending it.

Section 14(1), as recited here,\(^{50}\) is in some respects similar to charging provisions contained in the taxing statutes of other jurisdictions, such as Australia and New Zealand. The Hong Kong provision most strongly resembles those used in other British colonies, dominions and other territories in the early and middle years of the twentieth century. More recently, other jurisdictions have revised their wording (not always for the better); but even today the wording of s 14(1) has a very familiar ring to it.

It is necessary to emphasise, however, that in other jurisdictions (such as, again, Australia and New Zealand), basic charging provisions of this sort have commonly,

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\(^{45}\) The ‘standard rate’ is currently 16 per cent. See above n 15.

\(^{46}\) It might, incidentally, be argued that the words in parentheses imply that capital receipts other than those arising from the sale of capital assets are taxable; but the Inland Revenue Department has never suggested that this might be so. This is another example of the department’s unassertive approach to the administration of Hong Kong’s tax system. It demonstrates also that imprecision in drafting of a kind that would be problematic in other jurisdictions (where taxes are higher) is satisfactory in Hong Kong.

\(^{47}\) IRO s 14(1), emphasis added.

\(^{48}\) See below n 53.

\(^{49}\) The wording of s 14(1) (see above n 47) requires also, (1) that the person carrying on the trade, profession or business is doing so ‘in Hong Kong’; and (2) that the profits are ‘from such trade, profession or business’ (emphasis added). Disputes as to whether a firm is carrying on a trade or business are common; but if a firm is carrying on a trade or business at all, it is usually clear whether it is doing so in Hong Kong. Moreover, this issue is significant only if there are profits ‘arising in or derived from Hong Kong’ (because otherwise there is no liability in any event). The second requirement (that profits are taxable under s 14(1) only if they are ‘from’ the taxpayer’s business) is examined below at n 59.

\(^{50}\) Above n 47.
since the early twentieth century, been supported by a complex of ancillary provisions whose function is to bring within the scope of the charging provision (and so render taxable) income which would or might otherwise escape. For example, it is common to find provisions deeming various species of income to be derived from within the taxing jurisdiction—and therefore within the scope of the basic charging provision—and therefore taxable. Hong Kong has some such rules but, as will be seen, they are few in number and rudimentary in the extreme.\footnote{51} Equally, in other developed jurisdictions, much of the complexity of the tax legislation is due to the need to provide expressly and in detail for the problems posed by the taxation of corporations. In Hong Kong, again, there are some such rules, but, again, they are rudimentary in the extreme. Consequently, to an extent unparalleled in other developed jurisdictions, the law of Hong Kong really is as simple as the wording of the charging provision—\textsection{14(1)}—suggests.

Leaving it to the courts to define the scope of the tax on profits has required of the Hong Kong government a ‘let the chips fall where they may’ approach to the consequences. One of the consequences—perhaps the most important consequence—is of course the amount of money produced by the tax. Given that profits tax is the Hong Kong Government’s largest single source of revenue, the government’s restraint and trust in the judiciary is remarkable. It is very difficult to imagine the government of, say, Australia, entrusting its revenues to the Australian courts to anything like the same degree. And yet, as will be seen, the Hong Kong Government’s trust in the territory’s courts seems to have been well-founded. Of course the government has not agreed with every decision.\footnote{52} And some decisions have provoked extreme dissatisfaction on the part of Hong Kong’s taxpayers and their advisers. The decisions of Hong Kong’s courts are, of course, open to the same kinds of criticism as are levelled against the decisions of the courts in common law jurisdictions generally. But, at the end of the day, Hong Kong’s courts have interpreted \textsection{14(1)} in such a way that it works.

\textbf{B Corporations}

The law relating to the taxation of corporate profits in Hong Kong is extraordinarily simple. Section 2 of the IRO defines ‘person’ as including ‘corporation’. Section \textsection{14(1)}, which imposes profits tax on ‘every person carrying on a trade’ etc,\footnote{53} thus imposes the tax on both incorporated and unincorporated firms. Section \textsection{14(2)} provides that, in the case of a corporation, profits tax is imposed not at the ‘standard rate’ (that is, currently, 16 per cent),\footnote{54} but at the rate specified in Schedule 8. The rate specified in Schedule 8 is currently 17.5 per cent. Thus, profits tax is imposed on both incorporated and unincorporated firms; but corporations pay at 17.5 per cent and unincorporated firms pay at 16 per cent. The excess is colloquially referred to as the ‘corporate surcharge’. It

\footnote{51} Below n 64.

\footnote{52} If the courts \textit{had} agreed with the Commissioner in every case, that might indicate a problem—departure from the rule of law—even more serious than an unexpected shortfall in revenue.

\footnote{53} Above n 47.

\footnote{54} Above n 15 and 47.
has varied from time to time, but has always been slightly (1–2.5 percentage points) above the standard rate.\textsuperscript{55}

And that is all. Other developed jurisdictions’ tax statutes generally contain a complex array of rules dealing with the various problems posed by the taxation of corporations. For example, there are rules dealing with dividends; the integration of corporate and shareholder liability to tax; losses; groups; amalgamations; and so on. The Hong Kong Ordinance has virtually nothing of this kind. Dividends, as I have explained, are simply not taxable.\textsuperscript{56} Problems such as determining the consequences of, say, a transaction designed to allow a profit-making company to use a loss suffered by an affiliated company are simply left to be resolved by the Commissioner and the taxpayers concerned on the basis of general rules.\textsuperscript{57} The taxpayer, if dissatisfied with the Commissioner’s solution, can of course appeal; but such appeals are uncommon.\textsuperscript{58}

\noindent C Passive Income: Section 15

The wording of s 14(1) (see above at note 47) is such as to impose tax only in the case of taxpayers ‘carrying on a business’;\textsuperscript{59} and only on profits ‘from’ such business. Consequently s 14(1) generally does not cover ‘passive’ income such as, in particular, interest, royalties and sums received for the use of movable property.\textsuperscript{60}

For example, if a person (incorporated or unincorporated) receives interest as a result of carrying on a business (such as a business of money-lending or selling goods on credit), then the interest is taxable under s 14(1). But the mere making of a loan and the receipt

\textsuperscript{55} The corporate surcharge was introduced in 1975 by means of an amendment to s 14 itself. Various subsequent changes to the corporate surcharge were likewise brought into effect by amendment to s 14. Eventually, in 1992, the corporate rate of tax, like the personal rates, was shifted to a schedule at the end of the IRO (Schedule 8), so as not to clutter the charging provisions with the amendments resulting from occasional tinkering with the rates of tax.

\textsuperscript{56} Above n 9.

\textsuperscript{57} That is, mainly, the basic charging provision (s 14(1); see above n 47) and the basic provisions dealing with the deductibility of expenditure (s 16 and 17).

\textsuperscript{58} For further examples of provisions typically regarded as basic and obvious necessities in other jurisdictions, but simply missing in Hong Kong, see below at n 112. The IRO’s treatment of trusts is even simpler than its treatment of companies. Indeed the taxation of trusts is not specifically provided for at all (other than that s 2 defines ‘person’ as including ‘trustee’); rather, it is left to taxpayers and the Commissioner, supervised by the courts if necessary, to apply general rules (in particular, the rules relating to profits tax in the case of trading trusts and the rules relating to property tax in the case of property-holding trusts) to income derived by trusts.

\textsuperscript{59} To be precise, s 14(1) imposes tax also in the case of taxpayers carrying on a trade or profession. See above n 47. But for the sake of simplicity I here use the word ‘business’ to cover trades and professions also.

\textsuperscript{60} Other species of passive income include rents derived from land and dividends. But, as is explained above, rents derived from land are chargeable to property tax (in the case of unincorporated landlords) or profits tax (in the case of incorporated landlords); and the Hong Kong Government apparently does not wish to tax dividends.
of interest typically does not constitute the carrying on of a business.\textsuperscript{61} Thus, if a person (or a corporation) not carrying on business at all lends money and receives interest, the interest is generally not taxable under s 14(1). Moreover, even if a person (or corporation) \textit{is} carrying on a business, any interest received by that person (or corporation) is taxable under s 14(1) only if the interest is ‘from’ the business. For example, if a company carrying on a trading business holds surplus funds and lends these at interest, such interest is not ‘from’ the business but merely incidental to it—and therefore not taxable under s 14(1).

Similarly, if a royalty is derived from the taxpayer’s business, it is taxable under s 14(1).\textsuperscript{62} This might be so, for example, in the case of a firm carrying on a business of developing and licensing intellectual property. But the mere licensing of intellectual property and the receipt of royalties typically does not constitute the carrying on of a business. Consequently, such royalties are not taxable under s 14(1). Equally with sums received for the use of movable property (such as plant or machinery). If such a sum is derived from the taxpayer’s business, it is taxable.\textsuperscript{63} For example, the profits of a company carrying on a business of renting out cars are taxable under s 14(1). But the mere letting of movable property and the receipt of money for its use typically does not constitute the carrying on of a business. Such receipts are therefore not taxable under s 14(1). For example, if the owner of manufacturing plant leases it to a manufacturer, sums received under the lease are not taxable under s 14(1).

Thus interest, royalties and sums received for the use of movable property are generally not taxable under s 14(1). These gaps were obviously substantial. Moreover, they were open to very easy abuse. For example, a closely-held manufacturing company could assign its plant to the shareholders; who could lease it back to the company. Payments made under the lease would be deductible by the company and tax-free to the shareholders. Similarly, a sale and lease back of intellectual property could produce deductible but tax-free royalties. Likewise, financing a business by means of debt could produce deductible but tax-free interest payments.

Lacunae on this scale proved intolerable even by Hong Kong’s standards. Over the years and bit by bit they have been partly (but still only partly) filled by the addition to the IRO of rules dealing specifically with interest, royalties and sums received for the use of movable property. These rules are themselves extraordinarily simple. They are all contained in a single section, s 15. This provides that, in some circumstances, interest, royalties and sums received for the use of movable property are deemed to be ‘derived from Hong Kong from a trade, profession or business carried on in Hong Kong.’

\textsuperscript{61} There is English and other Commonwealth authority to this effect. It is notable, though, that Hong Kong’s Inland Revenue Department has accepted without argument that these cases are determinative of the interpretation of the Hong Kong statute—especially since the result (unlike in the jurisdictions where the cases were decided) was that important categories of income escaped tax altogether. Note too that, even if interest \textit{is} produced by the carrying on of a business, it is taxable under s 14(1) only if, (1) the business is carried on in Hong Kong and (2) the interest is derived from Hong Kong.

\textsuperscript{62} Assuming again that the business is carried on in Hong Kong and that the profit in question is derived from Hong Kong.

\textsuperscript{63} Assuming once more that the business is carried on in Hong Kong and that the profit in question is derived from Hong Kong.
Kong’.64 Thus s 15 effectively brings receipts of these kinds within s 14(1), and so renders them taxable.

It is necessary to mention s 15 because it is difficult otherwise to explain s 14(1). Perhaps too the very rudimentary rules contained in s 15 provide further illustrations of the extreme simplicity of Hong Kong’s tax system. But there seems little point in examining these rules any more closely—suffice to say that they are very simple, that the circumstances in which they apply are curiously limited, and that considerable scope for abuse remains.

D Trading Profits and Capital Gains

As has been explained, s 14(1) does not tax all profits, but only those produced by the carrying on of a ‘trade’, a ‘profession’ or a ‘business’.65 If a profit is produced by an activity covered by one (or more than one) of these words, it is taxable (assuming that the activity is carried on in Hong Kong; and that the profit produced by it is derived from Hong Kong). Otherwise, it is not. The formula ‘trade, profession or business’ was copied (indirectly, via various other British colonial taxing statutes) from the ‘trade’, ‘profession’ and ‘vocation’ which have long been central to British income tax legislation. The word ‘profession’ no doubt humours those who prefer theirs not to be classified as a trade or a business, but is otherwise unimportant.66 The word ‘vocation’ does not appear in Hong Kong’s IRO, and so is of no further concern here. The word ‘business’ was presumably intended to broaden the scope of the Hong Kong statute; as will be seen, however, it has had very little effect. The crucial word, then, is ‘trade’.

The word ‘trade’ has been used in British income tax legislation for over 200 years. It is defined as including ‘every adventure … in the nature of trade’. This wording, too, was adopted in Hong Kong.67 As is well-known, there are many cases, both British and from various other Commonwealth jurisdictions, on the meaning of both the word ‘trade’ and the formula ‘adventure in the nature of trade’. Perhaps most importantly, the use of the singular ‘adventure’ is interpreted as confirming that in some circumstances a one-off transaction amounts to the carrying on of a trade (and, therefore, that any resultant gain is taxable).68 Hong Kong’s courts have consistently accepted these cases as authoritative.69 Thus, by copying the terms of the legislation, Hong Kong received the benefit of the cases also.

64 Section 15 contains provisions dealing with various other sorts of income also, but there seems no point in examining these here.

65 Above n 47. Or the deemed carrying on of a business, trade or profession under s15: above n 64.

66 There is English authority to the effect that there is a distinction between a profession and a trade. See for example Inland Revenue Commissioners v Marxe (1919) 12 TC 41. But the issue has never arisen in Hong Kong and it seems doubtful that the English cases are of any modern relevance in the territory.

67 See IRO s 2, definition of ‘trade’.

68 See for example Leeming v Jones (1929) 25 TC 333.

69 See for example Beauliland Co Ltd v Commissioner of Inland Revenue (1991) 1 HKRC 90-053.
Copying what was tried and true was sensible, especially in the circumstances prevailing in Hong Kong in the 1940s. It is necessary to emphasise, though, that the word ‘trade’ bears a much heavier weight in Hong Kong than it does in the United Kingdom or in other Commonwealth jurisdictions. For example, in some circumstances the buying and selling of land amounts to an adventure in the nature of trade, and therefore to the carrying on of a trade. In other circumstances, it does not. Rather, it is the making and realising of an ‘investment’.70 In the United Kingdom, if the purchase and sale do not amount to trading, the profit is not chargeable to income tax, but it is generally chargeable to capital gains tax. Even in jurisdictions in which there is no tax on capital gains as such, there are commonly rules extending the definition of income to cover specified kinds of short-term capital gains. An example is New Zealand, where there is no capital gains tax as such, but in some circumstances capital gains on land are treated as income. In Hong Kong, on the other hand, the issue remains straightforward: if the purchase and sale amount to trading, the gain is chargeable to profits tax; conversely, if the purchase and sale do not amount to trading, the gain is not taxable at all. This is so of a private individual buying and selling a small residential apartment, and it is equally so of a large corporation buying and selling a billion-dollar building. Hong Kong has thus preserved a degree of simplicity in its tax legislation which elsewhere was lost long ago.71

The meaning of ‘trade’ has been frequently litigated in Hong Kong. Most of the cases concern land,72 while almost all the rest are about transactions in securities.73 Given the nature of the problem, and the scale of the revenues at stake, the number of cases is

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70 The issue of whether or not a person is trading arises not only in the case of the purchase and sale of land but in various other circumstances also. Most importantly, it arises in the case of, (1) the purchase, redevelopment and sale of land and (2) the purchase and sale of securities. Whether a particular transaction or series of transactions amounts to trading or not depends on factors traditionally referred to as the ‘badges of trade’. The most important of these are: (1) the period of ownership (the quicker the taxpayer sells the property, the more likely she is to be trading); (2) the number of transactions (the more transactions there are, the more likely the taxpayer is to be trading); and (3) the taxpayer’s intention (if she purchased with the intention of selling in the short-term at a profit, that is a strong indicator of trade). The word ‘investment’ is not used in Hong Kong’s IRO. Nor is it used in this context in the British legislation. But it is routinely used by the courts in this context. See for example Marson v Morton (1986) 1 WLR 1343, 1349: ‘[W]as the taxpayer investing the money or was he doing a deal?’

71 From time to time, it has been suggested that it might be desirable to deal with this problem by incorporating a time limit into the IRO. Thus, selling land within (say) two years of acquiring it would count as trading (and so any gain would be subject to profits tax); and selling land after holding it for two years or more would be treated as the realisation of an investment (and so any gain would be tax-free). But no such amendment has been formally proposed, let alone passed into law. Moreover, this debate seems to have been conducted almost entirely in terms of merely clarifying the law. The idea that it might be desirable to extend the tax system to catch short-term capital gains on land (let alone capital gains generally) seems to enjoy virtually no support in Hong Kong. In its administration of the IRO, however, the department generally acts on assumptions such as, for example, the purchase and sale of land does not constitute trading if the period between the buying and the selling is two years or more. Thus, if the taxpayer holds the land for two years or more, the department will generally accept without further questioning that any gain made on the sale is not taxable; whereas if the taxpayer sells the land within two years of buying it, the department is likely to seek further information. Such assumptions are however of no legal effect and are based on no particular authority.


73 See for example Commissioner of Inland Revenue v Dr Chiang Liang-Jen (1977) 1 HKTC 975 and Commissioner of Inland Revenue v Waylee Investments Ltd (1989) 3 HKTC 410.
unsurprising. The point, however, is not that the matter has been frequently litigated, but that the legislature has been content to leave it to the courts. Thus, an approach which seems old-fashioned and even quaint when judged by the standards of the rest of the developed world, still works well enough in Hong Kong.

Also requiring comment is the word ‘business’ (for s 14(1), as I have recounted, taxes not only the profits of ‘trade’, but also the profits of ‘business’).\(^{74}\) Given the apparent importance of the word ‘business’, one might expect its meaning to have been thoroughly tested. Indeed, given the restricted scope the courts have given ‘trade’, one might expect the Inland Revenue Department to have turned to ‘business’ with enthusiasm. Specifically, one might expect the department to have taken an expansive approach to its interpretation; to have issued assessments to tax accordingly; and, when challenged, to have defended them in court on the basis that the assessee’s activities, if not a trade, were at any rate a business. But it has seldom done so.\(^{75}\)

Rather, this basic issue has been approached almost exclusively in terms of whether the taxpayer’s activities amount to a trade. The reason is simply that the word ‘trade’ was used in the British legislation, and that there was a large body of English case law on its meaning. Consequently, there are many Hong Kong cases on the word ‘trade’; a small number on ‘business’;\(^{76}\) and none at all on ‘profession’. There is thus a curious imbalance in the cases defining the basic scope of Hong Kong’s tax system. In particular, it seems probable that the word ‘business’ is capable of a broader meaning than ‘trade’; that the scope of s 14(1) (properly interpreted) is therefore broader than the Inland Revenue Department has asserted; and that the Hong Kong government has consequently always failed (and is still failing) to collect a significant part of the revenue to which it was (and is) entitled. In most other developed jurisdictions, such a state of affairs would be intolerable and, indeed, difficult to imagine. The government of Hong Kong, in contrast, seems unconcerned.

E Source

Most countries tax resident firms on their worldwide profits, meaning both domestic and offshore profits. Hong Kong, however, does not. Rather, as I have mentioned, profits tax, like property tax and salaries tax, is confined to income derived from Hong Kong. In the vernacular, profits tax (like the other two taxes) is ‘based on the source principle’. Offshore profits, in other words, are simply exempt from tax. My purpose here is not to comment on the merits of this policy (though that is an interesting and important topic),\(^{77}\) but to examine the legislation by which it is affected.

\(^{74}\) Above n 47.

\(^{75}\) It is worth noting that Hong Kong’s courts appear never to have been asked to consider the scope of the word ‘profits’ (which seems fundamental to the meaning of s 14(1)—see above n 47). Once more, this is indicative of the level of simplicity achievable at low rates of tax. The comparison with the judicial consideration given to the word ‘income’ in other jurisdictions is striking.

\(^{76}\) See for example, *Commissioner of Inland Revenue v Bartica Investment Ltd* (1996) 1 HKRC 90080.

\(^{77}\) See Robert E Hall and Alvin Rabushka, *The Flat Tax*, (2nd ed, 1995) for a modern American defense of this approach. The Hall and Rabushka flat tax is, incidentally, structurally similar to Hong Kong’s IRO. This is presumably related to the fact that Alvin Rabushka has long been a student of Hong Kong’s systems of taxation, public finance and government and has written a number of important books about them. See in particular Alvin Rabushka, *Value for Money: The Hong Kong Budgetary Process* (1976).
As will be seen, the simplicity of Hong Kong’s IRO is in this respect extreme. Before examining its terms, however, it is necessary to emphasise that the absence of detailed source rules in the IRO is a far more telling measure of its simplicity than would be the case elsewhere. Many other jurisdictions have detailed rules for determining the source of income. But most of these jurisdictions tax residents on their worldwide incomes. Such jurisdictions’ source rules are not, therefore, the primary determinant of residents’ liability to tax. Rather, their function is, first, to determine the taxability of non-residents’ income (because non-residents are typically taxable only on income derived from within the taxing jurisdiction); and, secondly, to determine the availability to residents of foreign tax credits (because resident taxpayers are typically entitled to credit for foreign tax paid on offshore income, but they are not entitled to credit for foreign tax paid on income derived from the jurisdiction in which they are resident). Thus, many jurisdictions’ tax statutes contain detailed source rules, even though source is not the principal determinant of liability. Hong Kong’s IRO, on the other hand, contains almost nothing of this kind, even though source is the principal determinant of liability (in that profits derived from outside the territory are simply exempt from tax, whether taxed in some other jurisdiction or not).

It is necessary to emphasise also that the source of profits is a far more important issue in Hong Kong than in most other jurisdictions. Indeed, it seems likely that the issue is more important in Hong Kong than anywhere else in the world. This is because the reason for Hong Kong’s existence as a separate jurisdiction is to serve as a center for cross-border trade, finance and investment. The territory was colonised by the British in 1842 expressly for this purpose, and has fulfilled it very satisfactorily ever since (apart from the period from 1941–45, when it was occupied by the Japanese). In the beginning, the colony’s economy was based on the opium trade, which consisted of foisting Indian opium on Chinese consumers. Later, Hong Kong served as an entrepot for international trade in goods generally. After 1945, its economy came to be largely based on manufacturing for export. Then, in the 1970s, Hong Kong became an internationally important financial center. Again, much of this business was of an international nature—that is, it consisted of meeting the needs of lenders and borrowers outside Hong Kong. Later still, in the 1980s, Hong Kong became an important source of investment in the Chinese Mainland. The territory also came to function as a conduit for foreign investment in the Mainland. For these reasons, the purely domestic part of Hong Kong’s economy has always been relatively small; and, since the introduction of taxes on income in 1940, the distinction between domestic profits (which are taxable) and offshore profits (which are not) has been correspondingly crucial.

One might think, then, that if any jurisdiction needs detailed source rules, it would be Hong Kong. In fact, however, the legislation is simple in the extreme. As I have said, s 14(1) of the IRO imposes profits tax only on profits ‘arising in or derived from Hong

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78 An alternative way of looking at Hong Kong’s economic history is that the purpose for which the territory was colonized was to serve as a tax haven; that it has fulfilled that function very satisfactorily ever since; and that the changing nature of its economy has essentially reflected the evolving needs of those who use tax havens. Thus the handover in 1997 marked the formalization of the process whereby Chinese capital took over from British as the principal beneficiary of the tax advantages offered by the territory.
Kong’—and that is it.\textsuperscript{79} As to what these words might mean, the IRO says almost nothing.

In other jurisdictions, it is common for taxing statutes to contain a whole raft of rules for determining the source of profits produced by specific forms of commercial endeavour. Unsurprisingly, such rules typically serve not merely to clarify the law, but to do so in such a way as to prevent the erosion of the tax base. Most importantly, it is common for taxing statutes to provide that profits produced by carrying on a business within the jurisdiction are derived from the jurisdiction. Thus, if a non-resident carries on business within the jurisdiction, any profit produced by the business is taxable there. This basic approach is commonly both endorsed and limited by treaties based on the OECD Model Tax Treaty, Article 7 of which in effect both (1) confirms the right of a contracting state to tax business profits sourced within its territory, and (2) confines the exercise of the right to cases in which the taxpayer has a permanent establishment there.

In addition to the rule applicable to business profits generally, it is common for taxing statutes to contain more specific rules applicable to more specific forms of income, such as interest; income from land; rentals derived from movable property; royalties; insurance premiums; dividends; and so on. Again, treaties based on the OECD Model commonly both confirm and limit contracting states’ rights to tax income of these kinds.

Hong Kong’s IRO contains two rules of this nature. First, sums received for the use of intellectual property in Hong Kong (that is, royalties) are deemed to be derived from Hong Kong.\textsuperscript{80} Such sums are, therefore, taxable. Secondly, sums received for the use of movable property in Hong Kong are likewise deemed to be derived from Hong Kong.\textsuperscript{81} Again, therefore, such sums are taxable. But that is all; apart from these two rules, the territorial scope of profits tax depends simply on the words ‘profits arising in or derived from Hong Kong’.\textsuperscript{82} Most strikingly, the IRO does not provide that the profits of a business carried on in Hong Kong are derived from Hong Kong. Thus, the wording of s 14(1) appears to leave open the possibility that a firm carrying on business in Hong Kong, and without a permanent establishment anywhere else, can derive profits from outside Hong Kong; and that such profits are not subject to tax in Hong Kong.

Moreover, Hong Kong’s courts have confirmed that this interpretation is correct. In other words, Hong Kong’s courts have accepted that it is possible for a part (or even the whole) of the profits of a firm carrying on business in Hong Kong and nowhere else

\textsuperscript{79} See above at note 47. The courts have held that there is no significant difference between “arising in” and “derived from”. See in particular \textit{Commissioner of Inland Revenue v Hang Seng Bank Ltd} [1991] 1 AC 306. Henceforth, for convenience I sometimes use the latter term as covering the former also.

\textsuperscript{80} IRO s 15(1)(a) and (b); see above n 64.

\textsuperscript{81} IRO s 15(1)(d). See above n 64.

\textsuperscript{82} Section 2 of the IRO defines the words ‘profits arising in or derived from Hong Kong’ as including ‘all profits from business transacted in Hong Kong, whether directly or through an agent’. The meaning of this definition remains unclear. What is clear, however, is that, whatever its meaning, it has made little difference in practice, for no court has ever based a decision on it. But see \textit{Commissioner of Inland Revenue v Orion Caribbean Ltd (in voluntary liquidation)} (1997) STC 923 for hints that the definition might be important.
to be derived from outside Hong Kong; and that such profits are therefore not taxable in Hong Kong.  

As is mentioned above, the non-taxability of such profits in Hong Kong does not depend on their being taxable elsewhere. In other words, the profit of a firm resident in Hong Kong will go entirely untaxed to the extent that (1) it is derived from outside Hong Kong and (2) it is derived from a jurisdiction that does not tax it (such as a tax haven). The extent to which Hong Kong firms are able to escape tax as a result of this limit to the scope of the territory’s tax system is unknown, because Hong Kong generally does not require its residents even to disclose their offshore income. It seems reasonable to suppose, though, that the extent to which Hong Kong-resident firms enjoy tax-free offshore income is very substantial. In jurisdictions with higher rates of tax, simply to exclude offshore profits (and other offshore income) from tax would result in revenue losses and inequities so severe as to be probably intolerable. In Hong Kong, it is uncontroversial.

That so basic an issue has been left to the courts is in itself instructive. So, too, is the manner in which the courts have tackled it. Despite a more or less continuous stream of litigation, radical uncertainty persists. The taxability of even routine forms of business activity remains unclear. By the standards of the rest of the developed world, the uncertainty prevailing in Hong Kong would be plainly intolerable. In Hong Kong, however, the level of uncertainty, whilst acknowledged as a problem, is not regarded as a serious one. There has occasionally been discussion of reform, but the available cures seem generally to be regarded as worse than the ailment. One reason for this is presumably the lightness of the burden. Uncertainty as to liability is of course undesirable, but there is certainty of another kind: that the worst possible outcome (from the taxpayer’s point of view) is tax at 17.5 per cent.

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84 It is also possible for profits not to be derived from any jurisdiction. See in particular Commissioner of Inland Revenue v The Hong Kong and Whampoa Dock Co Ltd (1960) 1 HKTC 85; (1960) HKLR 166, which concerned salvage in international waters.

85 That is, the basic policy of not taxing offshore income is uncontroversial. As will be seen in the following section of this paper, since 1940 (when taxes on income were first introduced in Hong Kong) there has been controversy as to where the line should be drawn between taxable domestic income and non-taxable offshore income; and such controversy continues still. But this seems to be universally regarded as a merely technical problem. The idea of extending the tax system to cover offshore income seems to enjoy virtually no support in Hong Kong. Indeed, Hong Kong people seem commonly to be shocked when they learn that other states routinely tax residents on their offshore income.
The Interpretation of the Source Principle: Traders and Manufacturers

In the late nineteenth century and for the first few decades of the twentieth, most British colonies’ tax systems were based on the source principle. In other words, most colonies did not tax residents on their offshore incomes. This was so in, notably, Australia, New Zealand, India, the Canadian provinces and various British colonies in Africa. As the twentieth century went by, however, these jurisdictions generally withdrew this exemption. That is, they extended their tax systems to catch income derived by residents from outside the jurisdiction (though South Africa did so only in 2001). Thus, by the time Hong Kong adopted its source-based tax system in 1940, source-based tax systems had fallen out of fashion almost everywhere else. Before Britain’s other colonies took to taxing offshore income, however, their courts were repeatedly called upon to determine whether particular items of income were derived from within the jurisdiction (and therefore taxable) or from outside it (and therefore not). The Australian case law on the distinction was especially strong, but there were numerous New Zealand, South African, Canadian and Indian cases, too. There was also a series of nine Privy Council decisions.

When Hong Kong’s IRO became law in 1947, the territory’s new Inland Revenue Department assumed that these cases (which, for convenience, I will refer to collectively as ‘the Imperial source cases’) applied in the colony. In due course, this view was confirmed by the colony’s courts. As with the cases on the distinction between ‘trade’ and ‘investment’, this was sensible; for the courts of a small and under-developed colony to have attempted to reinvent the wheel would seem to have been at best a waste of effort. The Imperial source cases thus became in effect part of the law of Hong Kong. These cases established a number of rules (or, at least, guidelines) for determining the source of many different kinds of income. There were rules for determining the source of ‘trading’ profits (that is, profits made by buying and selling things); ‘manufacturing’ profits (profits made by manufacturing and selling things); interest; dividends; royalties; profits made by rendering services; profits derived from transactions in land; insurance premiums; income from employment; and so on. For present purposes it is not necessary to examine all of these rules, but those

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86 I use the word ‘colony’ in this paper generally to include also dominions and other territories. In United Kingdom tax parlance, the word ‘source’ has usually been used to denote economic source. In the colonies, it meant geographic source. This ambiguity is unfortunate, especially since it is not purely semantic. The economic source of income is generally situated in the geographic source, but the two are not the same.

87 For reviews of these cases, see Willoughby and Halkyard, above n 14, and Jefferson VanderWolk, The Source of Income: Tax law and Practice in Hong Kong (3rd ed, 2002). The Privy Council was, and is, the final court of appeal for British colonies (and, in some cases, dominions and other territories). For an analysis of the Privy Council decisions on source, see Michael Littlewood, ‘The Privy Council, the Source of Income and Stare Decisis’ (2004) 121 British Tax Review.

88 See for example Commissioner of Inland Revenue v The Hong Kong and Whampoa Dock Co Ltd (1960) 1 HKTC 85. See also Willoughby and Halkyard, above n 14; and VanderWolk, above n 87.

89 See above n 65–76.

90 See above n 88. Reviews of these cases can be found in the works referred to there, and also in some of the standard texts on the law of taxation in various jurisdictions including the United Kingdom, Australia, South Africa, etc.
bearing on trading profits and manufacturing profits are of such fundamental importance that it is necessary for even a summary account of Hong Kong’s tax system to examine them.91

As regards trading profits, the Imperial source cases had established that a profit made by buying and selling goods is generally derived from the place where the goods are sold. Thus, if a firm buys goods in jurisdiction A and sells them at a profit in jurisdiction B, the profit is generally derived from jurisdiction B. The profit is therefore not taxable in jurisdiction A (assuming jurisdiction A has a source-based tax system).92

For about thirty years, Hong Kong’s Inland Revenue Department administered the IRO in accordance with these rules. Then, in about 1980, the department adopted a more expansive interpretation of s 14(1) (that is, of the words ‘profits arising in or derived from Hong Kong’).93 Specifically, it took the position that the profits of a business carried on in Hong Kong are generally derived from Hong Kong, unless properly attributable to a permanent establishment outside Hong Kong. Moreover, the department succeeded in persuading the courts (including the Privy Council) to accept this view. Consequently, whilst the legislation remained unchanged (that is, s 14(1) continued to provide for profits tax to be imposed only on ‘profits arising in or derived from Hong Kong’), its effective scope was expanded dramatically. Most importantly, in Commissioner of Inland Revenue v HK-TVB International Ltd,94 the Privy Council established the ‘operations’ test, according to which a profit is derived from the place where the taxpayer carried out the operations which ‘in substance’ produced it.95 Thus, if a firm carries on business in Hong Kong, and has no permanent establishment anywhere else, its profit will generally be derived from Hong Kong and therefore taxable there. In the same case, the Privy Council observed that it is only in ‘rare cases’ that a firm carrying on business in Hong Kong can derive profit from outside Hong Kong, unless it has a permanent establishment outside Hong Kong to which it can properly attribute part (or all) of its profit.96 This appears to amount to a comprehensive rejection of the earlier decisions.97

As regards manufacturing profits, the Imperial source cases had established that a profit made by manufacturing goods in one jurisdiction and selling them in another is derived partly from each. Such a profit is therefore taxable in part in each of the two

91 Trading and manufacturing are basic, archetypal economic activities. The taxation of trading and manufacturing profits is consequently indicative of the operation of Hong Kong’s tax system as a whole. To demonstrate more or less the same dynamics by reference to the taxation of profits of other kinds would be straightforward, but tedious.

92 See for example Commissioners of Taxation v Kirk (1900) AC 588; Lovell & Christmas Ltd v Commissioner of Taxes (1908) AC 46; Federal Commissioner of Taxation v W Angliss & Co Pty Ltd (1931) 46 CLR 417; and The Commissioner of Taxation of Western Australia v D & W Murray Ltd (1929) 42 CLR 332.

93 Above n 47.


95 Ibid 407.

96 Ibid 409.

97 For an analysis of this reinterpretation see Michael Littlewood, ‘The Uncertain Geographical Scope of Hong Kong Profits Tax and the Possibility of Reform (11 October 1999) Tax Notes International 1441.
jurisdictions. Thus, if a firm makes a profit by manufacturing goods in jurisdiction C and selling them in jurisdiction D, part of the profit is derived from the place where the goods are manufactured (jurisdiction C) and part from the place where they are sold (jurisdiction D). In such circumstances, source-based tax legislation implicitly requires the apportionment of the profit. That is, jurisdiction C taxes the part of the profit attributable to the manufacturing, and jurisdiction D taxes the part attributable to the selling (assuming that both jurisdictions have source-based tax systems).98

This reinterpretation of s 14(1) has had important consequences for the tax treatment of profits generally, including both trading profits and manufacturing profits. The law of Hong Kong is now that a profit made by buying goods in Hong Kong and selling them elsewhere is generally derived entirely from Hong Kong (unless the sales are effected by a permanent establishment outside Hong Kong); and that such a profit is therefore generally taxable in full.99 Thus, profits of a kind which the Inland Revenue Department and the courts previously accepted as entirely exempt from tax are now taxable in full. At least, that is what the law seems to be—the cases are still too few and far between to allow a definitive statement.

Similarly, the law of Hong Kong now seems to be that a profit made by manufacturing goods in Hong Kong and selling them outside Hong Kong is derived entirely from Hong Kong and therefore taxable in full (unless, again, the sales are effected by a permanent establishment outside Hong Kong). Thus, profits of a kind which the Department previously accepted as taxable only in part are now taxable in full.

This reinterpretation is especially notable, in that it is based on no direct authority at all—for no Hong Kong court has ever been called upon to determine the source of a manufacturer’s profits. The original interpretation was based on manufacturing cases from other jurisdictions, notably Australia.100 That these cases were applicable in Hong Kong was accepted by the Inland Revenue Department and by all Hong Kong’s manufacturers without the point ever being litigated. The current interpretation is based on principles ostensibly derived from Hong Kong cases concerning forms of business having nothing whatever to do with manufacturing (notably banking, film licensing, salvage and trading).101 Again, the applicability of these principles to manufacturing

98 See for example Commissioners of Taxation v Kirk (1900) AC 588; Federal Commissioner of Taxation v W Angliss & Co Pty Ltd (1931) 46 CLR 417; International Harvester Co of Canada Ltd v Provincial Tax Commission (1949) AC 36; Provincial Treasurer of Manitoba v Wm Wrigley Jr Co Ltd (1950) AC 1; and The Commissioner of Taxation (New South Wales) v Hillsdon Watts Ltd (1936–37) 57 CLR 36.


100 See Commissioners of Taxation v Kirk (1900) AC 588; Federal Commissioner of Taxation v W Angliss & Co Pty Ltd (1931) 46 CLR 417; and The Commissioner of Taxation (New South Wales) v Hillsdon Watts Ltd (1936–37) 57 CLR 36.

profits has never been tested in the courts: the Inland Revenue Department simply asserted that it was so, and all of the territory’s manufacturers accepted it.\textsuperscript{102}

Since 1945, Hong Kong’s economy has been heavily dependent on manufacturing for export. It still is, though over the last twenty years or so almost all the actual manufacturing has been shifted across the border into the Chinese Mainland. As will be seen, this has raised new and difficult questions as to the source (and therefore the chargeability to tax) of Hong Kong-based manufacturers’ profits. Given the importance of manufacturing to Hong Kong’s economy, the fact that the source of manufacturing profits has never been litigated is an impressive indicator of the simplicity of its tax system. In other developed jurisdictions, it seems unlikely that such an important principle of law could stand on such a flimsy foundation. To put it another way, the complete lack of cases is powerful evidence of the degree of simplicity achievable at very light levels of taxation. Conversely, it is evidence also of the degree to which the complexity of other tax systems is a product of relatively high rates of tax.

It is difficult to conceive of the government of any other developed jurisdiction taking such a straightforward approach to the important business of defining the basic scope of its tax system. The reasons for this seem clear: if any other developed jurisdiction were to adopt Hong Kong’s approach, the consequences would include an intolerable level of uncertainty, an intolerable increase in the volume of litigation and perhaps also an intolerable collapse in revenue. In Hong Kong, there is indeed a high level of uncertainty; there have been numerous disputes as to the meaning of s 14(1); and possibly the government’s revenues have suffered as a result. But these difficulties could not by any stretch be called intolerable. The reason seems again to be the very low rates of tax.

\textbf{G The Taxation of Hong Kong/Mainland Joint Ventures}

Over the last twenty years or so, Hong Kong’s manufacturing industry has changed dramatically. Indeed, the transformation in manufacturing has transformed Hong Kong’s whole economy. Nowadays, almost all of Hong Kong’s manufacturers do almost all of their actual manufacturing in the Chinese Mainland. The reason is that land, labour and utilities (electricity, water and so on) are much cheaper in the Mainland than in Hong Kong. Many foreign firms too, of course, are involved in manufacturing operations in the Mainland. The reason, again, is the cheapness of land, labor and utilities. Many of these firms conduct their Mainland manufacturing operations through a Hong Kong subsidiary (for various reasons, including the tax savings to be had).

\textsuperscript{102} It is possible that the Department assessed only new taxpayers on the basis of its revised interpretation of the law. That is, it might have continued to assess existing taxpayers on the basis of its original interpretation. In other words, the Department might have “grandfathered” its treatment of taxpayers already benefiting from the earlier, more generous interpretation. If this is so, it is further evidence of what is achievable at very low rates of tax (because surely it would not be acceptable in, say, Australia to discriminate among taxpayers in this way). The only alternative possibility seems to be that the Department radically increased the extent of the liability of existing taxpayers on the basis of its own reinterpretation of the legislation, unsupported by any direct authority. But if this is so, it, too, is intriguing evidence of what is possible at low rates of tax.
Very commonly, the Hong Kong firm (or the Hong Kong subsidiary of the foreign firm) enters into a joint venture with a Mainland entity. This often takes the form of what is called a ‘processing arrangement’, the terms of which are typically as follows. The Mainland entity provides the factory, the workers, and the utilities; and the Hong Kong firm (or the Hong Kong subsidiary of the foreign firm) provides designs, prototypes, management expertise, factory plant, quality control, raw materials, finance and so on. These factors are combined to produce goods in accordance with the Hong Kong firm’s specifications. The goods so manufactured are the property of, and are sold by, the Hong Kong firm. Sometimes they are sold to foreign customers (mainly in the United States or Europe), sometimes to customers in Hong Kong, and sometimes to customers in the Mainland. The Hong Kong firm pays the Mainland party a ‘processing fee’ for its part in the process.

Businesses of this type present interesting challenges to Hong Kong’s tax system. Take the case of a Hong Kong firm which has entered into a processing arrangement with a Mainland entity to manufacture, say, sports shoes. The Mainland entity contributes a factory and workers; and the Hong Kong firm contributes the machinery to go in the factory. The Hong Kong firm acquires prototype shoes from, say, an American customer, which designs the shoes and controls the brand name to be attached to them. The Hong Kong firm also acquires, perhaps from a Taiwanese firm, the raw materials requisite to manufacture shoes in accordance with the prototype. The materials are shipped from Taiwan to the factory in the Chinese Mainland. At the factory, the materials are made into shoes. The Hong Kong firm pays the Mainland entity a processing fee, and sells the shoes to its American customer. The Hong Kong, American, Mainland and Taiwanese firms might all be independent; alternatively some or all of them might be related.

As a result of these operations, the Hong Kong firm makes a profit. The chargeability of this profit to Hong Kong tax depends on whether it is covered by Hong Kong’s IRO. Once more, the Ordinance contains no provision directed specifically at businesses of this kind (even though they account for a very large part of Hong Kong’s economy). Consequently, the liability of the firm to Hong Kong tax depends on section 14(1) of the Ordinance. Section 14(1), as has been seen, provides that profits tax is charged on ‘profits arising in or derived from Hong Kong’. The question, then, is: is this profit derived from Hong Kong? If so, it is taxable; if not, not. This basic question raises

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103 It is also possible in some circumstances for Hong Kong firms (and the Hong Kong subsidiaries of foreign firms), after overcoming various bureaucratic hurdles, to operate in the Chinese Mainland either directly themselves or indirectly through a wholly-owned subsidiary. The tax treatment of (and the planning opportunities available to) such firms offer further evidence of the simplicity achievable at low rates of tax, but examining them would inordinately increase the length of this paper. It might be worth noting, though, the well-established tradition of Mainland firms and individuals channelling funds through wholly-owned Hong Kong corporations in order to reinvest them in the Mainland. One reason they do this is so as to qualify for tax incentives offered to ‘foreign’ investment.

104 Such processing arrangements are a species of ‘contractual’ joint venture. Also possible are ‘equity’ joint ventures, in which an entity is established (typically under Chinese law) with the foreign and Chinese joint-venturers as shareholders. Again, the tax treatment of such arrangements provides compelling evidence of the simplicity achievable at low rates of tax, but examining them would inordinately increase the length of this paper.

105 See above n 47.

106 Above n 79.
several subordinate questions. In particular, does the basic question require an all-or-nothing answer? That is, does s 14(1) require that the profit must be either taxable in full or not taxable at all? Or does s 14(1) implicitly require the apportionment of the profit? In other words, does s 14(1) impose tax on the part of the profit attributable to the firm’s operations in Hong Kong, but not on the part attributable to its operations outside Hong Kong? Worse: if s 14(1) implicitly requires apportionment, how is this implicitly-required apportionment to be calculated? These are difficult questions. The IRO itself provides no answer to them: s 14(1) provides that tax is charged on ‘profits arising in or derived from Hong Kong’—and that is all. It is worth noting, though, that the difficulty is exacerbated by the fact that, no matter how these questions are answered, the answers are virtually certain to prompt responses in taxpayer behavior: if the profits of a particular form of processing arrangement turn out to be taxable, firms will tend to try some other.

It is not unusual for new ways of doing business to pose challenges to taxation (or, depending on one’s point of view, opportunities for tax planners). The instance generating much recent interest is of course the Internet. It is necessary to emphasise, though, that the challenge to Hong Kong’s tax system posed by Hong Kong firms involving themselves in manufacturing operations in the Chinese Mainland is far greater than that posed by the Internet. The Internet is obviously important. But manufacturing is a core economic activity for Hong Kong, and almost all of the territory’s manufacturers have decamped across the border. Firms not previously in the business of manufacturing have taken it up, in the light of the opportunities to be found in the Mainland. And many new firms have been formed for the purpose. From the Hong Kong Government’s point of view, the issue is critical.

One response would have been to legislate. But detailed new rules would no doubt have led to new problems; new problems would in turn have led to more new rules; the simplicity of the IRO would have been lost. Also, legislating might have presented political difficulties. So the Hong Kong Government did not suggest legislation. Instead, it left the Inland Revenue Department to deal with the problem. The department’s solution was strikingly simple. In 1992, it announced that it would treat the profits of Hong Kong firms engaged in manufacturing operations in the Mainland as 50 per cent taxable.107 In other words (to give this manifestly pragmatic solution a semblance of orthodox legal justification), the department adopted the view that s 14(1) implicitly requires the apportionment of profits produced in this way; and implicitly requires also that this apportionment be calculated by simply dividing the profit in two.

The only problem was that there was no authority whatever for the department’s interpretation of the law—at least, the department offered none.108 Commentators were
quick to point to the flaws in the department’s position. In particular, they pointed out that, according to the department, a profit made by manufacturing goods in Hong Kong is derived entirely from Hong Kong and therefore taxable in full.\textsuperscript{109} Thus, the department’s position on firms carrying out their manufacturing in Hong Kong seems to be based on the principle that a manufacturer’s profits are derived from the place where the manufacturing is carried out, and this seems difficult to reconcile with its view that profits produced by manufacturing goods in the Mainland are even partly derived from Hong Kong. Moreover, complained the critics, the department offered no authority for its view that the correct method of calculating the implicitly-required apportionment is simply to divide the profits in two. Perhaps, too, they went on, the department was wrong to regard the place of sale as altogether irrelevant.\textsuperscript{110}

The complaints were loud, but taxpayers seem to have been amazingly shy about standing by them. The department proceeded to assess firms to tax on the basis of the policy it had announced. Taxpayers complained but, as before, they did not litigate. To date, there is not a single case of a taxpayer objecting to an assessment of this kind. They have complained, but they have paid the tax. Once more, it is difficult to imagine the government of any other developed jurisdiction dealing with a tax problem (any tax problem, let alone one of this magnitude) in this way—that is, by issuing assessments to tax on the basis of a policy with a certain rough and ready justice to it, but based on only the flimsiest legal authority. Equally, it is difficult to imagine the taxpayers of any other developed jurisdiction responding as Hong Kong’s have done—by paying the tax, despite the flimsy legal basis of the assessments. Once more, it seems reasonable to suppose that the reason Hong Kong’s tax system can operate in this way, while others cannot, is the difference in the rates of tax. In Hong Kong, the rate of tax for corporations is 17.5 per cent. The department’s policy of 50/50 apportionment therefore results in an effective rate of 8.75 per cent—a significant cost; and worth complaining about; but not, apparently, worth litigating.\textsuperscript{111}

\section{H Provisions Notable for their Absence}

The brevity and simplicity of Hong Kong’s IRO is largely due to the fact that provisions of kinds regarded as indispensable elsewhere are simply not there. In particular, much of the complexity of other countries’ tax statutes is due to the need to prevent avoidance. Hong Kong, in contrast, has evidently not felt the same need. Given that offshore income is generally exempt from tax, there is plainly no place in Hong

\textsuperscript{109} See above n 99 and 100.

\textsuperscript{110} See above n 92 and 94.

\textsuperscript{111} Given that Hong Kong’s IRO is unusually generous in most other respects also (deductions, depreciation, transfer-pricing), the amount of profits, as calculated under it, is typically less than it would be under other jurisdictions’ tax systems. The effective rate of 8.75 per cent is therefore typically applied to a smaller amount.
Kong’s tax system for CFC rules. Therefore, there are none. Nor are there any rules restricting the deductibility of interest incurred by thinly-capitalised companies. There is a provision intended to prevent the abusive pricing of transfers between associates, but it consists of only two relatively short sentences, its drafting seems inadequate, and in any event there is no reported case of the department ever invoking it. Similarly, there is a section aimed at restricting the abuse of corporate losses, but it, too, is brief and poorly-drafted and has rarely if ever been invoked. The taxation of perks is notably generous. Employer-provided housing is taxed at a small fraction of its actual value, and various other benefits (for example, company cars and interest-free loans) are not taxed at all. Expenditure on such items by employers is in all ordinary circumstances deductible (or depreciable, in the case of expenditure of a capital nature). The scope for avoidance is therefore substantial, but this seems not to be regarded by the government as problematic. Indeed, the government is itself a notable provider of tax-effective perks (mainly housing and cars) to its employees. There is a general anti-avoidance provision, similar to those of Australia and New Zealand, but Hong Kong’s Inland Revenue Department has been relatively reticent about invoking it. Whether the Ramsay principle applies in Hong Kong remains unclear, because the Inland Revenue Department, in accordance with its generally unhurried approach, has yet to raise the issue.

Another important cause of complexity in tax law is the attempt to eliminate, or at least ameliorate, inequity. In particular, in most countries, a great deal of complexity is attributable to the attempt to provide as equitably as possible for persons whose incomes are relatively small and to achieve a reasonable degree of integration between the tax system and the system of social welfare. Hong Kong’s tax system, as I have explained, simply exempts the poorest two-thirds of the workforce from tax altogether.

112 IRO s 20.

113 Because taxes are lighter in Hong Kong than in most other places, groups of companies have traditionally set their transfer prices so as to shift income to Hong Kong rather than away from it. The abusive pricing of transfers has therefore generally operated to the advantage of the Hong Kong treasury rather than against it. But even light taxes are worth avoiding, and in recent years it has become very common for Hong Kong firms and individuals to shift income to other jurisdictions. For some years, the jurisdiction of choice has been the British Virgin Islands. The number of Hong Kong-controlled companies established there is rumoured to run to hundreds of thousands—an impressive number, given Hong Kong’s total population of about seven million. Hong Kong’s Inland Revenue Department has challenged such income-shifting arrangements, but in the only cases to appear in the law reports the department has based its challenge on grounds other than s 20. In some cases it has denied the deductibility of payments made to associates; in others, it has invoked the general anti-avoidance rule contained in s 61A of the IRO.

114 IRO s 61B.

115 See generally Willoughby and Halkyard, above n 14.

116 IRO s 61A.


118 The courts have upheld the department’s argument that the Ramsay principle applies to the interpretation of Hong Kong’s Stamp Duty Ordinance (Arrowtown Assets Ltd v Collector of Stamp Duty (2004) 1 HKLRD 77) and Estate Duty Ordinance (Shiu Wing Ltd v Commissioner of Estate Duty (2000) HKCFAR 215; (2000) 3 HKLRD 76), but the department has not yet raised the argument in a case under the IRO.
The need to achieve equity among this part of the populace thus does not arise.\textsuperscript{119} The inequity among the other third is considerable. Indeed, as the Hong Kong government itself has acknowledged (though not recently), the territory’s tax system is ‘inherently inequitable’.\textsuperscript{120} In particular, some forms of income are taxed (profits, rents and salaries), whereas others are not (interest, offshore income, perks).\textsuperscript{121}

Moreover, of those forms of income which are subject to tax, some are taxed at different rates from others. For example, rents received by a natural person are taxed at a flat 16 per cent;\textsuperscript{122} rents (and other income) received by a company are taxed at 17.5 per cent;\textsuperscript{123} and income from employment is taxed at rates varying from 0 per cent to 20 per cent.\textsuperscript{124} Similarly, companies can deduct their actual expenditure incurred in producing rental income; whereas natural persons cannot, but are effectively assumed to have incurred expenditure equal to 20 per cent of rents, irrespective of actual expenditure.\textsuperscript{125} But there are very few complaints about such inequities. Apparently people do not object to the inequitably light contribution required of their neighbors, if their own liability is capped at 16 per cent.

III THE FACILITATION OF SIMPLICITY

What, then, has made it possible for Hong Kong to retain such simplicity in its tax law? It might be said that the place was colonised for the purpose of serving as a tax haven; that it serves that purpose still; and that the rudimentary state of its tax law should therefore come as no surprise. There is considerable truth in this, but it falls far short of a complete explanation, for Hong Kong’s is a modern, complex, affluent society. The populace numbers seven million. The government, although not democratic, is mindful of public opinion. It finances a range of public services including a large public housing program, a comprehensive public health service and an expensive public education system. In some respects, Hong Kong’s public services are not up to the standard of those to be found in comparably affluent western societies. For example, Hong Kong’s public housing is cramped and uncongenial by western standards. In others, they are better. Examples include the public transport system, the financing of the territory’s eight universities and the preservation of extensive undeveloped parkland adjacent to urban areas. The simplicity of Hong Kong’s tax law cannot, therefore, be so easily written off.

The factors which appear to have made this simplicity possible include the absence of democracy; the fact that the Hong Kong government has generally operated at a

\textsuperscript{119} At least, the need to achieve tax equity does not arise. Whether the Hong Kong Government should do more to redress the gross inequality of incomes to be found in the territory is another question.


\textsuperscript{121} See above n 5 to 8.

\textsuperscript{122} See above n 14 to 19.

\textsuperscript{123} See above n 19 and 36.

\textsuperscript{124} See above n 20 to 25.

\textsuperscript{125} See above n 16 to 19.
surplus; the stability of the tax system over time; perhaps also a Chinese aversion to confrontation and litigation; and, most importantly, the lightness of the burden. Each of these requires comment.

Hong Kong’s system of government (outlined briefly above)\(^\text{126}\) is, and always has been, undemocratic and dominated by business interests. That such a government should finance itself by means of a simpler tax system than is to be found in most democracies is unsurprising. It is worth noting, though, that in other jurisdictions, especially the United States, the influence of business interests over tax policy has commonly manifested itself in the form of incentives of various kinds, and that these have tended to entail legislation of considerable complexity. In Hong Kong, in contrast, this had happened hardly at all.\(^\text{127}\)

From 1945 (when British rule was restored after the Japanese occupation) until 1997 (when Hong Kong returned to Chinese rule), Hong Kong’s financial secretaries were perennially worried that the colony’s tax system would fail to raise the revenues required to finance the massive expansion of the public services which, the British and colonial governments had decided, post-war sensitivities required.\(^\text{128}\) But this never happened. Rather, almost every year, despite exponentially increased government spending, the IRO (together with the government’s other sources of funds) produced greater revenues than the government required. Consequently, the government almost always operated at a large surplus, and so accumulated large reserves.\(^\text{129}\) It was never short of money, and so could afford not to plug all the gaps in its tax statute.\(^\text{130}\) Ironically, however, as soon as the Hong Kong government took the revenue-producing power of the IRO for granted, in the mid-1990s, the Asian financial crisis struck, and the government found itself having to operate at a deficit. This has not yet, however, led to any compromising of the tax system’s simplicity. The government has continued to amend and add to the IRO, but at more or less the same rate as before.

Hong Kong’s tax system is also unusually, perhaps uniquely, stable. There has been no basic change in the system since 1947. Hong Kong has thus been spared the kind of complexity that results from repeated changes in policy. This stability is itself of course

\(^{126}\) See above n 2.

\(^{127}\) Particular industries and commercial sectors have often sought specific tax concessions in Hong Kong, but the government has consistently refused. The allowances for investment in plant and machinery are very generous (see above n 44), but these are not industry-specific and, as the government itself has acknowledged, operate in effect as an across-the-board reduction in the rate of profits tax (thus affecting also a relative shifting of the burden by stealth from business profits to income from employment). For example, these allowances are available not only for manufacturing plants in the traditional sense but also for office fit-outs, company cars, works of art and so on. In recent decades, industry-specific tax provisions have fallen out of favour in most countries. In this respect, world opinion has changed so as to accord with what Hong Kong has been doing consistently since 1940 (when taxes on income were first introduced in the territory).

\(^{128}\) In Hong Kong (both in colonial times and since), the Financial Secretary was (and is) roughly equivalent to the Secretary of the Treasury (in the United States) or the Chancellor of the Exchequer (in the United Kingdom).


\(^{130}\) See Littlewood, above n 7.
largely attributable to the undemocratic system of government. The return of Hong Kong to Chinese rule in 1997 entailed no discernible change in tax policy. On the contrary, the Basic Law enshrines and gives constitutional status to the tax policy pursued during the colonial period.¹³¹

It is sometimes said that the Chinese people, or at least the Hong Kong Chinese, are generally non-confrontational, non-litigious and law-abiding. Perhaps this is so. The colonial Hong Kong Government, however, appears to have regarded the Hong Kong Chinese as even more prone to tax evasion than the expatriate part of the populace.¹³² The attitudes, beliefs and practices of the Hong Kong people are subjects particularly deserving of research, not least because the populace largely selected itself on the basis of an aversion to Communist rule. (The majority of the population are either immigrants or the children of immigrants from the Mainland.) Much work has been done in this field,¹³³ but it touches hardly at all on their attitudes to taxation. All that can be said, then, is that this is a subject in urgent need of research.¹³⁴

But of all the factors making feasible the extreme simplicity of Hong Kong’s tax system, one seems paramount—the exceptional lightness of the burden. To prove that the lightness of the burden is a more important causal factor than the others I have mentioned is of course impossible. There are large gaps in the evidence, and, even if these could be filled, the basic problem of demonstrating causation would remain.

Nonetheless, the proposition seems reasonable. More specifically, it seems reasonable to suppose that the exceptional simplicity of Hong Kong tax law could not have been maintained at substantially higher rates of tax. In other words, it seems probable that if the Hong Kong Government had substantially increased the rates of tax, it would have found it necessary also to complicate the IRO with the sorts of provisions which are elsewhere regarded as obvious necessities, but which it currently does not contain. In particular, it would probably be necessary to add rules that would be necessary to: (1)

¹³¹ Basic Law, article 108. See also above at note 2. The interpretation and enforceability of article 108 appear to raise difficult questions which remain as yet wholly unresolved. It is plain, however, that the Chinese Government, the Hong Kong Government and all the major political parties in Hong Kong are determined that the handover should not result in, or permit, any change in basic tax policy.

¹³² See Littlewood, above n 7.


¹³⁴ Such research is needed for several reasons. First, such legitimacy as the Hong Kong government possesses rests on its claim that it governs in the interests of the populace generally. In the absence of democracy, research is therefore needed to determine if the Hong Kong’s people’s preferences are indeed as claimed by the government. Some of their preferences (for example, their opinions of the Chief Executive) have been the subject of considerable research; but very little has been done on the extent to which they understand and approve of their tax system. Second, Hong Kong’s tax system is unusual in a number of important respects (one of these being its simplicity), and consequently of potential theoretical interest. But it is difficult to draw useful conclusions from it without being able to test the government’s claim that the territory’s people generally approve of both its tax system and its public finances. One powerful piece of evidence, however, is that there is no PAYE in Hong Kong; and that the tax system instead functions satisfactorily on the basis of taxpayer’s active compliance. (See above, under the heading Salaries Tax). This gives Hong Kong’s tax system a kind of legitimacy that cannot be claimed by the governments of most other developed jurisdictions (because if they abolished PAYE and attempted instead to rely on the active compliance of their taxpayers, their public finances would be reduced to chaos).
to make it at least somewhat more difficult to avoid tax;\textsuperscript{135} and (2) to ameliorate at least the grosser inequities which currently exist in the system.\textsuperscript{136} It seems reasonable also to regard the other factors I have mentioned (the lack of democracy; the surpluses; the tax system’s stability; and Chinese cultural norms) as perhaps facilitating simplicity, but not as necessary conditions for it.

IV CONCLUSION

Hong Kong tax law is very simple. The obvious measure of its simplicity is the succinctness of the statute. But the difference between Hong Kong’s tax system and those of the rest of the developed world is not merely quantitative; it is not just that other countries’ tax law consists of ten times, or a hundred times, as many words as Hong Kong’s. Rather, the difference is qualitative too. Hong Kong’s IRO is not just a leaner animal, but a different beast. Judged from the perspective of other developed common law jurisdictions, there are gaps which are difficult to fathom. How can it be, for instance, that the taxation of Hong Kong/Mainland joint ventures—one of the territory’s most important forms of business—is conducted, and conducted satisfactorily, on the basis of no direct authority? Viewed from outside the territory, the approach of Hong Kong’s Inland Revenue Department seems lacking in authority, even illegitimate—yet at the same time puzzlingly benign. It can also be seen, however, as robust, straightforward and sensible. Any taxpayer, at any time, could object to the department’s interpretation, and so oblige the department to defend it in court. Perhaps, one day, one will. In the meantime, the system works—and costs much less to run than it would if there were a rule to cover every case, and the courts were called upon to resolve every doubt.

The main reason for studying the simplicity of Hong Kong tax law is that it might be possible to learn from it something of more general application. Specifically, it seems possible that other governments, seeking to redress the appalling complexity of their tax laws, might be able to learn something from Hong Kong. Two lessons might be tentatively suggested.

The first is that the degree of simplicity which very low rates of tax might make possible seems commonly to be underestimated. To suggest that other governments might cut their taxes (and reduce their revenues) so as to facilitate the simplification of their tax laws would not be helpful. On the other hand, any tax reform is likely to be less than optimal if it is based on fallacious assumptions as to the relationship between the weight of the burden and the complexity of the law needed to collect it. In any project of tax reform, it is necessary to consider numerous variables, and one of these is the relationship between the rates of tax and the complexity of the law.

The second lesson which Hong Kong seems to offer is that a legislature might avoid considerable complexity by placing greater trust in the judges. The complexity of most

\textsuperscript{135} As is mentioned above, it is routinely possible in Hong Kong to escape tax by such simple means as remunerating employees in kind rather than in cash (see above n 115) and transferring income to offshore entities (see above n 113).

\textsuperscript{136} As is mentioned above, some forms of income are taxed and others are not, and of those forms which are taxed, some are taxed at different rates from others. See above n 120.
countries’ tax laws is very largely due to the perceived need to provide for every conceivable case; and to spell out the rules in advance, so that taxpayers can make commercial decisions with reasonable certainty of the tax consequences to follow. Hong Kong’s legislature, however, has promulgated rules of a very general nature, and left it to the courts to interpret them in such a way that the system works. This has meant, most importantly, that it has fallen to the courts to interpret the legislation in such a way as to accord with two basic norms. First, taxation must be in accordance with the law. It must not be, or appear to be, arbitrary or capricious. Second, the law must be interpreted in such a way as not to permit excessive erosion of the government’s revenues. Hong Kong’s courts seem to have succeeded on both counts.

This, in turn, has been possible only because the legislature produced a statute capable of sustaining a workable interpretation. The best example is the one I have laboured: that Hong Kong profits tax is imposed only on profits ‘arising in or derived from Hong Kong’. What these words mean has been determined by the courts; and the courts have developed a meaning which is adequately principled, adequately respectful of taxpayers’ rights and adequately protective of the government’s revenues.

It might be said that this is not a function that can satisfactorily be left to the courts. In so general a form, this proposition seems to be false, for the case of Hong Kong disproves it. Perhaps, then, there is something about Hong Kong, or its tax system, which makes it possible for its courts to bear such a burden, even though it would not be possible elsewhere? It is difficult, though, to see what this might be—other than, of course, that the rates of tax in Hong Kong are very low.

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137 IRO s 14(1); see above n 47.

138 As I have also explained, the taxation of Hong Kong/Mainland joint ventures depends on an interpretation of the law devised not by the courts but by the Inland Revenue Department. But the reason no-one has challenged it is presumably that taxpayers think the courts unlikely to interpret the statute any more generously.