Tax reform with the introduction of a Goods and Services Tax in Hong Kong

Release of Consultation Document

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Introduction

On 18 July 2006 the Financial Secretary, Mr. Henry Tang, released the Government's long anticipated Consultation Document on GST and tax reform in Hong Kong entitled *Broadening the Tax Base, Ensuring our Future Prosperity: What's the Best Option for Hong Kong?*

The Consultation Document, which runs to almost 100 pages, presents the rationale for reform, a proposed GST framework, household and business offsets, some analyses of the implications and a timetable.

KPMG is honoured to be engaged by the Government as its GST adviser. We welcome the release of the Consultation Document and support the development of a suitable GST tax reform initiative for Hong Kong.

With the recent improvement in the local economy and improved budget finances, there is no longer a necessity to use a GST to raise additional revenue to fill the budget deficit. Therefore, the Government has proposed to return the GST revenue to the community in a variety of forms, including household compensation and offsets, as well as tax relief and other business friendly measures. Based on the experience of the successful introduction of GST in Singapore and Australia, and given the current fiscal outlook for Hong Kong, a revenue neutral tax reform package should assist in its acceptance by the community.

The Consultation Document reiterates the rationale for Hong Kong to broaden its tax base and explains why GST is the best option. For those who have followed this debate over the past five years – during which time Hong Kong's revenues have been especially volatile – the case for reform is well documented and compelling. The profits and earnings tax rate differentials between Hong Kong and regional competitors have also narrowed markedly since 2001.

Timing

The Government has proposed an almost nine-month consultation process, until the end of March 2007. The end of the consultation process will be after the Chief Executive Election and next year's Budget.

The Consultation Document indicates that any decision to proceed with implementation will be made by the next Government, which takes office on 1 July 2007, following a recommendation to be determined at the conclusion of this consultation exercise.

The actual commencement date for any GST is stated to take around two to three years after a decision is made; that means not before 2009 or 2010.

History

The debate on the introduction of a consumption-based tax in Hong Kong dates back to the 1980s. More recently, in 2001, the then Financial Secretary, now Chief Executive, Mr. Donald Tsang, formed the Advisory Committee on New Broad-based Taxes (hereafter referred to as the Advisory Committee) to examine options for broadening Hong Kong's tax base. KPMG was engaged at that time by the Advisory Committee to prepare the Tax Base Study, which analysed Hong Kong's tax base compared to other jurisdictions and assessed possible base-broadening options.

In 2002, after a period of public consultation, the Advisory Committee recommended the adoption of a Goods and Services Tax (GST) as the best option to address the structural problems of Hong Kong's tax base.

At the end of 2004, the current Financial Secretary, Mr. Henry Tang, received a report from the Government taskforce established to look into the implementation of GST in Hong Kong. Following that report, the current Consultation Document was prepared.

What is GST?

GST (otherwise known as VAT) is a multi-stage value-added tax. It is the most common form of domestic household consumption tax (the other types are a single level sales tax or turnover tax) and has been adopted in over 135 countries, including all OECD jurisdictions except the United States (which has state-based retail sales taxes).

Under a GST, the consumer bears the total tax. The GST uses a tax and credit mechanism throughout the sale and distribution chain to tax the "value-added" by each business at each stage. Tax is charged on the value of the outputs or sales of a business (output tax) less the tax incurred on the inputs or purchases of the business (input tax). Only the "net" amount or difference between the output tax and input tax is remitted (or refunded if negative) by each business to the tax authority.

Consistent with the principle of only taxing domestic consumption and in order to accommodate cross-border flows, GST is not charged on exports (as they will be consumed somewhere else), but is charged on imports when they enter the local market.

The GST system requires businesses to register (this is compulsory if above the specified turnover level, but otherwise is voluntary). GST is only paid by registered businesses (and other prescribed activities or bodies) on taxable supplies made in the course of their business (or other prescribed activity) for consideration. Supplies can cover goods, services, rights, real and intangible property. Consideration can cover cash payments and non-monetary or in-kind consideration. Wages and salaries and private sales (for example the personal items of a sole trader) are not subject to GST.

There are three types of supplies under the GST, as follows:

- Taxable supplies – these supplies are subject to output tax, and input tax can be reclaimed
- Zero-rated supplies – these supplies are not subject to output tax, but input tax can still be reclaimed
- Exempt supplies – these supplies are not subject to output tax, but input tax cannot be reclaimed.

The Annex illustrates examples of the impost of GST under the three different types of supplies.

GST framework

For those who have been following the discussion and debate in Hong Kong regarding GST over the last few years, the Government's proposed framework should not come as any surprise. The framework is broadly consistent with both international best practice and recommendations from the Advisory Committee and International Monetary Fund (IMF).

The Government is proposing a low-rate GST (not yet determined but 5 percent is used for illustrative purposes). A rate of 5 percent would be comparable with the lowest rates in the region, for example in Singapore, Japan and Taiwan.

The high registration threshold (HK$5 million turnover) proposed means that small and medium sized businesses will not be compelled to be part of the GST system.

The Consultation Document proposes that GST will apply to a broad tax base, with few zero-rated or exempt supplies. In this respect, the proposed design is more similar to Singapore, than to Australia or the United Kingdom.

The following table provides a high level comparison of the GST framework proposed for Hong Kong with those in Singapore, Australia and the U.K.

	Hong Kong	Singapore	Australia	U.K.
Rate	5% (illustrated)	5%	10%	17.5% standard or 5% reduced rate
Threshold	HK$5 million	SGD1 million (HK$4,940,000)	AUD50,000 (HK$292,000)	GBP 61,000 (HK$877,000)
Basic food	Taxable	Taxable	Zero-rated	Zero-rated
Education	Taxable	Taxable	Zero-rated	Exempt
Health services	Taxable	Taxable	Zero-rated	Exempt
Financial services	Zero-rated (definition subject to consultation)	Exempt (narrow definition)	Exempt (narrowest definition) & special credit on some inputs	Exempt (broad definition)
Commercial property	Taxable	Taxable	Taxable	Exempt with option to tax
Residential property	Exempt	Exempt	New homes sales taxable / other sales and all rentals exempt	New homes sales zero-rated / other sales and all rentals exempt
Exports & international services	Zero-rated	Zero-rated	Zero-rated	Zero-rated
Tourist Refund Scheme	Yes	Yes	Yes	Yes

Unlike some overseas jurisdictions, the Consultation Document proposes no special treatment for any kind of food, education, healthcare, clothing or public transport. Accordingly, these daily expenditures are proposed to be subject to tax.

The overall broad base, low rate and lack of exemptions or special treatments proposed for Hong Kong should make the GST more business-friendly. Overseas experience shows that many zero-rated or exempt categories add considerable complexity (and implementation costs) to a GST system.

The most interesting areas for business in Hong Kong will be the treatment of financial services and property. These two sectors represent a significant part of the local economy yet are often difficult to tax under a value-added tax regime.

Financial services

The Government proposes Hong Kong be the first jurisdiction to adopt a zero-rating regime for defined financial supplies. From a business efficiency and international competitiveness perspective this represents a very positive move. In other jurisdictions, where financial supplies are exempt, financial institutions cannot recover all their input tax and therefore face higher operating costs. The proposal for Hong Kong will ensure that "stuck" GST input tax that is common in other jurisdictions will not arise in Hong Kong. It also advances the international trend towards greater input tax recovery for financial suppliers to its logical next step – full input tax recovery.

Financial institutions will want to actively engage the Government to ensure a workable, effective and efficient financial supplies definition can be agreed upon so the zero-rating proposal can proceed. In this respect, it is important to note that previous overseas attempts to either fully tax or fully zero-rate financial supplies have failed to come to fruition – except for New Zealand's partial domestic zero-rate for business-to-business transactions.

Property

The proposed treatment of property is similar to the Singapore approach. Taxing non-residential property is the preferred international GST practice and should relieve business of any input tax, while exempting residential property is also fairly common.

The Consultation Document indicates that the Government considered taxing new or first sales of residential property (like Australia, New Zealand and (partially) Canada and also recommended by the IMF) but proposes exempt treatment as the most feasible. Developers should welcome the more straightforward exemption approach (albeit input tax apportionment issues will arise) and the overall lower tax impact on new residential property. Exempting new residential property should also help avoid the Australian situation where new residential construction was accelerated prior to GST commencement only to slump shortly thereafter.

Import/export trade

Zero-rating for exports is the international norm for GST and is also the proposed treatment for Hong Kong. In doing this, all exports are fully relieved of any GST impost. A wide definition of exports is proposed to cover exported goods and international supplies, including, for example, international transport and logistics services.

The proposed framework also includes a number of schemes to address issues regarding the very important import/export trade. The schemes include a Deferred GST Payment Scheme, a Qualifying Exporters Scheme, Approved Temporary Storage Areas and Bonded Warehouses. In combination, when considered in the context of normal GST rules, these should cover off just about every import/export situation.

The most significant facilitation measure is the Qualifying Exporters Scheme that is to be modelled on the Singapore Major Exporter Scheme. It allows qualified importers to indefinitely defer any import GST; thereby it effectively relieves them of the GST on importation. It is proposed that qualification will require export (of both goods and services) of at least 51 percent of turnover and as such most major trading companies should be able to qualify for this important concession, hence relieving them of GST on their imports.

Tourist Refund Scheme (TRS)

A TRS is proposed to be available for all exit points; namely the airport, all seaports and land border crossings. To achieve this, a system based on the Australian transparent “sealed bag”, with appropriate modifications is proposed. A minimum spend of HK$1,500 is proposed to qualify for a refund.

Treatment of Government, charities and other not-for-profit bodies

The Government proposes to include government bodies and charities registered under Section 88 of the Inland Revenue Ordinance (IRO) in the GST system, predominately to allow them to reclaim their input tax. However, rather than zero-rate or exempt their supplies, which brings with it definitional complexities, they propose to subject to GST the commercial activities of these bodies. Such treatment will make their fee paying services consistent with businesses from a GST perspective.

Other not-for-profit bodies (such as clubs and associations) will only be part of the GST system if they are already subject to Profits Tax under Section 24 of the IRO.

Tax relief and compensation measures

With an estimated HK$30 billion in GST revenue per annum with the illustrated 5 percent GST rate, there is considerable scope for the Government to put forward generous compensation measures and significant tax relief.

The Consultation Document proposes (unspecified) Profits Tax and Salaries Tax reductions. Examples are included for returning all surplus funds (after deducting the specified compensation and relief measures) as either Profits Tax or Salaries Tax reductions. They show the Profits Tax rate could be reduced by five percentage points – implying a rate for incorporated bodies of only 12.5 percent, or Salaries Tax rates being lowered by up to five percentage points, resulting in a standard rate of just 11 percent. Clearly, the Government will not spend all the surplus funds on just one or the other form of tax relief, but rather will use the public feedback to put together a balance between these two taxes (and possibly may use some on increased spending or other compensation measures).

Tax or duty reductions are proposed for:

- motor vehicle first registration tax
- liquor and wine duty
- petrol and diesel duty
- methyl alcohol duty
- trade declaration charges.

The capital fee payable on authorised share capital and the hotel accommodation tax are proposed to be abolished. Set-up assistance is proposed to be made available to voluntary registrants only. In addition, the tax deduction limit (currently 25 percent of assessable income/profits) for charitable donations would be increased (50 percent of assessable income/profits is hinted).

A notable omission from the list of proposed tax reductions is stamp duty on stock transfers. Australia and Japan took the opportunity provided by the introduction of GST to abolish their stamp duties on listed securities. No reduction is proposed on stamp duty on immovable property either. Other taxes not mentioned include betting and sweeps duty, tobacco duty and air passenger departure tax. While government rates and rent are not proposed to be cut, rates could drop significantly for many households, due to the proposed HK$3,000 per household annual rates credit included in the compensation package (see below).

The proposed household compensation measures, aside from personal tax reductions, are spelt out in some detail. They include the following:

- Full price offset through CSSA adjustments to those recipients
- A "cash allowance" of HK$2,000 per annum for low-income non-CSSA households, with the specific definition and eligibility to be determined after feedback from the public
- HK$3,000 a year of rates reductions (or up to this amount if the household pays less than HK$3,000 a year), with the intention that tenants benefit through lower rentals
- HK$500 a year of free water and sewage charges.

The measures appear targeted towards lower income households. Given concerns about the impact of GST on the livelihoods of these more needy households this is understandable. For most households, the measures should mean HK$3,500 a year of relief plus any (as yet undetermined) benefit that arises from tax cuts.

Economic impact

The Government has estimated that a 5 percent GST would add 3 percent to the prevailing level of inflation. With current inflation running at a bit over 2 percent this means the inflation rate shortly after the commencement of a GST could rise to around 5 percent before returning back to the 2 percent annual rate. Closer to any introduction date, managing consumer pricing expectations and stock levels could be an important implementation issue for local retailers.

The Consultation Document references many overseas experiences and studies that suggest the introduction of GST would not adversely impact the economy. In fact, if the tax relief for business was meaningful, the economic growth rate should be enhanced from the tax reform package.

Moreover, as the Government seems to be indicating a revenue neutral approach is preferred, albeit leaving open the option of using funds for increased expenditure, the overall impact on the economy should be neither expansionary nor contractionary. This should calm financial markets as the Budget balance should be able to remain in surplus and tax levels kept low.

What should you do now?

As this Consultation Document does not represent conclusions on the GST design framework or the overall reform package, there is an opportunity for the general public and all stakeholder groups to influence the shape of the final proposals. Moreover, as the proposed tax reform package and its implementation are not even certain (with no timetable set for implementation and still requiring the go-ahead by the next administration) it is also a good time to consider how the proposed measures could enhance the competitiveness of Hong Kong businesses.

We urge you to examine the proposals thoroughly. At the very least undertake a high level assessment of the potential impact on your industry and business, to determine what could be improved and whether you should support the measures going forward.

We would suggest you then make your views known; prepare a submission and take the opportunity to engage in dialogue and consultation with the Government. There is no question that a lack of support from business will make the chance of the next Government embracing reform all the less likely. Furthermore, business is likely to continue to suffer from ad-hoc responses to issues (such as the recent higher tax rates used to plug the budget deficit) unless a more systemic reform can be implemented that secures a more robust tax base for the future.

When analysing the possible impact of GST, we suggest you should look closely at the following:

- Current (and near term planned) IT and other systems – can they be easily adapted to handle GST?

- GST cost to your business – are you likely to face unrecoverable GST or find your products are disadvantaged tax wise compared to competitors or substitutes?

- Long term supply and procurement contracts – how could GST affect these, and should you include a special tax clause just in case?

- Leasing, construction, and intangible property undertakings – could these run past a possible GST introduction date (around four years away) and if so how should it be factored in?

- Turnover based arrangements (such as retail premises rentals or commissions) – will these be calculated on GST inclusive or exclusive turnover or sales figures?

The Consultation Document says "we can take our time to consider, plan and develop the best approach." With just under nine months, you have time to properly evaluate the proposals, consider alternatives or refinements, and submit your views.

ANNEX

Taxable supply example

The table below shows how the GST tax and credit mechanism works (assuming a 5 percent GST rate and all businesses are registered for GST).

	Purchase (HK$)			Sale (HK$)			GST remitted to the IRD (output tax less input tax)
	Price before GST	GST (input tax)	Amount paid (incl. GST)	Price before GST	GST (output tax)	Amount received (incl. GST)	
Vegetable grower				100	5	105	5
Wholesaler	100	5	105	200	10	210	5
Supermarket	200	10	210	300	15	315	5
Consumer	300	15	315				
Total GST							**15**

Zero-rated supply example

If the example in the table above is modified so that the supermarket is making a zero-rated supply, the result changes as follows. (Note: if the supermarket was exporting the vegetables to an overseas consumer, e.g. they receive an order to send the vegetables to Japan, the supply would be zero-rated.)

	Purchase (HK$)			Sale (HK$)			GST remitted to the IRD (output tax less input tax)
	Price before GST	GST (input tax)	Amount paid (incl. GST)	Price before GST	GST (output tax)	Amount received (incl. GST)	
Supermarket	200	10	210	300	0	300	-10
Consumer	300	0	300				
Total GST							**0**

A zero-rated supply effectively bears no GST, as any GST paid throughout the chain has all been refunded.

Exempt supply example

If the first example is further modified so that the supermarket is making an exempt supply (assuming they maintain the same HK$100 margin) the final sale will operate as follows. (Note: an unregistered supermarket also has the same effective treatment.)

	Purchase (HK$)			Sale (HK$)			GST remitted to the IRD (output tax less input tax)
	Price before GST	GST (input tax)	Amount paid (incl. GST)	Price before GST	GST (output tax)	Amount received (incl. GST)	
Supermarket	200	10	210	310	0	310	0
Consumer	310	0	310				
Total GST							**10**

An exempt supply effectively bears tax up to the last point of registration, but no tax on the value added thereafter (i.e. by the supermarket in this instance).

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