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A Proposal for the Introduction of Group Tax Loss Relief in Hong Kong

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Executive Summary

1. The issue of group tax loss relief in Hong Kong has been the subject of debate many times. Over the years, there has been much lobbying to the Government of the Hong Kong Special Administrative Region ("HKSAR") to consider introducing group tax loss relief measures so that Hong Kong businesses can offset losses from one group company against profits from another group company.

2. In Hong Kong, unlike most other developed tax jurisdictions, tax losses cannot be transferred amongst group companies via a group tax loss relief system. Losses incurred by a company can be carried forward to offset against its own future profits until the losses are fully utilised, but they cannot be transferred to other profitable companies within the group.

3. The group tax loss relief proposal has met considerable reluctance from the Government. The chief reasons provided by the Government have been the perceived volatility in revenue collections and the potential administrative complexity. However, most developed tax jurisdictions now have some form of group tax loss relief, including Singapore, which introduced such relief in 2003.

Group Tax Loss Relief encourages entrepreneurial risk taking and innovation

4. One of the main reasons for adopting a corporate group structure is to quarantine commercial risks through separate legal entities. The risk management function of the corporate group structure is critical for encouraging entrepreneurial risk taking and innovation, all of which are catalysts for the growth and development of businesses in Hong Kong.

5. When a business engages in new commercial ventures that have elements of entrepreneurial risk taking and innovation, its risk profile may be altered and get itself exposed to undue risk. A corporate group structure would quarantine such risk by segregating the respective risk profiles of its different businesses into silos. At the

same time, the business can preserve the benefits of common managerial control and share group resources attributable to a single economic unit.

6. From a tax perspective, the lack of group tax loss relief can result in a tax disadvantage for businesses operated via a group company structure, as compared with those operated via a single company structure. While a group company cannot offset losses from one business operated by another group company against profits from its own business, a single legal entity can offset the profits and losses of its different businesses.

7. The absence of group tax loss relief potentially creates tax inefficiencies and distortions. A single corporate entity structure is favoured whilst a corporate group structure is in a way financially penalised. These potential undesirable outcomes are not consistent with the policy objectives of growing and developing Hong Kong's economy by encouraging and supporting entrepreneurial risk taking and innovation.

8. Introducing group tax loss relief in Hong Kong would recognise corporate groups in Hong Kong as a single economic unit for tax purposes. Losses can be offset against other group companies' profits, whilst preserving the ability for the group companies to undertake effective commercial risk management.

9. In the financial services industry (the banking sector in particular), the quarantining of commercial risk is a key component of risk management.

10. In the banking sector, the retail deposit-taking / lending businesses are often undertaken in separate entities from the capital markets / merchant banking businesses. Banks tend to consider the separation as part of their prudent commercial risk management measures, which benefit investors, customers and creditors alike. Whilst such separation is not required under the Banking Ordinance of Hong Kong, foreign banks operated in Hong Kong, which constitute the majority of banks operated here, are often subjected to the regulatory measures in their home

jurisdictions that require riskier businesses to be quarantined. However, as group tax loss relief is not available in Hong Kong, the banks have to bear the financial cost of this quarantine, despite the fact that it is part of the responsible risk management measures.

11. In contrast to Hong Kong, other major international financial centres, such as Japan, Singapore, the United Kingdom ("UK") and the United States ("US"), all have group tax loss relief mechanisms. As part of the efforts to maintain Hong Kong's status as a leading international financial centre and to align its practice with the prevailing international standard, Hong Kong must have a tax system that is supportive of the development of the financial services industry.

Singapore's approach to group tax loss relief

12. Hong Kong has long had a simple, low rate territorial system of taxation, which has generally served Hong Kong well in promoting economic growth over the years. However, many other developed jurisdictions now have corporate tax rates that are similar to that in Hong Kong. Arguably, a low corporate tax rate on its own is no longer appealing enough to attract and promote trade and investment activities.

13. Singapore, which has a tax regime similar to that in Hong Kong, recognised the importance of incentivising business investment and entrepreneurial risk taking by introducing group tax loss relief measures. Singapore introduced a tax loss transfer regime from the year of assessment 2003 and a tax loss carry back system from the year of assessment 2006.

14. Singapore implemented the group tax loss relief with relative ease, requiring only relatively minimal adjustments to its existing taxation legislation. Singapore did not experience significant fluctuations in revenue collections following its introduction of the group tax loss relief.

A framework for Group Tax Loss Relief in Hong Kong

15. There are three main forms of group tax loss relief: (i) group consolidation; (ii) group tax loss transfer; and (iii) consortium relief. The most appropriate form for Hong Kong would be a group tax loss transfer amongst wholly owned group companies.

16. Similar to the experience in Singapore, introducing group tax loss relief by way of a group tax loss transfer mechanism should require the fewest amendments to existing taxation laws in Hong Kong and should be relatively straightforward to administer. The key features of the group tax loss relief rules would be:

— Companies within a wholly owned group should be able to offset tax losses via a tax loss grouping / transfer system;

— The companies within the wholly owned group need to have the same accounting year;

— For the tax losses to be grouped and offset, the tax losses must arise at the time the companies are in the same wholly owned group;

— Where the company transferring the tax losses ("Loss Company") is subject to tax at a lower rate than the company receiving the tax losses, the tax losses will need to be adjusted to reflect the tax benefit of those tax losses to the Loss Company;

— Specific anti-abuse measures may need to be implemented to counteract tax-avoidance arrangements effected to take advantage of group tax losses that were incurred prior to the implementation of group tax loss relief (i.e. anti-avoidance rules);

— Where a company within a wholly owned group does not elect to transfer the tax losses for offset, or has excess tax losses, they are

retained by the company and are treated in the same manner under the ordinary tax loss rules (i.e. tax loss carry forward); and

— The company will continue to account for taxable income and deductible losses in the ordinary manner (i.e. there is no tax consolidation).

17. A regime similar to that described above should be relatively simple to administer and could mitigate the risk of tax avoidance arrangement.

Introduction

18. Hong Kong has debated the issue of group tax loss relief for a number of years. Unlike many other developed jurisdictions, Hong Kong's tax regime does not currently allow the transfer of tax losses between group companies operated in Hong Kong. Tax losses are quarantined to the legal entity to which they pertain, although they can be carried forward indefinitely until the tax losses have been fully offset against future profits.[1]

19. Whilst the issue of group tax loss relief has been raised in several occasions over the years, there has been considerable reluctance by the Inland Revenue Department to consider the implementation of such a regime. The most commonly cited reasons against introducing tax loss relief for group companies in Hong Kong have been the perceived volatility in revenue collections and the administrative complexity of such rules.

20. However, in an ever increasingly competitive global environment in which corporate groups need to operate within, Hong Kong should continue to look at ways of ensuring that its taxation regime remains competitive and attractive to businesses operating within the city. As many competing jurisdictions (such as Singapore) now offer corporate tax rates similar to or even lower than that of Hong Kong, Hong Kong needs to ensure that it has a modern tax regime that caters to the needs of global business organisations.

21. Many internationally developed tax regimes[2] allow for some form of group tax loss relief or tax consolidation. These jurisdictions acknowledge the commercial reality that corporate groups operate business undertakings through separate legal entities for a variety of reasons, including those that are determined by commercial or regulatory requirements.

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[1] Refer to Appendix A for details regarding the mechanism of Hong Kong's tax loss carry forward rules.

[2] Refer to Appendix B for details of the different tax loss rules adopted by a number of developed economies.

22. In Hong Kong, there are some provisions for the ability to transfer tax losses, but these are very limited, involving arrangements between a partner and its share of partnership losses, or between spouses who have elected for a joint tax assessment. A broad group tax consolidation or group tax loss relief is not available.

Hong Kong's Tax System with respect to Tax Losses

23. In accordance with Article 108 of the Basic Law, the HKSAR Government strives to maintain a low rate taxation system, consistent with the HKSAR's tax policy in prior years, whilst maintaining fiscal prudence. These objectives are intended to be achieved through Hong Kong's relatively simple and principle based territorial tax system, whereby only Hong Kong sourced revenue profits derived from a trade, profession, or business carried on in Hong Kong are subject to profits tax; the worldwide profits of a person are generally not subject to taxation, even if repatriated to Hong Kong.

24. From a tax loss perspective, Hong Kong companies may carry forward tax losses indefinitely for offset against future taxable profits, subject to anti-avoidance rules; but there is no ability to carry tax losses back to prior years or to utilise tax losses via a group tax loss offset.[3]

25. The discussion on the issue of group tax loss relief can be traced back to the 1960s. The group tax loss relief proposals back then were rejected by the Second Inland Revenue Ordinance Review Committee (in 1968) as well as by the Third Inland Revenue Ordinance Review Committee (in 1976). At the time, both committees considered that the principle of the separate entity of the corporation should be preserved and since the Inland Revenue Ordinance permitted the aggregation of profits and losses from multiple trades carried on by a corporation and the unlimited carry forward of losses, they did not see any grounds for introducing group tax loss relief.

26. Following subsequent lobbying by various business and professional bodies, the then Financial Secretary of the HKSAR indicated in his 2006/07 Budget that he had no intention to introduce any tax loss carry back or group tax loss relief regime in Hong Kong. In particular, the then Financial Secretary was concerned that the loss carry back arrangement would place enormous pressure on tax revenue during

[3] Refer to Appendix A for details on the operation of Hong Kong's tax loss carry forward rules.

periods of economic downturn and the group tax loss relief arrangement could easily be abused as a means to evade tax.[4]

27. In March 2011, the then Secretary for Financial Services and the Treasury reiterated the Government's position against the introduction of tax loss carry back rules and group tax loss relief in Hong Kong.[5] The impact on revenue collections and the perceived administrative complexity were the main concerns. The Government was of the view that small and medium-sized enterprises ("SMEs"), which made up 98% of business establishments, would unlikely benefit from the measures.

28. Hong Kong's approach with respect to group tax losses appears to be outdated and not competitive when compared to the tax systems in other modern tax jurisdictions.[6] Most members of the Organisation for Economic Co-operation and Development ("OECD") and modern tax jurisdictions have some form of group tax loss relief in place. Singapore has also introduced group tax loss relief in 2003.

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4 https://www.budget.gov.hk/2006/eng/budget24.htm

5 http://www.ird.gov.hk/eng/ppr/archives/11031601.htm

6 Refer to Appendix B for details of the different tax loss rules adopted by a number of developed economies.

The Common Approach to Group Tax Losses

29. Many developed economies allow some form of group tax loss relief to taxpayers, whether by way of a transfer of tax losses between group companies or through tax consolidation.

30. A summary of the developed economies that have adopted group tax loss relief is outlined in Appendix B, including regional jurisdictions such as Australia, Japan, Malaysia, New Zealand and Singapore.

31. The mechanisms by which jurisdictions group or transfer losses can be broadly described as a combination of either Group Consolidation, Group Tax Loss Transfer or Consortium Relief.

(i) Group Consolidation

32. A group consolidation regime is a comprehensive system for taxing corporate groups. Broadly, corporate group entities are treated as a single economic unit and the taxable income and loss of member entities are considered together in order to determine the group's overall tax position.

33. The consolidation mechanism is adopted in a diverse manner among the jurisdictions and is generally more complex than a loss transfer regime. Typically, a consolidation regime involves a new discreet body of tax law, more complex consolidation requirements, separate anti-avoidance provisions, as well as higher administration and compliance costs.

34. Jurisdictions such as Australia, Austria, Denmark, France, Germany, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Portugal, Spain and the US currently adopt the group consolidation regime.

(ii) Group Tax Loss Transfer

35. A group tax loss transfer regime is generally simpler than a consolidation regime. It allows unutilised tax losses of a group company to be transferred to and set off against the taxable income of another company within the same corporate group.

36. The transfer rules are relatively straightforward and easier to administer. Typically, a tax loss transfer regime would require only amendments to existing laws (rather than a new body of law), more flexible joining requirements (by percentage of direct or indirect ownership) and lower administration and compliance costs. A loss transfer regime is likely to fit better into Hong Kong's current tax system as compared to the group consolidation regime.

37. Jurisdictions such as Cyprus, Ireland, Malaysia, New Zealand,[7] Singapore, and the UK currently adopt the group tax loss transfer regime.

(iii) Consortium Relief

38. Consortium relief is an extension of the group tax loss transfer regime. It allows tax losses to be transferred between the consortium company[8] and its consortium members. It is more complex than a simple transfer of group tax losses.

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[7] New Zealand operates a 'dual system', which allows for tax loss transfers and tax consolidation for corporate taxpayers on an elective basis.

[8] A 'consortium company' is a company whereby at least 75% of it is owned by other companies, where each of which has at least a 5% shareholding ('consortium members').

The Group Tax Loss Regime in Singapore

39. Singapore, which shares many of the characteristics of Hong Kong's tax regime, introduced a tax loss transfer regime from the year of assessment 2003 and a tax loss carry back regime from the year of assessment 2006 onwards.

40. The Singapore group tax loss regime allows companies within the same corporate group to transfer unabsorbed trade losses, capital allowances and donations.

41. Upon introducing the rules in Singapore, the then Deputy Prime Minister of Singapore provided the following explanation for the group tax loss relief regime in his budget statement 2002[9]:-

> *"The ERC Sub-Committee has recommended allowing group relief to help reduce the cost of doing business in Singapore. Group relief recognises group companies as a single economic entity by allowing the unutilised losses and capital allowances from one company to offset the profits of a related company in the same group. This is already the case in most developed countries, including the US and the United Kingdom…*
>
> *The introduction of group relief will lower the tax burden on companies, and encourage more risk-taking and enterprise. It will also help companies during recessions or the early years of new ventures, when they are likely to make losses. Companies which set up subsidiaries for risky ventures will be able to enjoy the limited liability benefit of separate subsidiaries, and still offset those subsidiaries' losses against their own profits."*

[9] http://www.singaporebudget.gov.sg/data/budget_2002/download/FY2002_Budget_Speech.pdf

42. Singapore also specifically considered the potential loss of revenue in evaluating the tax loss carry back regime. The report prepared by the Singapore Economic Review Committee: Sub-Committee on Policies related to Taxation, the CPF System, Wages and Land in 2002[10] stated that:

> *"We recognise that a loss carry-back feature would lead to greater uncertainty in government revenue. However, there is no long-term impact on government revenue as the current system already allows losses to be carried forward. The loss of revenue only arises if the company does not recover from its current losses and subsequently fails. It would also help to relieve the cash flow burdens of businesses suffering losses during hard times. We therefore recommend introducing a one-year loss carry-back feature in the corporate tax system."*

43. In the budget statement 2005[11], the Prime Minister of Singapore further explained the reasons for introducing the loss carry back regime as follows:

> *"Small businesses are the backbone of many economies. They support the MNCs and larger local companies as part of an integrated production network and provide jobs for a large part of the population. They are also often key sources of innovation and buzz. We too must ensure that our SMEs thrive and grow in our competitive economic landscape ..., we will provide tax relief for small businesses to help them cope with cash flow problems, especially in a cyclical downturn. Our corporate tax system already allows companies to carry forward business losses to offset future tax liabilities. In other words, if you lose money this year, you can carry the loss forward and you can offset it against profit you make next year. So next year, you can reduce the tax you have to pay..."*

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[10] https://www.mti.gov.sg/ResearchRoom/Documents/app.mti.gov.sg/data/pages/507/doc/ERC_Taxation_MainReport2.pdf

[11] http://www.singaporebudget.gov.sg/data/budget_2005/download/FY2005_Budget_Statement.pdf

44. The group tax loss rules in Singapore acknowledge that corporate groups are in substance a single economic entity, with shared control, business operations and financial resources. Such organisations should therefore be able to group tax losses as a combined single economic group for taxation purposes.

45. More importantly, Singapore took the view that the ability to transfer tax losses amongst group companies should not lead to greater uncertainty in revenue collections. Singapore's government understood that an ultimate loss in revenue would only arise if a business did not recover from their current year losses and subsequently failed. The grouping of tax losses would therefore not only assist with a group's cash flow by reducing the tax liabilities of the group, but it would also help businesses to overcome cyclical downturns in business and continue as a viable going concern in the future.

46. Singapore's approach to group tax loss relief is outlined in Appendix C.

The Need for Group Tax Loss Relief in Hong Kong

47. Many developed jurisdictions continue to look at ways of modernising and updating their tax regimes to remain globally competitive in attracting capital and investment. Hong Kong is not alone in this respect. The OECD members have been working to reduce corporate tax rates that are competitive to Hong Kong.

48. By way of comparison, in April 2017 the Trump Administration reportedly announced a proposal to reduce the US corporate tax rate to 15% from the current rate of 35%.[12] Besides, the UK government announced that their corporate tax rate would be reduced to 18% from the financial year beginning 1 April 2020, with an initial corporate tax rate reduction from 20% to 19% effective from the financial year beginning on 1 April 2017.[13] In Asia, Singapore has a current corporate tax rate of 17%. It also introduced loss carry back and group tax loss relief in 2003.[14]

49. Hong Kong should not solely rely on its low tax rate and simple tax system to remain competitive in attracting capital and investment. Hong Kong's tax system must evolve and be modernised to not only maintain its competitiveness against other major international financial centres, but to also support the economic growth and development of Hong Kong businesses. Introducing group tax loss relief in Hong Kong would be one of the ways to support existing and future businesses in Hong Kong.

50. Group tax loss relief acknowledges the underlying commercial reality that group companies are economically a 'single' unit represented by a portfolio of businesses that is ultimately managed by the same group of persons. The lack of group tax loss relief might discriminate against taxpayers that operate businesses through separate legal entities in Hong Kong, compared to those that operate multiple

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[12] *Trump is Said to Seek Cutting Corporate Tax Rate to 15 Percent,* The New York Times, 24 April 2017

[13] https://www.gov.uk/government/publications/corporation-tax-to-17-in-2020/corporation-tax-to-17-in-2020.

[14] Refer to Appendix C for details regarding Singapore's group tax loss transfer and tax loss carry back rules.

businesses through a single legal entity. The former would not be able to offset losses from one business against profits from the other, whilst the latter form of business organisation would be able to do so.

51. From a tax policy perspective, arguably there should be no distinction between the taxation of either type of business structure, particularly when there are clear commercial reasons for doing so. Where there are differences, tax inefficiencies and distortions can arise and potentially create an inherent tax bias. Such tax bias might have adverse economic implications for Hong Kong businesses.

52. Corporate groups operate businesses using separate legal entities (as opposed to using a single legal entity) for various commercial reasons, such as:-

— To quarantine / ring-fence commercial risks among different businesses, otherwise there would be a pooling of capital / assets available for creditor claims from unrelated businesses;

— To facilitate the divestment of businesses by separating them into separate legal entities and to provide a platform for future investors where required;

— To implement a legal structure for the various business operating units in view of implementing management, operational and investment evaluation frameworks; and

— To comply with regulatory restrictions i.e. certain business activities may not be undertaken by the same legal entity and are required to be separated.

53. Clearly, there are genuine commercial drivers that influence the legal structure of a business organisation and of particular importance is the need to quarantine risk that may arise from entrepreneurial investments.

54. A key element of effective risk management is the ability for businesses to quarantine the risks arising from new commercial ventures, so that in the event of commercial failure, a business' broader group operations would not be adversely impacted. If such businesses have access to group tax loss relief, from a group perspective, the financial costs associated with a commercial failure would be mitigated. Consequently, Hong Kong businesses should be more inclined to engage in commercial ventures that involve entrepreneurial risk taking and innovation if group losses can be offset against group profits.

55. If made available, group tax loss relief in Hong Kong would be beneficial to the financial services industry in Hong Kong, as financial services businesses (banking businesses in particular) often need to be operated under separate legal entities for risk management purposes.

56. Banks in Hong Kong are not required under the Banking Ordinance to undertake their capital markets / merchant banking businesses in separate legal entities from their deposit-taking / consumer finance businesses. However, in practice, they may choose to do so as part of their prudent risk management measures to quarantine commercial risk, benefitting their shareholders, customers and creditors alike. Moreover, foreign banks operating in Hong Kong, which make up the majority of banks operated here, are required, as part of their overall risk management framework, under the regulatory requirements in their respective home jurisdictions[15] to operate parts of their businesses via separate legal entities.

57. Without group tax loss relief, banks operating in Hong Kong that are structured as a corporate group to implement risk management measures and / or to comply with regulatory requirements are somehow financially penalised, provided that there are loss and profit making entities within the corporate group.

58. In contrast to Hong Kong, other major international financial centres such as Japan, Singapore, the UK and the US, all have their own group tax loss relief

[15] These jurisdictions include Japan, Taiwan, the UK and the US.

mechanisms. As part of the efforts to maintain Hong Kong's status as a leading international financial centre and to align its practice with the prevailing international standard, Hong Kong cannot afford to be an outlier by having a tax system that is not supportive of the development of the financial services industry.

A Potential Group Tax Loss Relief Framework for Hong Kong

59. Hong Kong should look to introduce a group tax loss transfer regime that would allow for unutilised tax losses of a group company to be transferred to and be set off against the taxable income of another company within the same corporate group.

60. A group tax loss transfer regime should be relatively straightforward and simple to administer, as compared to other forms of group tax loss relief such as group consolidation. Typically, group tax loss transfer provisions would require minimal amendments to existing laws (as opposed to a new body of law) and incur lower administration and compliance cost. On balance, a group tax loss transfer regime appears to be the preferred approach for Hong Kong to adopt.

61. The proposed group tax loss transfer in Hong Kong should apply to losses amongst wholly owned companies only and in respect of losses that arose from when the companies were within the same corporate group. Such requirements would ensure that the rules are simple to administer and can mitigate the risk of tax avoidance arrangement.

62. The group tax loss relief would need to cater to instances where tax losses are incurred by a company that qualifies for taxation at a rate lower than the standard 16.5% corporate tax rate. This could arise in respect of, inter alia:

— Corporate treasury centre rules, which apply 8.25% profits tax rate to qualifying profits from certain corporate treasury centre activities from 1 April 2016;[16]

— Aircraft leasing rules, that will apply an 8.25% profits tax rate to qualifying profits from certain aircraft leasing activity;[17] and

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[16] Inland Revenue (Amendment) (No. 2) Ordinance 2016.
[17] Inland Revenue (Amendment) (No. 2) Bill 2017.

— Two-tiered corporate tax system proposed in the Chief Executive Mrs Carrie Lam's manifesto,[18] which would impose profits tax at 10% on the first HK$ 2 million of profits and 16.5% thereafter ("Two-Tiered Proposal").

63. To this end, one of the following approaches could be implemented in a relatively simple manner:

— Ring Fencing Approach – Restrict the offset of tax losses to instances where the company receiving the tax losses ("Profit Company") is subject to tax at the same, or lower rate, than the company incurring the tax losses ("Loss Company").

— Adjustment Approach – The transfer of tax losses would be permitted, regardless of the tax rate of the Profit Company. However, the tax benefit of such losses would be limited to the corporate tax rate of the Loss Company – this is the current approach in Singapore where the transfer of group tax losses are permitted from Loss Companies that are taxed at a rate lower than the Profit Company. For illustrative purpose, where the Loss Company is subject to tax at say, 8.25% and incurs a tax loss of say, HK$ 1,000,000, a Profit Company subject to corporate tax at 16.5% would only be entitled to an adjusted tax loss transfer of HK$ 500,000 (being 50% of HK1,000,000, mirroring the 50% tax rate difference between 8.25% and 16.5%).

64. We consider that the Adjustment Approach would be the preferred approach given the flexibility provided and the relative simplicity. If the Ring Fencing Approach were implemented, corporate groups might need to maintain much complicated tax loss records / schedules to track tax losses incurred at different tax rates amongst the various corporate group members.

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[18] https://www.carrielam2017.hk/en/pr_0213_b/.

65. We do not consider that any specific loss restriction rules in respect of either the Ring Fencing Approach or the Adjustment Approach would be required under the Two-Tiered Proposal. This is on the basis that the Two-Tiered Proposal would effectively implement a graduated scale of taxation applicable across all members of the corporate group, rather than providing a preferential tax rate to specific group companies, such as corporate treasury centres and aircraft lessors. In this regard, the Two-Tiered Proposal is not vulnerable to tax rate arbitrage, which might warrant the introduction of the Ring Fencing Approach.

66. Based on the above discussion, the key features for group tax loss relief could therefore include:

— Companies within a wholly owned group (including Hong Kong branches of wholly owned group companies) should be able to offset tax losses via a tax loss grouping / transfer system;

— The companies within the wholly owned group need to have the same accounting year;

— For the tax losses to be grouped and offset, the tax losses must arise at the time the companies are in the same wholly owned group;

— Where the Loss Company is subject to tax at a lower rate than the Profit Company, the tax losses transferred would be adjusted to reflect the tax benefit of those tax losses to the Loss Company (i.e. the Adjustment Approach);

— Specific anti-abuse measures may need to be implemented to counteract tax-avoidance arrangements effected to take advantage of group tax losses that were incurred prior to the implementation of group tax loss relief (i.e. anti-avoidance rules);

— Where a company within a wholly owned group does not elect to transfer the tax losses for offset, or has excess tax losses, the losses

would be retained by the company and treated in the same manner under the ordinary tax loss rules (i.e. tax loss carry forward); and

— The company would continue to account for taxable income and deductible losses in the ordinary manner (i.e. there would be no tax consolidation).

67. Going forward, if group tax loss relief were introduced in Hong Kong, it should obviate the compliance burden with respect to domestic transfer pricing rules between wholly owned group entities. This is on the basis that Loss Companies would be able to transfer tax losses to Profit Companies. Consequently, there should be no practical need to counteract domestic profit-shifting arrangements through transfer pricing rules.

Tax Loss Carry Back Rules

68. As well as group tax loss relief, many jurisdictions also provide for tax loss carry back to an earlier year of assessment. Loss carry back rules ensure that a company pays a fair amount of taxation over a period of time and that the tax payments are not affected by fluctuations in profits from one year to another.

69. The majority of the jurisdictions that have tax loss carry back rules typically restrict the carry back to the immediately preceding year.

70. We would not propose that tax loss carry back rules be introduced in Hong Kong in the first instance. We would recommend that the Government introduce a simple group tax loss transfer regime at the initial stage and then consider the implementation of tax loss carry back rules, with appropriate restrictions in place.

Conclusion

71. In an ever increasingly competitive global environment, Hong Kong should continue to look at ways of ensuring that its tax regime remains competitive and attractive to businesses operating within the city.

72. Group tax loss relief measures are not some radical or untested taxation concepts, nor are they viewed in the international community as a means of tax avoidance. Singapore, the UK and the US all have some form of group tax loss relief, either by way of loss transfers, group consolidation or a combination of both.

73. In prior years, the issue of group tax loss relief had been dismissed over perceived concerns with volatility in revenue collections and complexity in administration. However, clear economic benefits associated with implementing group tax loss relief are now observed and these should be at the forefront of any discussion on the topic. In the absence of group tax loss relief, Hong Kong corporate groups operating through separate legal entities are more likely to:-

- suffer heavier tax burden and higher effective tax rates;
- pay tax even though they are loss making as a group;
- have less favourable cash flow positions;
- engage in more complex intercompany transactions; and
- be discouraged from expanding or investing in Hong Kong, especially for projects which involve higher risks, substantial upfront investments and / or longer pay back periods.

74. Allowing Hong Kong group companies to group tax losses could provide an immediate fiscal benefit to those companies without the need to reduce the existing corporate tax rate. For those corporate groups that have losses quarantined within

group companies, the measures would result in an effective tax rate reduction for the group and therefore have a positive impact on cash flow.

75. The quarantining of commercial risk is a key component of risk management in the financial services industry. The implementation of group tax loss relief would support the financial services industry by removing a tax distortion associated with risk management. The introduction of group tax loss relief measures would also ensure that Hong Kong's tax rules are on par with other major international financial centres.

76. Group tax loss relief would encourage further investment in Hong Kong as it would enable businesses to invest knowing that if losses are incurred, such losses can be offset against other profits within the group. This should encourage entrepreneurial risk taking, directly benefiting the overall economy of Hong Kong.

77. On the whole, group tax loss relief would ensure that business groups are not discriminated against compared to other taxpayers that operate multiple businesses under the same legal entity.

78. We would recommend the introduction of group tax loss measures for wholly owned group companies, which should be relatively straightforward to legislate and administer. Going forward, following the introduction of group tax loss relief, we would recommend Hong Kong to consider tax loss carry back provisions.

Appendix A – Hong Kong's Current Tax Loss Regime

The current tax loss regime in Hong Kong is relatively simple. Where a tax loss is incurred by a corporation, it can be carried forward indefinitely and set off against the corporation's future assessable profits until fully utilised (subject to anti avoidance provisions). However, as compared to many other jurisdictions, tax losses cannot be carried back to offset against taxable profits in prior years or transferred between group companies (commonly known as group relief).

By way of illustration, an example of how Hong Kong's current tax loss relief mechanism operates is set out below:

Tax loss carry forward (Hong Kong's current system)

	Year 1 - loss year	**Year 2 – profit year**	**Year 3 – profit year**
	HK$	HK$	HK$
Income	100,000	970,000	1,300,000
Expenses	(600,000)	(700,000)	(900,000)
Profit / (loss) *(a)*	(500,000)	270,000	400,000
Tax losses brought forward	0	500,000	230,000
Tax losses utilized *(b)*	0	(270,000)	(230,000)
Taxable Profit = *(a) – (b)*	0	0	170,000
Total tax losses carried forward	500,000	230,000	0

The tax loss carry forward system can disadvantage businesses operating via a group structure by potentially imposing taxation even though the overall corporate group has incurred a loss. Further, the tax loss carry forward system can result in taxation for a

company even though it is loss making over its operating life. Both the aforementioned outcomes do not result in an equitable and fair taxation outcome.

Appendix B – Tax Loss Relief Mechanisms in Developed Economies

The following summary table provides an overview of the tax loss relief mechanisms adopted by different developed economies.

Economies	Tax loss carry back	Group relief
Austria	Not available	Group consolidation
Australia	Not available	Group consolidation
Canada	3 years	Not available
Cyprus	Not available	Loss transfer
Denmark	Not available	Group consolidation
Finland	Not available	Loss transfer [19]
France	1 year	Group consolidation
Germany	1 year	Group consolidation
Ireland	1 year	Loss transfer, consortium relief [20]
Italy	Not available	Group consolidation
Japan	1 year	Group consolidation
Luxembourg	Not available	Group consolidation
Malaysia	Not available	Loss transfer
Netherlands	1 year	Group consolidation
New Zealand	Not available	Dual system [21]
Norway	2 years [22]	Loss transfer [19]
Portugal	Not available	Group consolidation
Singapore	1 year	Loss transfer

[19] The loss transfer regimes operated in Finland, Norway and Sweden are commonly known as group contribution regime. It allows profits (instead of losses) to be transferred within a corporate group.

[20] Consortium relief is an extension of group tax loss transfer regime that allows tax losses to be transferred between the consortium entity and its consortium members.

[21] New Zealand offers both group consolidation and loss transfer mechanisms to taxpayers on an elective basis.

[22] Applicable in the year of ceasing business only.

Economies	Tax loss carry back	Group relief
Spain	Not available	Group consolidation
Sweden	Not available	Loss transfer [19]
United Kingdom	1 year	Loss transfer, consortium relief
United States	2 years	Group consolidation

Appendix C – Singapore's Tax Loss Transfer and Loss Carry Back Regimes

Tax loss transfer regime

Under the group relief system in Singapore, a company belonging to a group may transfer the following loss items to another company belonging to the same group for set-off against the assessable profits of the latter company:

— Current year unabsorbed capital allowances;

— Current year unabsorbed trade losses; and

— Current year unabsorbed donations.

For this purpose, two Singapore incorporated companies are members of the same group if:

— At least 75% of the total number of issued ordinary shares in one company are beneficially held, directly or indirectly, by the other; or

— At least 75% of the total number of issued ordinary shares in each of the two companies is beneficially held, directly or indirectly, by a third Singapore incorporated company.

In addition, members of the same group must have the same accounting year end to qualify for group relief.

Loss carry back regime

The main features of the loss carry back regime in Singapore are:-

— Only current year unutilised capital allowances ("CAs") and trade losses are allowed to be carried back for one year of assessment

immediately preceding the year of assessment in which the capital allowances were granted or the trade losses incurred.

— An aggregate amount of $100,000 of current year unutilised CAs and trade losses can be carried back.

— The carry-back system is available to all businesses, including sole proprietors, partnerships and corporations.

— The current requirements for carry forward of unutilised CAs and trade losses similarly apply when these amounts are carried back (i.e., the substantial shareholding and the same business test).

— The carry back will be given on due claim.

About the Financial Services Development Council

The Hong Kong SAR Government announced in January 2013 the establishment of the Financial Services Development Council (FSDC) as a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for development. The FSDC advises the Government on areas related to diversifying the financial services industry, enhancing Hong Kong's position and functions as an international financial centre of our country and in the region, and further consolidating our competitiveness through leveraging the Mainland to become more global.

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