2 Capital gains tax regimes abroad—countries without capital gains taxes

Tax avoidance due to the zero capital gains tax

Some indirect evidence from Hong Kong

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Consistent with its image as a free-market economy with minimal government intervention, Hong Kong is a city with low and simple taxation. Unlike most industrial and developed economies with full-fledged tax structures, Hong Kong has a relatively narrow tax base. It has direct taxes, which account for about 60% of the total tax revenue. These direct levies fall on earnings and profits and include an estate duty. Hong Kong also has indirect taxes, which account for the remaining 40%. These consist of rates, duties, and taxes on motor vehicles and so on.[1] Nonetheless, Hong Kong has neither a sales or value-added tax nor a capital gains tax. In this paper, we explain the absence of the capital gains tax and provide some indirect evidence on the tax-avoidance effects induced by this fact.

Notes will be found on pages 51–53.

Why is there no capital gains tax in Hong Kong?

Under the British colonial rule, no tax was levied on capital gains in Hong Kong.[2] This continues to be the case since the Chinese government took over in 1997.

During the pre-1997 (colonial) period, the tax structure in Hong Kong was based on the British tax system, which uses the *source* concept of income for the taxation of different kinds of income. This concept originated in Great Britain in the late eighteenth century. It argues that only incomes derived from identifiable sources—rather than the sources themselves—are subject to tax. In this sense, income generated by a capital asset is taxable while the capital asset itself is not.

Historically, countries with common-law regimes have adhered to the source concept and have not had capital gains taxation. However, there are a few exceptions to this rule. Capital gains are taxed in Australia, Canada, and Great Britain, all of which are common-law jurisdictions. The capital gains taxes in these countries are justified on the highly debatable ground that capital gains are a part of capital income, do not represent the source, and therefore are taxable even if the source principle is followed. This is one of the few areas where the Hong Kong tax system diverges from its British counterpart. In this sense, history and convention alone cannot explain the absence of the capital gains tax in Hong Kong.

After the 1997 hand-over, the *Basic Law* provided for the retention by the Hong Kong Special Administrative Region (HKSAR) of the tax structure already existing.[3] Until recently, the fiscal budgets in Hong Kong have been surplus prone.[4] Thus, there has been little need for the government to introduce new taxes—including a capital gains tax—to finance its expenditures. The taxing authority has not given any official explanation for the absence of that tax and no tax reform or review committees have been created to look into the issue.[5, 6] Circumstantial evidence suggests that the main reason for not introducing the capital gains tax stems from the HKSAR government's obsession with the simplicity and efficiency of the existing low tax policy—even at the expense of the no less important principles of vertical and horizontal equity. However, the reluctance to introduce a capital gains tax may also be due to the well-known problems of valuing capital assets, avoiding the lockin effects, and eliminating inflation-induced distortions, which accompany the administration of the tax.

Although there is no capital gains tax in the HKSAR, there are two distinct types of taxes on capital. They fall on property rather than on gains from property, and they are levied under different conditions. First, stamp duties are charged on documents relating to the transfer of certain types of property (e.g., leases, shares, and immovable properties). Second, estate duties are a form of inheritance tax imposed on the value of property located in the HKSAR and passed on to heirs at the death of a person. Stamp duties bring in more than 10% of the total operating revenue for the government whereas estate duties account for only 1%.

Trading profits versus capital gains

The absence of the capital gains tax does not mean that all incomes generated in the process of asset transactions are tax-free. Under section 14 of the Inland Revenue Ordinance, the profits tax expressly excludes "profits arising from the sale of capital assets" (i.e., profits from *capital* sources). More precisely, such a sale must involve "assets." But, profits arising otherwise than from "the sale of capital assets" are not excluded from profits tax liability.

There is, however, no legal authority to impose tax on these profits either, unless they arise in the ordinary course of a "trade, profession, or business." The exclusion provided by this provision is to avoid doubt more than anything else. What constitutes a "sale" and what is an "asset" are nonetheless not always clear. On the other hand, profits arising from a trade or the practice of professions (i.e., profits from *non-capital* sources, or profits of a revenue nature) are taxed. In addition, a tax may be charged on the profits of speculative transactions if they can be shown to constitute an adventure in the nature of trade.[7]

Problems arise when assets are traded as a matter of routine business, as in the case of a real estate firm specializing in the purchase and resale of buildings and land. Profits from such trade in assets are taxable. In principle, profits from the increase in the value of such property held as trading inventory are not taxable. In practical law, however, the concept of "trade" has not been precisely defined in the Inland Revenue Ordinance. As a result, courts are often asked to adjudicate disputes between citizens who claim that income is from capital gains rather than from trade and the tax authorities who argue that the income is due to trading.

Hong Kong courts have often been asked to rule on such ambiguities. These rulings constitute the common-law base for deciding whether a particular transaction is a trade or involves a capital gain. Six basic factors called “the badges of trade” have emerged from these rulings and have been summarized in the *Final Report* published in 1955 by the British Royal Commission on the Taxation of Profits and Income. The “badges of trade” considered by courts are:

(1) the subject matter of realization,

(2) the length of the period of ownership,

(3) the frequency or number of similar transactions by the same person,

(4) supplementary work on, or in connection with, the property realized,

(5) the circumstances that were responsible for the realization,

(6) the motive for the realization.

It is beyond the scope of this paper to discuss trade in greater detail. For our purpose, it is sufficient to note that many appeals concerning profits tax assessment by the Inland Revenue Department are related to disputes over the issue whether profits earned are trading profits (which are taxable) or capital gains (which are tax-exempt). Almost always, the verdict whether a transaction is deemed to have given rise to a taxable profit is based on the “badges of trade” test.

Tax avoidance and the Hong Kong Inland Revenue board of review

Although there is no capital gains tax in the HKSAR, in the 1998/1999 fiscal year, tax on gains from the property sector accounted for 32% of the total profits tax collected (equivalent to 14% of total government tax revenue). Together with revenues from stamp duty and estate duty, tax on capital-related income accounted for some 25.5% of the total tax revenue. Accordingly, there is a very strong incentive for taxpayers to shift their income into capital gains while adhering to anti-avoidance provisions in the code.

Believing in the basic principle of simplicity, the Inland Revenue Ordinance from the outset has been designed to contain very little strict anti-avoidance legislation. However, over time, the growth of sophisticated tax planning arrangements has led to the introduction of many sub-sections in the Inland Revenue Ordinance aimed at closing loopholes. Now the Inland Revenue Ordinance contains two general anti-avoidance provisions. The first sets out to disregard any "artificial or fictitious" transactions that do not, in fact, take place and any that reduce or would reduce the amount of tax payable. The second applies the test of "sole or dominant purpose" to determine whether a transaction is conducted mainly for the purpose of obtaining tax benefits through the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof.

Among the specific anti-avoidance provisions of the Inland Revenue Ordinance, the most relevant to our analysis is section 15A. It is intended to counteract the following type of transaction. A person sells the right to a stream of taxable income to another person for a lump sum. This lump sum is claimed to be a tax-free capital gain. However, as long as the seller retains the ownership of the underlying asset, such a lump-sum sale of a stream of income is deemed to have been undertaken to avoid the payment of income taxes on the income and the alleged capital gain is taxed as income. Such an arrangement was the subject of a legal procedure in Australia (*FC of T v. Myer Emporium Ltd.* (85 ATC 411)). Initially a court held that the receipt was indeed of the nature of a capital gain and thus not taxable. However, a higher court in Australia later reversed that decision on appeal.[8] The money received through the transaction was considered to be trading profit and hence taxable. Although the court decision has become a common-law precedent, section 15A of the Inland Revenue Ordinance code has been retained to avoid any ambiguities.

In fact, the court decision and section 15A have not prevented attempts to avoid taxes through transactions that turn income into non-taxable capital gains. This is, at least in part, due to the fact that it is not always clear whether a given transaction is designed to avoid taxes or whether it is a genuine commercial activity that only appeared to involve tax evasion. As a result, a number of rulings by the Commissioner of Inland Revenue that specific transactions are for tax avoidance have been appealed to the Board of Review of the Hong Kong Inland Revenue. These appeals may be considered to reflect the extent to which the absence of a capital-gains tax has induced shifting of ordinary income into capital gains.

Table 1 contains some statistics about appeals to the Board of Review against the decisions made by the Commissioner of Inland Revenue that the transactions involved were revenue in nature (hence, taxable) rather than capital in nature (hence, not taxable). The table also distinguishes whether these appeals involved transactions in land or other assets. Note that under the statutes of the Board of Review, the onus of proving that the receipts are capital in nature rests with the appellant taxpayers.

The second column in the table shows in parenthesis the total number of appeals filed in the years concerned. The numbers reveal that about 40% of the appeals are related specifically to the dispute about "revenue versus capital" or "profits versus capital gains." Table 1 also shows that during the three years under consideration, in cases involving land, more than 3 times as many appeals (49) were dismissed than were allowed (15). In the case of non-land the ratio was 2.1, with 85 appeals dismissed and 40 allowed. Although we have not reported data on the values of the transactions involved in these appeals, the high rates of unsuccessful appeals suggest that many taxpayers would have devised schemes to avoid tax liabilities by shifting their assets from trading stock to capital. Had they been successful, there would be substantial tax savings.[9]

In this context, it is worth noting that taxpayers filing appeals face fees charged by lawyers and accountants, which tend to be small relative to the gains expected from a favourable ruling. At the same

Table 1: Appeals to the Board of Review

	Total number of cases	Appeal dismissed		Appeal allowed	
		Land	Non-land	Land	Non-land
1997	54 (out of 126)	12	23	8	11
1998	77 (out of 179)	25	29	7	16
1999	58 (out of 152)	12	33	0	13

Source: Board of Review Decisions 1997–99.

time, the downside risk of an unfavourable ruling is also relatively small. The assessed tax has to be paid and the amount is the same as it would have been without the appeal. Furthermore, the Board imposes only rarely a deterrent penalty of US$640, which in principle is payable upon unfavourable Board rulings. For these reasons, we believe that taxpayers have strong incentives to appeal. Therefore, the numbers in the table represent a reasonable estimate of the number of times Inland Revenue agents decide to rule against taxpayers and force them to treat claimed capital gains as taxable other income.

However, this conclusion is mitigated to some degree by the fact that some taxpayers do not go to the appeal board and instead settle their perceived grievances through direct deals with the Inland Revenue Department. They have strong incentives to do so since the Department has the authority to impose a penalty on incorrect returns of up to three times the tax owed. Unfortunately, there are no estimates of the number and value of appealed rulings settled through direct dealings with the Inland Revenue Department.

Techniques for converting income into capital gains

The most popular technique used in converting ordinary income into non-taxable capital gains involves the use of "creative" accounting. This practice is limited by the fact that under the Companies Ordinance auditors must certify accounting documents to show a "true and fair view" of the company's affairs. Auditors have some room for subjective view of such conditions to suit a client's interest but the actions based on such views must comply with accepted accounting standards.

Of course, such compliance can be ambiguous and can lead to legal challenges. For example, in Case No. D180/98 it was alleged that with the approval of an auditor, a taxpayer shifted property from trading to capital in the "current assets" account in 1991, 8 years after its acquisition. The taxpayer argued that this accounting measure was proper since the original acquisition of the asset as a trading property had been a mistake from the very beginning and, since it was not sold after 8 years, it had become a balance-sheet asset. The Inland Revenue Department argued that there was a change of intention only after the taxpayer failed to find a purchaser.

The Board of Review held that there must be strong evidence to substantiate a mistake. After considering all the surrounding circumstances, it concluded that the taxpayer's transfer of the property from trading stock to capital took effect on the date upon which the revaluation of the property was based, i.e., 1991 instead of 1983 (the acquisition date). This revaluation, which was done in 1991 rather than 1983, would be unnecessary had there not been a change of intention. In other words, while the conversion was granted, the taxpayer would still have to pay taxes due to the change in the property's value between 1983 (when it was treated as a trading asset) and 1991 (when it was reclassified as a long-term fixed asset). In relation to this revaluation issue, see also the discussion about *Sharkey v. Wernher* below.

As another example of a strategy used to convert income into capital gains that led to a legal challenge, consider case No. D108/97. In this case a taxpayer claimed to have acquired a property for building for use as storage facility (which made it an investment for general business purposes) because of the serious traffic problems he was facing in existing storage spaces. However, the taxpayer encountered a change of cost conditions that made it infeasible to use the property for storage. The property was sold and claimed to have resulted in a capital gain. The taxpayer submitted evidence in the form of reports from chartered surveyors used to plan the construction of the storage and also submitted detailed statistical evidence on planned sales and logistics.

The cost of preparing this evidence was insignificant in relation to the tax savings realized if the sale was considered to have resulted in a capital gain rather than taxable income from ordinary business investment. The Board of Review argued that the taxpayer had to prove that his intention was genuine, realistic, and realizable. It dismissed the appeal on the grounds that the estimated traffic congestion was unrealistic and the change in business environment not valid as a reason for changing the intended use of the property.

Another example of the importance of accounting records in determining whether income constitutes a capital gain is found in Case No. D64/98. In this case, one firm compensated another for the early termination of an agreement to distribute capital goods. The recipient of the funds claimed that this payment was a non-taxable capital gain. The payer of the funds claimed it as a loss, which should reduce its income for tax purposes. The Board of Review agreed with the firm receiving the money because it was mere coincidence that the present value formula used to estimate the compensation (a stock) yielded a level that was roughly equal to one-year's foregone profit of the distributor (a flow). It went on to argue that the early termination of the distribution contract was a loss or sterilization of the taxpayer's capital asset. It amounted to an enduring destruction of its profit-making potential. The compensation payment was therefore a once-only capital gain, which compensated for this loss. By the same token, the Board decided that the payer of the compensation could not claim the payment as business losses for tax purposes.

Difficulties in deciding whether a transaction gives rise to capital gains or ordinary income can arise when the shift of assets from trading to capital uses takes place while the ownership of the property has not changed. According to a legal precedent (*Sharkey v. Wernher),* the property should be revalued at the time it is shifted. The value is to be determined by applying the doctrine of imputed income from trading use and compared its value as a capital asset to determine whether there is taxable profit involved. But arguably this doctrine is not applicable when the taxpayer is in only one type of business and there is no real change in the services derived from the asset by redefining it as capital.

In *Commissioner of Inland Revenue v. Quitsubdue*, the Board of Review held that there was a change of intention by the taxpayer when trading stock was converted into fixed assets; but that, since the property in question had never been disposed of by the taxpayer, there was no profit. The Court of First Instance said *obiter* that *Sharkey* could not generally apply in the HKSAR because a person cannot trade with himself and earn a profit in the process. In this case, the property had always been in the possession of the same enterprise.

It is interesting to note that in *Sharkey* the taxpayer transferred racehorses from her stud farm to her racing stables, which were separate taxing entities and the exchange did not strictly involve a trade with oneself. It was a misfortune that the Court of First Instance did not address this distinction.

In many appeals, the taxpayer would argue that the sale of an asset is related to a long-term or permanent investment and gives rise to a non-taxable capital gain. In Case No. D28/98, a private limited company claimed that it had initially intended to acquire a property as a long-term investment for use as an office for the company. Profits arising from the subsequent sale of this property should be treated as a capital gain. The Board found the taxpayer's explanations for the sale of the property somewhat contradictory and dismissed the appeal. This was a clear case in which the taxpayer tried to exploit the absence of the capital gains tax to avoid the tax on profits, which had arisen from an ordinary business deal.

In Case No. D117/97, a taxpayer took out a mortgage of HK$4,000,000 to purchase a property worth HK$8,500,000. Within half a year, the property was sold for HK$11,650,000. The Board decided that this transaction involved speculative trading rather than an investment. The profits were subject to income taxation.

All of the preceding cases involved real estate property. But, as table 1 reveals, there were also quite a few non-land cases. In Case No. D113/98, for instance, a private, incorporated company was engaged in retail and wholesale business. It sold shares of two listed companies operating in the property sector and argued that these shares had originally been acquired as long-term investments so that profits from the sale should be treated as non-taxable gains rather than taxable profits. The appeal was dismissed by the Board on the ground that the shares were claims on firms whose business was unrelated to that of the taxpayer. It rejected the taxpayer's claim of being on the constant lookout for good investments in its own areas of business and ordered that the profits from the sale of the shares gave rise to taxable trading income

There are many more cases of similar nature. We believe, though, that these examples are sufficient to illustrate the main methods used by Hong Kong taxpayers to avoid the payment of income taxes by converting income from trading into non-taxable capital gains.

Conclusions

In the absence of capital gains taxes, businesses and private taxpayers have incentives to shift taxable profits or incomes into non-taxable capital gains. These practices reduce economic efficiency and cause inequities in the incidence of taxes. However, direct evidence on the frequency and quantitative importance of such practices is impossible to obtain because by the very nature of the transactions, they are highly confidential and unpublicized.

In this paper, we used some indirect evidence to assess the extent of the shifting of other income into non-taxable capital gains. We considered appeals to the Board of Review of the Hong Kong Inland Revenue about the classification of income on which the tax is levied as revenue or capital.

Based on this indirect evidence and our common sense about the Hong Kong economy we have reached the following conclusions:

- Few businesses "invest" in properties for the long term or for their own business use. Such investment in real estate is speculative and bets on the soaring property values. The investments have often been financed through mortgage loans rather than retained profits. The returns to such speculative investments were properly treated as taxable profits.

- Before the Asian crisis, when the property market was still booming, the absence of the capital gains tax probably stimulated some businesses to buy office or factory buildings rather than rent them.[10] While some of these investments may have been for the medium or long term, it is disputable whether profits made from their sales should then be considered as non-taxable capital gains.

- Tax avoidance through the claim that purchase of property is long-term investment, hence profit so derived is capital gains, imposes relatively low costs on taxpayers. It is, therefore, attempted by some, but the Revenue authorities often disallow these attempts and the Board of Review tends to uphold these rulings.

- Firms have the option to reinvest earnings and take tax-free capital gains rather than pay tax on the earnings. However, such excessive reinvestment of business earnings by definition implies investment in projects or assets with lower risk-adjusted expected rates of return than can be earned by placing the funds in outside investments. It makes sense only if the gains from tax avoidance exceed the losses from the low-return internal investments. Since personal and corporate income taxes in Hong Kong are very low, the incentives to reinvest earnings and take the implicit losses are relatively minor.

- Casual empirical evidence suggests to us that only small businesses tend to make efforts to avoid taxes by increasing capital gains through excessive reinvestment of profits and low personal compensation of owners. The economic importance of such small businesses is relatively minor in Hong Kong.

On the basis of the indirect evidence available to us we conclude that the absence of a capital gains tax in Hong Kong has resulted in little, if any, inefficiencies and inequities.[11]

Notes

1. Rates are levied on landed properties at a fixed percentage of their ratable value in order to finance the various public services provided by the provisional municipal councils. Duties include stamp duty, betting duty, and duties on four types of commodities (i.e., hydrocarbon oil, alcoholic beverages, methyl and ethyl alcohol, and tobacco).
2. As capital gains are not taxable, capital losses are not tax-deductible either.
3. According to Article 108 of the *Basic Law*, *"... [t]he HKSAR shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation."* For a more detailed description of the background on the HKSAR tax system and the source concept of income, see Hsu (1996) and (2000). See also One Country Two Systems Economic Research Institute Ltd. (1992).
4. For the past two decades, deficits have only been recorded in 5 years, and they were covered by the fiscal reserves accumulated from the surplus years. In keeping with the living-within-our-means rule, the following guiding principles of financial management have been used repeatedly by the financial secretaries in Hong Kong in drawing up budgets: (a) *spending constraints:* public spending should be sufficiently covered by revenue and should not grow faster than the economy; and (b) *adequate reserves:* the fiscal reserves should provide a sufficient cushion to meet known commitments and to guard against future uncertainties. This conservative philosophy has been re-emphasized in Article 107 of the *Basic Law*, according to which *"[t]he HKSAR shall follow the principle of keeping expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product."*
5. A few years ago, there were some discussions about whether the capital gains tax should be introduced as a device to curb speculative activities in the Hong Kong property market. Despite support from some political parties, many people (economists included) were concerned about the potentially harmful effects of introducing a capital gains tax or some kind of anti-speculation tax on property. A capital gains tax may choke off speculative demand for

housing and bring down property prices in the short run. However, if the capital gains tax rate is sufficiently high, it would ultimately discourage developers from increasing the supply of new housing units, reduce the liquidity of the property market, and perhaps slow down the growth of the whole economy through its negative effect on the property and banking sectors. (For example, see Siu 1997.) It was suggested instead that the surging property prices would be contained better through a long-term policy of increasing land supply, which was actually adopted by the HKSAR government at the time. This so-called "85,000" policy was later abandoned due to the collapse of the property market following the onset of the Asian crisis.

6 Owing to the growing problem of fiscal deficits, the HKSAR government has started to consider measures to broaden its tax base. The introduction of a sales tax is currently under serious consideration but that of the capital gains tax is still not in the picture.

7 Section 2(1) of the Inland Revenue Ordinance provides that "trade includes every trade and manufacture, and every adventure and concern in the nature of a trade." This definition is not exhaustive. Basically, the Ordinance looks for whether the taxpayer engages in an "adventure and concern," which is similar to a trade, or has the nature and special characteristics of a trade. The majority of litigation in this regard is related to transactions involving an "adventure and concern in the nature of a trade." This is a grey area of law on the borderline. Whether a particular activity is a "trade" fundamentally is a question of fact. Members of the Board of Review and judges are only human so that idiosyncrasies inevitably filter into their findings of fact. Therefore, it may sometimes be difficult to reconcile reported cases on the definition of "trade." In *Kowloon Stock Exchange Ltd. v. Commissioner of Inland Revenue*, for instance, the Privy Council adopted the principle that trade denoted "operations of a commercial character by which the trader provides to customers for reward some kind of goods or services." An isolated transaction may trigger "an adventure and concern in the nature of a trade." Accordingly, section 14(1) of the Inland Revenue Ordinance may operate to tax a person even though he does not carry on a "trade" or "manufacture." In *Rutledge v. Inland Revenue Commissioners*, it was held that a one-off transaction without a continuous series of trading operations could trigger a trade.

8 One may wonder why an Australian decision should be relevant to Hong Kong. Article 84 of the *Basic Law* provides that the courts of the HKSAR "*. . . may refer to precedents of other common law jurisdictions . . .*" in adjudication cases.

9 For the transaction of a residential flat of 1,000 sq.ft. at average mid-1990s prices and under a profits tax of 15%, say, such tax-avoiding appeal could easily save the owner a tax liability of HK$900,000.

10 Purchases of residential properties might have further been stimulated by tax-deduction benefits for depreciation allowances and for mortgage payments applied to first-time purchases.

11 It does not, therefore, follow that a zero capital gains tax is totally efficient. As is familiar from the theory of optimal taxation, the inability to collect tax revenue from capital gains implies that some other activities have to be taxed more heavily in order to finance fiscal spending, thus resulting in excessive distortions at other margins.

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