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COMMON LAW HERITAGE AND STATUTORY DIVERSION—TAXATION OF INCOME IN SINGAPORE AND HONG KONG

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Singapore and Hong Kong share a common legal heritage in income taxation. Given the spectacular economic growth enjoyed by both, it is instructive to analyse how the common inheritance and values have produced very different taxation systems in both states. This article commences with a brief historical account of the development of those systems, and the role the common law has played in shaping them. It then attempts to identify the unique imperatives that are absent in other areas of law to account for the diversions in the two systems of taxation. That is followed by an analysis of how both systems meet the challenge of maintaining a viable tax base without compromising the ease of compliance and the rights of taxpayers. It concludes with observations on how both taxation systems are poised to meet the challenges posed by the economic conditions prevalent in the 21st century, and to articulate the role the common law will play in that context.

I. AN HISTORICAL ACCOUNT OF THE DEVELOPMENT OF THE INCOME TAX SYSTEMS IN HONG KONG AND SINGAPORE

A. *Singapore*

In 1860, the first attempt to impose income tax in the Straits Settlements failed when the British India office in Calcutta withdrew the proposal of the local Governor to levy income tax after their attempt to collect port dues was successfully resisted by local merchants.[1] In 1910, a second attempt made by the British Colonial Government

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[1] See CM Turnbull, *A History of Singapore 1819–1975*, 2nd ed. (Singapore: Oxford University Press, 1985) at 72 and 230.

to introduce income tax in the Straits Settlements Legislative Council in Singapore failed to progress beyond the Bill stage when violent opposition by European and mercantile interests proved too strong.[2] However, a third attempt in 1917 succeeded because of the need to make contributions to the Imperial War Expenditure during the First World War.[3] Although initially passed as an annual tax to support the war effort, the *War Tax Ordinance* was re-enacted for several years until its post-war repeal in 1922.[4] In the years that followed without income tax, the Government was able to rely on revenue from opium, liquor, petroleum and tobacco to finance public expenditure.

The *War Tax Ordinance*[5] was revived in 1941 to raise money for Britain's war effort against Germany. This Ordinance survived the Japanese occupation and continued to impose taxes until a new *Income Tax Ordinance* came into force in 1947.[6] This was necessary since the taxes raised not only replaced the loss of revenue from the outlawed opium trade, but they also funded Singapore's post-war reconstruction. There was an urgent need to restore infrastructure, promote health, and provide housing and education. In this regard, taxation played an obvious role.

The contents of the 1947 Ordinance were the product of a Commission appointed by the Governors of the Malayan Union and Singapore.[7] Besides the inclusion of several provisions derived from the United Kingdom *Income Tax Act 1945*, and modifications to suit local circumstances, the Ordinance appears to be largely based on the *Model Colonial Territories Income Tax Ordinance 1922*.[8] Despite objections from many business quarters, the Governor declared in December 1947 that income tax would be imposed in Singapore.[9] The Ordinance took effect on 1 January 1948.

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[2] See L Yew, *Singapore's Response to the Introduction of Income Tax 1946–1948* (Academic thesis submitted in part satisfaction of a degree in Bachelor of Arts in History, University of Singapore, History Department, 1974) at 1 [unpublished]. See also Leo Pointon, *Revenue Law in Singapore and Malaysia*, 2nd ed. (Singapore: Butterworths Asia, 1993) at 7.

[3] *Straits Settlements War Tax Ordinance* (No. 8 of 1917). It took effect retrospectively from 1 January 1917.

[4] See Yew, *supra* note 2 at 2. After the war ended, the Ordinance was re-named the *Income Tax Ordinance* in 1920. Strenuous resistance in 1921 preceded its eventual repeal.

[5] Straits Settlements Ordinance No. 3 of 1941, which took effect retrospectively from 1 January 1941. The Ordinance was modelled on the *Straits Settlements War Tax Ordinance* (No. 8 of 1917).

[6] *Income Tax Ordinance* (No. 39 of 1947).

[7] It was headed by RB Heasman, an official of the British Inland Revenue Department. The Heasman Report: *Income tax; a report to Their Excellencies the Governors of the Malayan Union and Singapore, with recommendations, including a draft bill and proposals for administration and staffing* (Kuala Lumpur: Malayan Union Government Press, 1947) was published on 19 August 1947. It should be noted that several of the provisions in the final *Income Tax Ordinance* were modified to adopt the recommendations of the *Report of the Joint Committee appointed by the Governors of the Malayan Union and Singapore to consider Mr. Heasman's recommendations for the institution of an Income Tax and to report whether, if the policy of Income Tax were adopted, the principles of the legislation, a draft of which is annexed to Mr. Heasman's Report, would, in their opinion, be suitable for the purpose* (Kuala Lumpur: Government Press, 1947).

[8] See CCH Asia Ltd, *Singapore Master Tax Guide Manual* (Singapore: CCH Asia Ltd., 1989-) at para. 1929. See also Sat Pal Khattar, "Tax Systems and Laws of Singapore" (1981) 2 M.L.J. xlvii at xlvii.

[9] See Yew, *supra* note 2 at 32.

Apart from certain significant income tax reforms[10] introduced during the last decade, the key features of the income tax regime as enacted in 1947 have largely remained intact today. Specifically, Singapore continues to impose income tax on a territorial basis, and capital gains are not taxed. The basic charging provision remains unchanged with tax being imposed on income classified into various heads, such as trade, business, employment, dividends, interest, rent and royalties.[11] Income tax is then imposed on the aggregate income from these heads arising from sources within Singapore. Interestingly, the headline tax rates for companies and individuals have dropped steadily over the last 20 years and are currently about the same as those imposed 60 years ago.[12] The main framework for deductions and capital allowances is largely the same although many incentives have been introduced to promote selected capital and recurring expenditures.

However, as we shall see in Parts III and IV below, it would be inconceivable that the Singapore tax system had remained static while the economy grew spectacularly in the last 60 years. Indeed, the tax system has evolved to meet the unique challenges that prevailed in the decades that followed 1947. A network of Double Taxation Agreements sprouted in tandem with tax incentives to drive the industrialisation efforts of Singapore. More recently, the imputation system made way for one-tier corporate taxation where dividends are exempted. The remittance basis has been effectively abolished in many situations. Group relief for losses was also introduced. These recent tax reforms are in line with the shift towards a service-oriented economy primarily focussed on the provision of financial services to the region.

B. *Hong Kong*

Researchers examining the historical development of Hong Kong's taxation system are fortunate—because they have access to one of the few detailed studies conducted in a former Commonwealth Colony on this topic.[13] It is a fascinating story which, for our purposes, starts around the beginning of the Second World War, which led Hong Kong to impose a tax on earnings and profits, and ends on a rainy night on 30 June 1997.

In 1940 Hong Kong's Colonial Government enacted the *War Revenue Ordinance*[14] to "impose War taxes and regulate the collection thereof". This Ordinance was based on Addington's *Income Tax Act 1803*,[15] which introduced the concept of a schedular

[10] The main areas of reform include the introduction of one-tier corporate taxation to replace the imputation system and the major curtailment of the remittance basis of taxation and taxation of interest income.

[11] Section 10, *Income Tax Act* (Cap. 134, 2004 Rev. Ed.).

[12] The income tax rate prescribed in the Heasman Report, *supra* note 7 at 68 and 89, was 20% for companies and a progressive tax rate structure for individuals rising from 3% to 20%. After hitting a high of 40% in 1986, the current corporate tax rate and the highest marginal rate for individuals is 20% (for individuals, the 20% rate applies from the year of assessment 2007).

[13] Michael Littlewood, *Taxation Without Representation: The History of Hong Kong's Troublingly Successful Tax System* (Ph.D. Thesis, University of Hong Kong, 2001) [Littlewood, Ph.D. Thesis], a significant part of which is distilled in an article by him bearing the same name ([2002] British Tax Review 212).

[14] Ordinance No. 13 of 1940.

[15] 43 Geo. III., c. 122. On the origin of the income tax in the United Kingdom, see *Whiteman on Income Tax*, 3rd ed. (London: Sweet & Maxwell, 1988) at §1-10 *et seq*.

tax system, as distinct from a general income tax, in the United Kingdom. It also contained a key feature of the *Model Colonial Territories Income Tax Ordinance 1922* by exempting offshore income from tax.[16] The *War Revenue Ordinance*'s brief life ended on Christmas day in 1941. No successor appeared until 3 May 1947, when the *Inland Revenue Ordinance* ("IRO")[17] was enacted to "impose a Tax on Earnings and Profits".

The *War Revenue Ordinance* was designed to raise revenue in the special circumstances that prevailed in Hong Kong in 1940. It was never intended to be a comprehensive tax on income (notwithstanding the Colonial Government's best efforts to the contrary). The fact remains, however, that it significantly influenced the ultimate form of the 1947 Ordinance which, in essence, still represents the income and profits tax law of Hong Kong today. Various factors influenced the government of the day against the introduction of an orthodox income tax system including: privacy of the individual, the advantages of a conveniently located free port, the fear of driving away foreign investment and, most importantly, the vehement opposition of the local (Hong Kong) business community.[18] This was in spite of the view expressed by the Committee on Taxation[19] set up at the end of the Second World War that:

> the imposition of a tax on incomes would theoretically result in the most equitable distribution of the burden of taxation and that a tax on income is inevitable here if the Budget of the Colony is to be balanced and if Hong Kong is to conform to the standards generally expected in the middle of the 20th Century.

The end result, despite many technical amendments to the IRO since 1947, is that Hong Kong's taxation legislation today is broadly similar in form and content to the 1940 Ordinance. The key features of that legislation are: low proportional tax rates,[20] a jurisdiction to tax depending almost entirely on the concept of source,[21] tax imposed on only three types of income or business profits,[22] no capital gains

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16 See Littlewood, Ph.D. thesis, *supra* note 13 at 60.

17 Ordinance No. 20 of 1947.

18 *Report of the War Revenue Committee* (Hong Kong: Noronha & Co Ltd, Government Printer, 14 February 1940) at 8-12. The *Hong Kong Hansard* for 1939-40 and 1946-47 also make for fascinating reading. Virtually all the non-government legislators of the day ("the Unofficials") had business and professional backgrounds. As indicated above, they made their antipathy towards a general system of income tax, and indeed any form of income tax, clear beyond peradventure. See generally Littlewood, "Taxation Without Representation: The History of Hong Kong's Troublingly Successful Tax System" [2002] *British Tax Review* 212.

19 Quoted in the *Report of the Inland Revenue Ordinance Review Committee*, Part II (Hong Kong: Government Printer, 1968) at para. 5.

20 The standard tax rate, which also represents the highest average rate of tax for individuals, is 16%; the corporate tax rate for business profits is 17.5%: see IRO, Schedules 1 and 8. One very interesting conclusion arising from Dr. Littlewood's research is that Addington's schedular system had "[another] fundamentally important characteristic: it would not support high rates of tax" and in Hong Kong "the representatives of business proposed the schedular structure precisely because they knew [this]": Littlewood, *supra* note 13, [2002] British Tax Review 212 at 222.

21 Income from land and buildings in Hong Kong (property tax), income from an employment or office or a pension sourced in Hong Kong (salaries tax), and profits sourced in Hong Kong from a trade, profession or business carried on in Hong Kong (profits tax).

22 IRO, ss. 5(1) (property tax), 8(1) (salaries tax) and 14(1) (profits tax).

tax, no tax on dividends or interest income,[23] and the virtual absence of withholding taxes.[24]

Let us now move to modern times. As readers well know, on midnight 30 June 1997, the PRC resumed sovereignty over Hong Kong. Hong Kong was not, however, integrated into the political, economic and social system of the PRC. Instead it enjoys a special status under Article 31 of the PRC Constitution as a Special Administrative Region. In accordance with the *Basic Law of the Hong Kong Special Administrative Region* ("*Basic Law*"),[25] Hong Kong is promised a high degree of autonomy. The *Basic Law* also provides that Hong Kong's capitalist market system will remain unchanged for 50 years after 30 June 1997[26] and that the laws previously in force in Hong Kong, including the common law, rules of equity, ordinances and subordinate legislation, shall be maintained except for any that violate the *Basic Law* and subject to any amendment by the legislature of the Hong Kong Special Administrative Region ("HKSAR").

When examining the fiscal system applied in Hong Kong, an apparent conundrum exists. This arises because various economic objectives are set out in the substantive provisions of Chapter V of the *Basic Law*.[27] Although these appear akin to policy objectives, their status seems to be that they represent broad economic guidelines or directions for the future governments of the HKSAR to follow. Furthermore, they can be distinguished from substantive rights, such as the right of abode, and do not appear justiciable. In accordance with this view, depending upon Hong Kong's economic needs and circumstances, future governments should be empowered to freely decide on their implementation.

The contrary view is that their enactment in the *Basic Law* amounts to entrenching a certain philosophy, deliberately included to fetter the government of the day. For example, Article 108 of the *Basic Law* prescribes that Hong Kong shall continue to practice a low tax policy. Although this is clearly in line with previous policy and appears generally to meet with the approval of the Hong Kong public, it is highly debatable whether such a policy should be enshrined as a mandatory provision in the laws of the HKSAR. This provision appears to limit the discretion and policy choices available to future governments of Hong Kong. The same could be said of Article

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[23] Unless derived by a person in the course of carrying on business in Hong Kong, and not being interest income paid on a deposit with an authorized financial institution: see respectively IRO, ss. 15(1)(f)-(g) and the *Exemption from Profits Tax (Interest Income) Order 1998*. Special rules apply to financial institutions: IRO, s. 15(1)(i).

[24] The only significant exception relates to the withholding tax on royalties which, provided certain anti-avoidance provisions do not apply, is levied on royalties paid to non-residents at an effective rate of 5.25% (for corporations): IRO, ss. 15(1)(a), (b) and (ba) and 21A.

[25] Enacted in April 1990 by the National People's Congress of the People's Republic of China. See generally, Yash Ghai, *Hong Kong's New Constitutional Order: The Resumption of Chinese Sovereignty and the Basic Law*, 2nd ed. (Hong Kong: Hong Kong University Press, 1999).

[26] Ghai, *supra* note 25 at 231-244, concludes that the principal objective of the Basic Law is the separation of the economy of Hong Kong from that of the mainland, rather than autonomy as such.

[27] The discussion in this and the following two paragraphs is taken from Halkyard, "Treating Taxpayers Right: Taxpayers' Rights With Special Reference to Hong Kong" (2001) 9(2) Asia Pac. L. Rev. 133 at 138-9.

107 of the *Basic Law* which provides that Hong Kong shall follow the principle of balancing its budget and avoiding deficits.[28]

The goals set out in Chapter V of the *Basic Law* dealing with the economy, such as balanced budgets, maintaining low rates of taxation as well as a free port, seem generally laudable as policy objectives and they appear to have broad public support. Indeed, they have been adhered to for many years (both prior to and after 30 June 1997) and, subject to a stable economic environment, will doubtless continue to be pursued in the foreseeable future. However, given the increasing economic volatility of international business, the ability of the HKSAR Government to successfully pursue these goals in the longer term, let alone on an annual basis, may be questionable. To enshrine these policies in what is essentially the constitution of the HKSAR restricts the policy choices available to the HKSAR Government. If, contrary to the argument submitted above, a restrictive interpretation of Chapter V were adopted, then, as Yash Ghai[29] suggests in a broader political, social and economic context, the separateness of Hong Kong's economy from that of the Mainland has been preserved by the *Basic Law*—but preserved at the expense of true autonomy.

A related issue is the extent to which the tax systems of Hong Kong and the rest of the PRC will interact after 1 July 1997. This is provided for unambiguously by the *Basic Law* where Article 108 of the *Basic Law* provides that Hong Kong will have "an independent taxation system" and Article 106 of the *Basic Law* goes on to state that the Central People's Government will be prohibited from levying taxes in the HKSAR.

Under Article 151 of the *Basic Law* Hong Kong may, on its own, maintain and develop tax relations, and sign and implement tax agreements with foreign states and regions as well as with relevant international organizations. Accordingly, Hong Kong is able to independently enter into comprehensive double taxation agreements with interested states. However, it has only concluded three such agreements, with Belgium, Thailand and, most recently, Mainland China. All three agreements are based on the OECD *Model Tax Convention on Income and on Capital*.[30]

In conclusion, when describing Hong Kong's taxation system, one could usefully adapt Deng Xiaoping's well-known aphorism—whilst firmly rooted in established Colonial precedent it is, given the history of its enactment and the passage of Hong Kong's *Basic Law*, undeniably one with 'Chinese Hong Kong characteristics'.

[28] See further, Tang Shu-hung, "The Political Economy of Tax Reform in Hong Kong" (2005) 9(2) Asia Pac. J. Tax'n 52 at 73–75, who reflects upon this "key article [which governs] the fiscal policy and budgetary management of the HKSAR Government" in the course of concluding that "the time [has] come for an independent review of public finances in Hong Kong."

[29] See Ghai, *supra* note 25 at Chapter 4.

[30] For a concise discussion of Hong Kong's efforts to conclude comprehensive tax treaties, see Martin Glass, Deputy Secretary for Financial Services & The Treasury, HKSAR, "The Future of Tax in Asia: A Hong Kong SAR Government Standpoint" (Paper delivered at the STEP Asia Conference, Hong Kong, 12-13 October 2006) at paras. 1-5. See also, Connie Cheng, "The Implications of Double Taxation Agreements for Hong Kong's Tax Policy" (2005) 11 Asia Pac. Tax Bull. 485; Dick Rijntjes, "Does Hong Kong Need Tax Treaties?" (1997) 3 Asia Pac. Tax Bull. 34 and Andrew Halkyard, ed., *Tax Treaties for Hong Kong?* (Hong Kong: Law Faculty, University of Hong Kong, 1991).

II. Examining the Role the Common Law has Played in Shaping the Income Tax Systems in Hong Kong and Singapore

Has the system of common law, insofar as it affects the income tax systems of Hong Kong and Singapore, served those places well? We propose to answer this question from each of the perspectives of legislative process, the interpretation of the law and application of legal principle by the courts, and the transparency and accountability of the taxation authorities. Before doing so however, it is important to appreciate that by adopting well-established concepts and phrases such as "trade", "plant" and the distinction between capital and revenue items, both Hong Kong and Singapore derived enormous benefit from the significant body of case law from the United Kingdom and other colonies interpreting the same. It goes without saying that, in the taxation area, this is an important part of their shared common law heritage.

A. *Legislation in Hong Kong*

In Hong Kong it is axiomatic that taxation is only imposed by statute. Turning to the specific laws imposing taxation in Hong Kong,[31] they have all been enacted by the Legislative Council and, with very few exceptions dealing with human rights issues (such as the legality of the so-called 'stop order' provision preventing persons with outstanding tax liabilities from leaving Hong Kong[32] and of the mandatory requirement to pay stamp duty in dispute before an appeal against the imposition of duty[33]) their validity has never been seriously questioned. They do not, as a matter of general policy, have retrospective effect—although exemptions from taxation may operate retroactively.[34] Furthermore, there are very few instances of delegated legislation made under those laws. With the exception of the *Inland Revenue Rules*,[35] most rules and regulations enacted under delegated authority are specific in effect and narrow in scope.[36] The laws imposing taxation and the delegated legislation made thereunder are readily accessible by the public and it is fair comment that the IRO aggregates few discretionary powers to the Commissioner of the HK-IRD and her staff in relation to their powers to assess.

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[31] The most important being the *Inland Revenue Ordinance* (LHK, Cap. 112); the *Estate Duty Ordinance* (LHK, Cap. 111) and the *Stamp Duty Ordinance* (LHK, Cap. 117). See <www.justice.gov.hk/Home.htm> (last accessed on 4 June 2007).

[32] See *CIR v. Lee Lai-ping* [1993] HKPLR 141 (D.C.), noted in Andrew Halkyard, "Treating Taxpayers Right: With Special Reference to Hong Kong" (2001) 9(2) Asia Pac. L. Rev. 133 at 139. After this case was decided s. 77 of the IRO was amended so as to be compliant with the Hong Kong *Bill of Rights Ordinance* (LHK, Cap. 383).

[33] See *Harvest Sheen Ltd v. Collector of Stamp Revenue* [1997] 4 HKTC 750 (H.C.), noted in Halkyard, *supra* note 32 at 140. The *Stamp Duty Ordinance* (LHK, Cap. 117) was also amended after this case was decided.

[34] See, *e.g.*, the *Profits Tax (Exemption for Offshore Funds) Ordinance 2006*, discussed in detail in Part III below.

[35] The Board of Inland Revenue made these rules under the express authority given by IRO, s. 85.

[36] Interestingly, the most important piece of delegated taxation legislation in Hong Kong, the *Inland Revenue Rules*, must be submitted to the Chief Executive and approved by the Legislative Council: IRO, s. 85(4).

B. *Legislation in Singapore*

Similarly, the income tax laws of Singapore are creatures of statute. Unlike the case in Hong Kong, the *Income Tax Act*[37] ("ITA") contains many provisions where the authority to make further supporting rules are conferred on the Minister for Finance. However, in these cases, the delegated authority is generally confined to circumstances where expediency may dictate that certain administrative or computational details be kept out of the enabling ITA. Not surprisingly, these instances are generally limited to situations where tax concessions or reliefs prescribed by the ITA require a fair amount of administrative verification for eligibility and compliance. Another significant provision in the ITA enables the Minister for Finance to enter into bilateral Double Taxation Treaties with a view to provide relief from double taxation.[38] The terms of these treaties come into force when gazetted as subsidiary legislation and upon ratification.

C. *Judicial Interpretation of Hong Kong's Taxation Laws*

Turning to the role of the judiciary in interpreting the law, the benefits of courts being well grounded in the tenets of the common law are clear. For example, the adept use of precedent and discrimination in rejecting either overly narrow or overly expansive interpretations of earlier cases and statutory wording are hallmarks of a valuable appellate court system. It is pleasing to note that the Hong Kong courts have shown all these abilities.[39]

Perhaps the most enduring legacy provided by the Hong Kong courts in taxation matters is that they have, by and large, made sense from a minefield of difficult conceptual issues concerning the source of profits. The judgments in *CIR v. Hang Seng Bank Ltd*,[40] *CIR v. Orion Caribbean Ltd (in voluntary liquidation)*[41] and *Kwong Mile Services Ltd v. CIR*[42] underscore this emphatically. In the 15 years since the first of these decisions, *Hang Seng Bank*, was delivered, it has stood the test of time. As one commentator has stated:

> [One] lesson that Hong Kong seems to offer is that a legislature might avoid considerable complexity by placing greater trust in judges. The complexity of most countries' tax laws is very largely due to the perceived need to provide for every conceivable case and to spell out the rules in advance, so that taxpayers can make commercial decisions with reasonable certainty of the tax consequences to

[37] Cap. 134, 2004 Rev. Ed.

[38] ITA, s. 49.

[39] For the period prior to 1 July 1997, see Halkyard, "The Privy Council's Hong Kong Tax Legacy" [1998] British Tax Review 32. Since the resumption of sovereignty, the Court of Final Appeal has given several well reasoned and principled decisions in revenue law, two of the best examples being *Shiu Wing Ltd v. Commissioner of Estate Duty* [2000] 3 HKLRD 76 and *Kwong Mile Services Ltd v. CIR* [2004] 3 HKLRD 168, FACV 20/2003 (July 2004).

[40] [1991] 1 A.C. 306 (P.C.).

[41] (1997) 4 HKTC 432 (P.C.).

[42] [2004] 3 HKLRD 168 (C.F.A.) (FACV 20/2003 (July 2004)).

follow. Hong Kong's legislature, however, has promulgated rules of a very general nature and left it to the courts to interpret them so that the system works. That has meant, most importantly, that it has fallen to the courts to interpret the legislation so as to accord with three basic norms. First, taxation must be in accordance with the law. It must not be, or appear to be, arbitrary or capricious. Second, the courts must not give the tax system a broader scope than the legislature intended, or, at least, they must not appear to do so. And, third, the courts must interpret the law so as not to permit excessive erosion of the government's revenues. Hong Kong's courts seem to have succeeded on all three counts. That, in turn, has been possible only because the legislature produced a statute capable of sustaining a workable interpretation. The best example is the one I have emphasized—that Hong Kong profits tax is imposed only on profits 'arising in or derived from Hong Kong.' The courts have determined what those words mean and have developed a meaning that is adequately principled, adequately respectful of taxpayers' rights, and adequately protective of the government's revenues.[43]

D. *Judicial Interpretation of Singapore's Taxation Laws*

For many years, judges in Singapore (as in Hong Kong) have had to grapple with the rules of statutory construction laid down in the common law. While a stricter approach has traditionally been adopted in the case of revenue statutes,[44] the courts in Singapore (as in Hong Kong) are required to adopt a purposive approach to the interpretation of statutes.[45] Although income tax law is not part of the common law, the judges adopt similar "common law" reasoning in dealing with judicial precedents from other jurisdictions. Judicial precedents from jurisdictions having the same common heritage[46] or those enacting similar provisions are often accorded the highest regard and are deemed to be highly persuasive. As such, judicial precedents from South Africa, East Africa, New Zealand, Australia, Malaysia and some other former colonies have nearly always served as authoritative guides.[47] This pragmatic approach is also evident in the legislature in circumstances where provisions elsewhere have been adopted. A good example of this can be seen in the records of parliamentary debates in Singapore when the Minister for Finance moved for an

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[43] See Littlewood, "How Simple Can Tax Law Be? The Instructive Case of Hong Kong", 38 Tax Notes Int'l 689 at 701–702.

[44] See *Cape Brandy Sydnicate v. IRC* (1920) 12 TC 358 at 366 per Rowlatt J (H.C.): "There is no equity about a tax."

[45] In Singapore: see s. 9A, *Interpretation Act* (Cap. 1, 2002 Rev. Ed.). For the position prior to the enactment of s. 9A, see *Tan Boon Yong v. Comptroller of Income Tax* [1993] 2 S.L.R. 48 at 54-55 *per* Chao J.A. (C.A.). In Hong Kong: see s. 19 of the *Interpretation and General Clauses Ordinance* (LHK, Cap. 1); see further *CSR v. Arrowtown Assets Ltd* [2004] 1 HKLRD 77, where the Court of Final Appeal unambiguously followed a purposive approach to statutory interpretation.

[46] That is, those jurisdictions that adopted income tax legislation based on the *Model Colonial Territories Income Tax Ordinance 1922*.

[47] See SC Rolt, *Income Tax in Singapore and the States of Malaya* (Singapore: Craftsman Press, 1964) at 1. In the case of Australia and New Zealand, which have moved to more complex income tax regimes, the statutory similarities were confined to those provisions that were initially adopted: Sat Pal Khattar, *supra* note 8.

amendment to the ITA to introduce a general anti-avoidance provision in 1988, which was based upon Commonwealth legislative precedent.[48]

E. *Administration of Taxation Laws in Hong Kong*

Let us now briefly examine the role played by the HK-IRD, the administrative arm of the HKSAR Government which collects tax and enforces the main revenue laws in Hong Kong. In short, taxpayers are entitled to an efficient system of tax administration and in Hong Kong they generally get it;[49] taxpayers are entitled to be treated equally before the law and this can be enforced if discrimination occurs; and taxpayers also enjoy the right to have accessible up-to-date sources of the law and practice governing a person's rights to have, and pay, tax properly charged. Judged comparatively, judicial review applications in the context of Hong Kong taxation are still fairly rare.

But a word of caution against self-satisfaction is necessary, since the conclusions reached in the previous paragraph need to be judged in the context of Hong Kong's overall system of imposing taxation—which can only be described as 'featherweight'. Given this context, it has been comparatively easy for the HK-IRD to foster good relations with the (small) taxpaying community. Is it any wonder then that generally Hong Kong taxpayers, let alone non-taxpayers, appear happy with the status quo and seemingly have no real desire for great change?

These comments are not, however, intended to deprecate the HK-IRD's achievements, since its image remains generally positive, and the process of tax administration, assessment and collection is transparent. Rather, they are a reminder that in this rapidly changing world it behoves both tax collector and tax payer to guard against complacency.

F. *Administration of Taxation Laws in Singapore*

Similar sentiments to those expressed above have found resonance in Singapore courts regarding the role and powers of the Inland Revenue Authority of Singapore[50] ("IRAS"). By way of background, it should be explained that the IRAS was set up as a statutory board in 1992 to take over the functions of the Inland Revenue Department. One of the main objectives for its creation was to provide it with the autonomy to improve the outcomes of its tax collection functions. The IRAS acts as an agent of the Government in administering, assessing, collecting and enforcing payment of income tax, property tax, stamp duties, estate duties and other taxes. The purpose of constituting it as a board was to provide the necessary flexibility to formulate personnel policies and offer more competitive wages to recruit and retain

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[48] Dr Richard Hu, Minister for Finance: "Furthermore, there are adequate safeguards provided under the amendment which are to be found in the judicial interpretations of legislations having similar wordings such as in New Zealand and Australia, for there is a considerable body of case law on which we can rely for the purpose of construing the proposed section 33." Sing., *Parliamentary Debates*, vol. 50 at col. 366 (13 January, 1988)

[49] See Halkyard, *supra* note 32 at 143, 146 and 148.

[50] *Inland Revenue Authority of Singapore Act* (Cap. 138A, 1993 Rev. Ed.).

talent competitively to enhance the management and professional competence and to improve the efficiency of revenue collection.[51] In recent years, the IRAS invested in technology that enhanced its performance and it is pleasing to note that the cost of collection per tax dollar was a mere 0.93 of a cent.[52]

Notwithstanding its achievements, the courts have found it necessary to remind the IRAS that the court is the final arbiter of any tax dispute. In the case of *Comptroller of Income Tax v. GE Pacific Pte Ltd*, Yong C.J. said:

> Before concluding, we feel it necessary to note that counsel for the Comptroller repeatedly referred to the fact that the practice of the Comptroller has always been to give the balance of the capital allowances to the related buyer in a s 24 situation. This, though an interesting fact, has had no effect on our decision whatsoever. That this has been the practice of the Comptroller does not in any way illuminate the question of whether this *should* be the practice of the Comptroller. Practice is not law.[53]

III. What are the MAjor Themes of Similarity and Divergence in the Income Tax Systems in Hong Kong and Singapore?

In embarking on this analysis, it is necessary to first recall the key features of the Hong Kong and Singaporean tax systems relating to the taxation of income and business profits and then to determine in which major ways they are similar and in which significant ways they diverge.[54]

A. *Hong Kong*

Turning first to Hong Kong, generally speaking it does not encourage particular types of business activity by providing tax and other targeted incentives such as rules for enhancing deduction of expenses, reduced tax rates and tax holidays, and concessions for land allocation and property rates.

The major exception to this statement can be found in various forms of government assistance, usually indirect, provided to industry through the auspices of the Innovation and Technology Commission. In this regard, perhaps the most significant assistance is rendered by the Hong Kong Science and Technology Parks Corporation, which offers infrastructural support to technology-based companies and activities.[55]

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[51] Sing., *Parliamentary Debates*, vol. 60 at col. 133 (31 July 1992).

[52] See *Annual Report/Inland Revenue Authority of Singapore* (Singapore: Inland Revenue Authority of Singapore, 2005-6) at 35 [*IRAS Annual Report* 2005-6].

[53] [1994] 2 S.L.R. 690 at 700 (C.A.).

[54] For an analysis of the taxing jurisdiction over, and levels of tax on income derived by, corporations in Singapore and Hong Kong, see P Gurney, "Corporate Taxation in Australia, Hong Kong and Singapore: Observations on Some Jurisdictional and Operational Distinctions" (2006) 36 Hong Kong L.J. 259.

[55] This statutory corporation began operating in 2001 following the merger of the former Hong Kong Industrial Estates Corporation, the Hong Kong Industrial Technology Centre Corporation and the Provisional Hong Kong Science Park Company Ltd. See generally, *Directory on HK Science and Technology Resources*, online: The Government of the Hong Kong Special Administrative Region of the People's Republic of China Innovation and Technology Commission <http://www.itc.gov.hk/en/directory/stpublic.htm#stparks> (last accessed on 4 June 2007).

Its aim is to provide a one-stop service to industry, from nurturing technology start-ups through the incubation programme, providing premises and services in Hong Kong's Science Park for applied research and development activities, to offering land and premises in the industrial estates for production.

Prior to 2006, the two exceptions to Hong Kong's professed principle of neutrality in taxation treatment between different industries and trades, and between residents and non-residents, can be found in the reduced profits tax rate applicable to interest income from qualifying debt instruments and to the profits of reinsurance business.[56] Subsequently, 2006 saw the enactment of the *Profits Tax (Exemption for Offshore Funds) Ordinance 2006*,[57] which retroactively exempted offshore funds from profits tax for the last six years (a period which represents the normal limitation period for prior year assessments) and for the future. In short, the Ordinance aims to enhance Hong Kong's status as an international financial centre by exempting "non-resident persons" (including individuals, corporations, partnerships and trustees) from profits tax on dealings in securities and other financial instruments typically traded by offshore funds,[58] provided the dealings are arranged through authorized financial institutions and brokers licensed under Hong Kong's *Securities and Futures Ordinance*.[59] The concepts of "resident" and "non-resident" fund entities (as indicated above, residence as a criterion for taxation is generally irrelevant for Hong Kong taxation purposes—since Hong Kong taxes on a source basis) is determined on the basis of a "central management and control" test (for a fund entity which is not an individual), notwithstanding that its fund's asset portfolios are controlled and managed by a Hong Kong manager. The profits tax exemption does not apply if the non-resident fund carries on business in Hong Kong, except for the qualifying transactions and incidental transactions.

To prevent abuse of the exemption by Hong Kong residents, deeming provisions apply to tax their share of an offshore fund's Hong Kong-source tax-exempt profits where a Hong Kong resident holds a beneficial interest in the offshore fund. In determining the extent of a resident's beneficial interest, a 30% *de minimis* rule applies, unless the offshore fund is an associate of the Hong Kong resident (in which case the *de minimis* rule does not apply).

B. *Singapore*

Hong Kong's system of taxation can be compared and contrasted with that of Singapore. While Singapore flourished as a trading centre for the region in the 19th Century, the devastating effects of the Second World War had left the country with a dire need to secure a broader growth driver to economically sustain the needs of an

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[56] IRO, ss. 14A and 14B. The reduced tax rate under these provisions is 50% of the normal corporate profits tax rate (which currently stands at 17.5%).

[57] Ordinance No. 4 of 2006, which was enacted on 10 March 2006.

[58] These 'qualified transactions' are defined in Schedule 16 of the IRO as transactions in (1) securities, (2) futures contracts, (3) foreign exchange contracts, (4) making deposits (except for a money-lending business), (5) foreign currencies and (6) exchange traded commodities (gold and silver). Transactions involving insurance policies and shares in private companies are excluded.

[59] LHK, Cap. 571.

increasing population. It chose to embark on a path to create an industrial base for foreign investors in Singapore. Given its urgency, Singapore proceeded to employ tax incentives as a means to mitigate the risks and costs of setting up operations in a country where both natural resources and requisite skilled manpower were lacking.

Despite some pessimism with that strategy, two Ordinances were passed in 1959. They were the *Pioneer Industries (Relief from Income Tax) Ordinance*[60] and the *Industrial Expansion (Relief from Income Tax) Ordinance*.[61] A statutory body, the Economic Development Board, was set up in 1961 to oversee the industrialisation of Singapore. In 1963, after gaining independence from Britain, Singapore merged with the Federation of Malaya to form Malaysia. However, political and economic differences were not conducive to engender the environment necessary to propel the industrialisation plan. Singapore left Malaysia in 1965 and became an independent republic.

The effects of the separation from Malaysia and the withdrawal of the British bases in 1967 set Singapore on a more determined course to create jobs and succeed despite the adversity. It restructured its objectives to create a manufacturing base for multinational corporations to produce goods for export. The twin Ordinances of 1959 were repealed and in their place the *Economic Expansion Incentives (Relief from Income Tax) Act 1967*[62] ("EEIA") was enacted. A host of fiscal incentives targeted at the desired industries were created. That included tax holidays for varying periods for pioneer industries as well as reduced income tax rates for other forms of economic contributions. Foreign investment into Singapore grew rapidly and Singapore prospered.

In the decades that followed, the provisions of the EEIA evolved to reflect the economic priorities that prevailed. It created specific incentives to encourage capital formation, expansion into the service industries and provided further sectoral differentiation through outright exemptions and concessionary tax regimes. Some of these regimes found their way into the *Income Tax Act*.[63] The more well-known ones include the concessionary rate of tax at 10% for approved companies such as Headquarters, Offshore Entities, Global Traders as well as those that offer trustee services.

Over the years, however, the corporate income tax rates continued to fall from a high of 40% in 1986 to 20% in 2005. Generally, a fall in the headline tax rate has a direct adverse impact on the attractiveness of a tax concession. Furthermore, international competition for hosting high value-added foreign investments is sufficiently intense to potentially undermine the significance of the role played by tax incentives. Tax incentives alone are certainly no longer effective in attracting desired inbound foreign investments as many host nations are also prepared to offer significant non-fiscal incentives to differentiate themselves from competition. As such, it would not be surprising if Singapore incrementally reduces its reliance on tax incentives in the future to target specific investments. Furthermore, as the government becomes more aware of the difficulties in picking tomorrow's winners in a globalised economy,

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[60] No. 1 of 1959, Colony of Singapore, Ordinances 1959.

[61] No. 2 of 1959, Colony of Singapore, Ordinances 1959.

[62] Act No. 36 of 1967.

[63] See generally, ITA, ss. 43A to 43U.

it may choose to rely on the private sector to play a greater role in capital allocation. Instead, it might move towards restoring sectoral fiscal equity at lower effective income tax rates across the board.

C. *Summary*

In conclusion, whilst the origins of both the Hong Kong and Singapore taxation systems are the same—indeed, various key features of the *Model Colonial Territories Income Tax Ordinance 1922*, such as a source based jurisdiction to tax, are mirrored today in both places—it is necessary to appreciate a fundamental philosophical difference between the two jurisdictions. Specifically, whilst the Hong Kong taxation and foreign investment regimes are based upon the concept of neutrality in the sense that the HKSAR Government has not used these to pick 'winners', those of Singapore are carefully focused to actively encourage investment by means of specific taxation and other commercial incentives. Why this divergence has occurred is the focus of the following Part IV of this article.

IV. Are there Unique Imperatives that Account for the Divergences in the Income Tax Systems in Hong Kong and Singapore?

It is trite to state that neither Singapore nor Hong Kong has natural resources to anchor their economic survival. Singapore survived by evolving from a centre for a flourishing entrepot trade to an industrial nation through a carefully targeted economic programme as outlined above. Through a variety of tax and non-tax measures, it successfully attracted foreign capital by taking a pragmatic approach in balancing the public interest of maximising tax revenues and the private interest of maximising returns. Besides granting tax incentives to multinational corporations ("MNCs") that set up operations in Singapore, it has diligently carved out a network of Double Taxation Agreements ("DTAs") to provide relief from double taxation on income earned by these MNCs. Today, Singapore has signed 61 comprehensive DTAs. Of these 54 are now in force. In addition, Singapore has concluded 7 limited treaties relating to the taxation of airline and shipping income, including one with Hong Kong.

However, tax incentives are of no value to the intended investor if the exemption from Singapore income taxes resulted in the investor bearing the full tax burden in the home state. But for the Singapore tax exemption, the investor would generally have borne a reduced tax burden in the home state as it would generally be eligible for foreign tax credits on the taxes suffered in Singapore. The necessity to provide for tax sparing credit relief in the DTAs became critical to Singapore, and thus most of its DTAs contained this provision.

In recent years, several contracting states have either moved to limit the scope of tax sparing credit reliefs under Singapore's DTAs or have allowed them to lapse upon expiry. Tax sparing credits are no longer available in Singapore's DTAs with Australia, Denmark,[64] Finland, Japan, New Zealand, Norway, The Netherlands, Sweden and United Kingdom. Currently, Singapore has 23 DTAs where provision

[64] There are provisions to exempt dividends from Singapore if the holdings are 10% (Finland) and 25% (Denmark).

for mutual tax sparing credit relief exists and six DTAs where Singapore grants tax sparing credit. It is therefore abundantly clear that the success of continuing with the strategy of providing tax incentives would diminish in a global environment of falling income tax rates, a proliferation of tax incentives in many countries and the absence of reciprocal tax sparing credit relief.

In addition, the move by MNCs to locate labour-intensive manufacturing operations to cheaper locations meant that Singapore had to re-invent itself economically. The communication revolution has enabled global businesses today to operate along functional rather than geographical structures. These functions can be located in different jurisdictions to achieve comparative efficiencies without compromising performance. As such, the Singapore economy adapted quickly to meet the demands of these global businesses for financial services. The tax system continued to align its goals to support the financial sector in its provision of headquarter, holding companies, finance, R & D and other high value added services to the regional subsidiaries of these MNCs.

To further enhance the appeal of Singapore as a world class service economy, Singapore introduced two bold tax reform measures in 2003 to simplify the tax system. The first measure taken was that, except in limited circumstances, Singapore effectively abolished the remittance basis of taxation in 2003.[65] In the same year, Singapore introduced a new system of corporate taxation—One-Tier corporate taxation. Under this system, all Singapore sourced dividends paid by any company shall be exempt from tax.[66] The transitional rules permit the continuation of the imputation system until 31 December 2007.[67]

These two major tax reforms effectively reduced the tax and associated compliance burdens borne by MNCs that use Singapore as a hub for their regional operations. As a result, the typical forms of unrelieved double taxation on certain types of corporate income flowing through Singapore entities have largely been eliminated. MNCs no longer need to manage their foreign tax credits for the sole purpose of paying franked or exempt dividends to their shareholders outside Singapore.

Turning to Hong Kong, like Singapore after the Second World War it also survived by becoming a centre for entrepot trade. Again, like Singapore, it evolved into an industrial economy and, most recently, after its industrial base decamped to mainland China, into a regional service and international financial hub. If one were to jump to the present day, and take a snapshot of Hong Kong taxation developments during the past year, it is no coincidence that virtually all of them are viewed as impacting upon Hong Kong's status as an international financial centre. The most important of these are (1) a profits tax exemption for offshore funds, (2) the conclusion of comprehensive double taxation agreements with Mainland China and Thailand, (3) a perceived toughening of Hong Kong's source rules relating to the taxation of business

[65] With effect from 1 January 2004, the remittance basis ceased to apply to individuals except where income is received through a partnership: ITA, s. 13(7A). In the case of resident persons other than individuals, exemption applies to foreign sourced dividends, branch profits and service income in certain circumstances: ITA, ss. 13(8), (9), (10). See also *IRAS e-Tax Guides (2003/BC/3)* dated 21 May 2003 and *Supplementary Circular (2004/IT/8)* dated 30 July 2004. As an administrative practice, non-resident persons other than individuals are rarely subject to the remittance basis: see clarification by IRAS on ITA, s. 10(25) in *e-Tax Guide (1995/IT/5)*, updated 15 March 2005.

[66] ITA, s. 13(1)(za). With some planning, virtually all dividends are exempt from Singapore tax.

[67] ITA, s. 44A.

profits, (4) the abolition of estate duty and (5) the (now defunct) proposal to introduce a goods and services tax.[68]

Apart from the exceptions noted in Part II of this article, Hong Kong, unlike Singapore, has not encouraged investment through taxation and other broader incentives. Although largely correct, this statement ignores the fact that the philosophy underlying Hong Kong's economic and taxation system is to provide maximum incentive to *all* businesses to operate in a singularly compliance friendly regime without regard to the form they take or the industry or trade in which they operate. Indeed, foreign investors may be surprised to learn that it has historically been the case, and is still the case today, that the very great majority of business transactions in Hong Kong are not driven by taxation considerations. The key to all this is undoubtedly that, since 1947 to the present day, the tax rates in Hong Kong have always been pitched low. Thus, by and large, tax incentives have been neither necessary nor indeed thought desirable to attract and retain business within the territory.

In conclusion, it would appear that factors such as the desire to enhance economic wellbeing and foster social stability (in both jurisdictions) by maintaining a very light but revenue productive tax regime (in Hong Kong) and the need to retain sovereignty and deal with drastically changing economic circumstances after independence (in Singapore), have led to the diversity in legislative approach to imposing taxation. Notwithstanding some major differences in their experiences, both jurisdictions embraced common imperatives that could account for the tax policies and regimes they ultimately adopted. Both jurisdictions remain fully convinced that enhanced competitiveness in an increasingly globalised economy is vital to economic well-being and social stability. Yet, this common goal did not preclude the diversity in their taxation systems. As a policy objective, Hong Kong chose a low rate, tax neutral environment for investment and business activity while Singapore pursued a more differentiated tax regime that comprised a multitude of domestic tax incentives coupled with a wide ranging tax treaty network.

V. Can the Taxation Systems of Hong Kong and Singapore Meet the Challenge of Ensuring a Viable Revenue Base?

A. *Singapore*

The Prime Minister of Singapore in a recent speech in Parliament highlighted the need to maintain a competitive advantage to sustain economic growth, create employment opportunities and generate wealth.[69] To ensure that this advantage is sustainable, more resources would have to be devoted to upgrade and improve outcomes in education, research and development and infrastructure. With a government that consumes only 14–15% of GDP, it is a big challenge to finance those objectives with an ageing population, widening income disparity and intense competition for foreign

[68] These matters are analysed in Halkyard, "Developments Affecting Hong Kong's Status as an International Financial Centre" 44 Tax Notes Int'l 1051.

[69] Speech by Prime Minister Lee Hsien Loong in Parliament: see Sing, *Parliamentary Reports*, vol. 82 (13 November 2006).

investments from jurisdictions with lower corporate tax burdens and cheaper costs of production.

Compared to the situation in 1980, Singapore's old age dependency ratio is expected to deteriorate from 1:14 to 1:5 in 2020.[70] The demographic pattern appears bleak. Total fertility rate ("TFR") has been falling since 1970 (3.07) and hit a record low of 1.25 in 2005.[71] The Singapore TFR fell below replacement rate in 1976. The combined effect of falling birth rates and rising old age dependency meant that Singapore's age dependency ratio dropped from 73.9 in 1970 to 39 in 2006.[72] Apart from arresting the root causes of low birth rates and raising the official retirement age, it is imperative for Singapore to correctly calibrate its existing labour, social support, citizenship and tax policies to successfully compete with many other jurisdictions to be a desired destination for a limited pool of desirable immigrants from other nationalities to augment the population.

Unlike some other countries, Singapore does not have the burden of funding a comprehensive and costly public social security system. However, a significant amount of resources is nevertheless required to meet the financial needs of an increasing number of elderly in an ageing society. In addition, there is a need to strengthen safety nets to assist citizens whose earning powers have been adversely aggravated by globalisation and employers outsourcing some functions to cheaper locations. It is vital to devise innovative measures to minimise abuse and misallocation of precious subsidies to replace blunt and rigid instruments of redistribution.

The combined effect of abundant cheap skilled labour in China and India together with falling corporate tax burdens in some Eastern European countries[73] have curtailed the Government's ability to raise more revenues through direct taxes to fund these costly social programmes. Instead, Singapore has to remain vigilant to reduce direct taxes when necessary to remain a competitive location for foreign capital seeking the best returns.[74]

In the light of the challenges facing the nation, the Government decided to advance the objectives of the tax reform and implement further measures to secure the desired social and economic outcomes. It announced the decision to increase the rate of its most important indirect tax, the Goods and Services Tax ("GST"), from 5% to 7% with effect from 1 July 2007. The increased tax revenue will provide for a limited revenue substitution to cope with any further erosion to the existing tax bases or the need to reduce income tax rates. In line with this, corporate and the highest personal tax rates will be reduced to 18% and 20% respectively.

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70 Statistics taken are from the Prime Minister's speech. Dependants are defined as those who are 65 years old and above. The broad measure compares these dependents with young working-age persons.

71 See also TC Heng and MT Png, "Singapore's Demographic Trends in 2003", *Singapore Statistics Newsletter* (September 2004) 12 at 15.

72 Per 100 population aged 15-64: see *Population Trends 2006* (Singapore: Department of Statistics, 2006) at 3.

73 Poland, Hungary, Slovakia, Czech Republic, Latvia and Lithuania all have corporate tax taxes that are less than 20%.

74 The Prime Minister noted that "[d]irect taxes cannot go up. In fact, we have been bringing down our direct taxes, ie, personal income tax and corporate tax. We have brought them down to 20% over a long period of time. In fact, we may have to lower them further. … [but] I am not going to tax 50% on income tax. I am not going to tax 20% on GST, or 25% the way the Scandinavians do. But I have to make an adjustment—2%—I think this is fair and I think Singaporeans will support it." see *supra* note 69.

1. *Introduction of GST*

GST[75] was introduced in 1994 at a rate of 3% as a broad-based consumption tax with very limited exemptions.[76] The main rationale for the introduction of GST was clearly revenue substitution for direct taxes in the long term.[77] It was a reform package that included immediate significant reductions especially in income tax rates.[78] As it was introduced at a time when the nation was in a healthy budgetary position, Singapore was able to offer a package of direct financial transfers to the low income groups coupled with other tax offsets that more than cushioned the regressive effects of the broad-based GST.

2. *The fiscal transformation since the introduction of GST*

The total tax revenue collected in the 2005–06 financial year was S$19.9 billion.[79] Expressed as a percentage of GDP, the total tax revenue amounts to a mere 10.2%. Total tax revenue accounted for 70% of government operating expenditure. At S$3.8 billion, GST at the current rate of 5%[80] accounted for nearly 20% of total tax revenues. Income Tax contributed the lion's share at about 58.7%—a total of S$11.7 billion.[81] Prior to the introduction of GST in 1994, taxes on income and profits were the major source of tax revenues and contributed about 67% of total tax revenues.[82]

3. *A bigger role for GST in the future: consolidation and growth*

The world economic situation has undergone dramatic changes since the introduction of GST in 1994. Competition for foreign investments has taken on new dimensions with China, India and many dynamic emerging economies offering opportunities and returns to investors that are difficult to match or refuse. Global businesses have also

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75 Although it was only introduced in 1994, Mr. Lee Kuan Yew, when he was Prime Minister, had stated categorically in 1977 that: "[t]he real tax policy for us as a developing country is a tax on expenditure. Yes, value added, which is the way the European Community does it. Their biggest tax comes from value added tax. The more you spend, the more money you have, the better the life you lead, the more you can afford to pay for other people's children's education, good health. But here, the higher the income tax, by cutting the base you put the burden on a small group, the more unjust it becomes." Sing., *Parliamentary Debates*, vol. 36, cols. 444-5 (23 February 1977).

76 Reflecting the views of Mr. Lee Kuan Yew when he commented on the relative merits of a broad based income tax: "And I think the broader the base the more people pay income tax, the less they are in favour of things for free." See *supra* note 75 at col. 444. The only supplies that are exempt from GST relate to supplies in most financial services and transfers of interest in immoveable property zoned for residential use: see Fourth Schedule, *Goods and Services Tax Act* (Cap. 117A, 2005 Rev. Ed.).

77 *The Goods and Services Tax* (Singapore: Ministry of Trade & Industry and Ministry of Finance, 1993) at 7-8.

78 As a result, about 75% of individual taxpayers in Singapore fell outside the income tax base in 1994: G Jenkins and R Khadka, "Tax Reform and its implementation in Singapore", (Development Discussion Paper Series 644, Harvard Institute for International Development, 1998) at 9. As pointed out by these authors, GST effectively replaced income tax for this category of taxpayers.

79 See *IRAS Annual Report* 2005-6, *supra* note 52 at Appendix 2, 111.

80 The rate was increased to 4% from 1 January 2003, and subsequently to 5% on 1 January 2004.

81 The rest comes mainly from Property Tax, Betting Duty, Stamp Duty and Estate Duty.

82 *Annual Report/Inland Revenue Authority of Singapore* (Singapore: Inland Revenue Authority of Singapore, 1993), Appendix 2.

been rapidly adopting business models that have further enhanced the attractiveness of dispersing business units geographically along efficiency and functional lines.

The proposed increase in the GST rate to 7% is estimated to raise about S$1.5 billion in revenue.[83] GST provides a more stable source of government revenue in the long run that is less dependent on economic cycles.[84] It would also secure more diversified and stable sources of tax revenue for Singapore. In addition, it will raise additional resources to implement social programmes to build safety nets for the marginalised and vulnerable segments of the population without compromising the incentive to work. If the correct policies continue to be put in place to deal with the adverse impact on the lower income group, there would be less social or political objections to the increase in tax burden.

In the 2007 Budget,[85] it was announced that more than 50% of the estimated S$7.5 billion to be collected from the rate increase over the next 5 years will be used to fund offset packages to address the redistributive effects of GST. Broadly, all citizens will receive various rebates with precise entitlements pegged to income and assets of each citizen. Low income earners, retirees who are dis-saving and education grants for children will account for the lion's share of the package. In the medium term, the Government must continue to utilize any temporary reprieve to further enhance the outcomes of public expenditure, selectively reduce public expenditure through "user pay" structures and create new sources of non-tax revenue.

Depending on a confluence of circumstances including the state of the domestic economy, public sentiment and global developments, it may be not far fetched to expect a further fiscal rationalization of substituting direct tax cuts with an increase in GST rate to 10%.[86] The average GST revenue as a ratio to GDP in OECD countries was 11.4% in 2004.[87] At the current rate of 5% in Singapore, GST barely extracted 2% of GDP in 2005,[88] about one-sixth of the 2004 OECD average. From the trends emerging in the majority of OECD countries, the share of total tax revenues as a ratio of GDP has been falling since 2001.[89] In percentage terms, the contribution of taxes from income and profits to total tax revenues in these countries has also been shrinking since 2000.[90] It appears that the traditional role played by direct taxes as major contributors to the tax revenues in these countries may appear to be

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[83] Assuming current GDP prices. See SH Leong, "Time to explore ways of raising govt revenue", *Business Times* (15 November 2006) (LexisNexis).

[84] Currently, the "Wholesale and Retail" sector alone accounts for a whopping 43.7% of all GST revenue collected in the financial year 2005/6: *IRAS Annual Report* 2005-6, *supra* note 52 at Appendix 11, 120.

[85] The 2007 Singapore Budget Speech was delivered by Second Minister for Finance, Mr Tharman Shanmugaratnam. See Sing., *Parliamentary Debates*, vol. 82 (15 February 2007).

[86] The management of the expectations of businesses and public through continuous engagement is vital. It is critical to educate them on the relative merits of limited taxation options, implications of inter-generational transfers of wealth and the challenges of maintaining an optimal tax incidence to fund essential public expenditure without distortions to individual work ethics and efficient capital allocation or compromising returns to capital investment.

[87] See *OECD Factbook—Economic Environmental and Social Statistics* (Paris: Organisation for Economic Co-operation and Development, 2007) at 207.

[88] The GST collected in FY 2005/6 was about S$3.8 billion: *IRAS Annual Report* 2005-6, *supra* note 52 at Appendix 2, 111. The GDP in 2005 was about S$195 billion at current prices: see "Singapore Statistics", online: Ministry of Trade and Industry <www.mti.gov.sg> (last accessed on 4 June 2007).

[89] In 2004, the average ratio was 35.9%: see *OECD Factbook*, *supra* note 87 at 205. The ratio in 2003 was 35.8%.

[90] In 2004, the average ratio was 12.5%: see *OECD Factbook*, *supra* note 87 at 206.

shrinking. In a truly globalised economy, some countries may eventually regard tax competition as inevitable, harmful or otherwise. Hopefully, nations will achieve some global consensus on the parameters for a harmonious divergence in sovereign tax policies as legitimate outcomes of a competitive global environment.

B. *Hong Kong*

As with Singapore, Hong Kong faces similar challenges concerning the fragility of its tax base. And, as with Singapore, the Government's initial response was the same—GST.[91] But in Hong Kong's case this took the form of a proposal only and, even when the Government initially advanced the GST proposal, it was by no means assured of legislative approval. This was so notwithstanding the results of a detailed study published in 2002 showing that Hong Kong's tax base is both narrow and volatile.[92]

Although it is clear that Hong Kong must deal with similar problems to those facing Singapore, including an ageing population and its rising need for health and medical care, narrow direct tax base, likely increasing demands for more and higher standards of government assistance, and the necessity to remain economically competitive, many members of the public,[93] economists, journalists and academics,[94] as well as the major political parties in Hong Kong, all either opposed or expressed significant reservations about Government's proposal. In the event, on 5 December 2006, four months before the GST consultation was scheduled to end, in the face of this strenuous opposition the Government effectively withdrew its support for the proposal, accepting "that at this time there is insufficient public support, nor are the conditions right, for introducing GST."[95]

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[91] Specifically, on 18 July 2006 the Hong Kong SAR Government released a consultation paper on the possible introduction of GST. The consultation period was scheduled to last for nine months. The Government announced that the year 2010 was the earliest date on which GST would be implemented in Hong Kong. The proposal advanced by the Government was for a broad-based, low rate (say, 5%) GST, based upon the modern international GST model tax system adopted by countries such as New Zealand and Singapore. For a summary of and commentary on the proposal: see Steven Sieker, "Recent Developments Affecting the Private Banking Industry in Key Jurisdictions" (Paper presented in Hong Kong to the 11th Annual International Tax and Trusts Conference, 7 September 2006). See further, Tang Shu-hung, "A Critical Review of the 2006 Consultation Document on Broadening the Tax Base in Hong Kong" (2006) 10(2) Asia Pac. J. Tax'n 37; Yvonne Law, "Hong Kong—Consultation Paper on Goods and Services Tax Released" 43 Tax Notes Int'l 382.

[92] See *Final Report to the Financial Secretary: Task Force on the Review of Public Finances* (Hong Kong: Printing Department, February 2002).

[93] See Press Release, "Chief Executive Speaks on Goods and Services Tax" (12 September 2006), online: The Government of the Hong Kong Special Administrative Region of the People's Republic of China Inland Revenue Department <www.ird.gov.hk/eng/ppr/archives/06091201.htm> (last accessed on 4 June 2007).

[94] See Tang Shu-hung, "A Critical Review of the 2006 Consultation Document on Broadening the Tax Base in Hong Kong" (2006) 10(2) Asia Pac. J. Tax'n 37.

[95] See "Gov't to look beyond GST: Henry Tang" (5 December 2006), online: <www.news.gov.hk/en/category/ businessandfinance/061205/html/061205en03004.htm> (last accessed on 4 June 2007). See further, Martin Glass, "Hong Kong's Experience With Tax Reform" (Paper prepared by the Financial Services & the Treasury Bureau of the HKSAR Government and presented at the Asia Tax Forum, 18–20 April 2007, Hanoi) at 1–6.

But the problems set out in the previous paragraph will not simply disappear.[96] Indeed, it appears the greatest challenge concerning taxation in Hong Kong in the short to medium term lies in how it will deal with the effective abandonment of the proposal to introduce a GST. It goes without saying that this challenge will affect all of the Hong Kong SAR Government, business interests and taxpayers generally.

The key issue involves an appreciation that the direct tax base in Hong Kong is not only arguably narrow but, more importantly, very volatile and dependent upon confidence and the healthy state of the property market. Hong Kong experienced significant budget deficits during the Asian economic crisis and continuing into the early part of the new millennium. It should be anticipated that similar pressure will be placed upon its tax base in times of further economic downturn. Moreover, the major political parties, who unanimously and successfully opposed the introduction of GST, may be forced to recognize a different realpolitik when they become responsible for spending (and taxing) policy, since democratisation of the political landscape in Hong Kong cannot be postponed forever.[97]

All these factors bring into sharp focus the question whether Hong Kong's present reliance upon direct taxation for providing the bulk of government revenue can continue indefinitely and whether the imposition of a broadly-based system of indirect taxation can be postponed indefinitely. Notwithstanding the current climate of 'broad-based' opposition to the notion that Hong Kong should have a GST, change in this regard seems ultimately inevitable and, in a time of healthy budget surpluses, that time should be sooner rather than later. But, to state the obvious, that is not the current reality.

At present Hong Kong lives in a Jurassic Park tax world[98] and there is virtually no political or business momentum or will to change it. Structural tax reform would occur when budgetary needs dictate—and arguably they do not at present—and the Hong Kong public seemingly does not see this time of relative prosperity and stability as the right time. Whether GST or another form of more broadly-based tax will form part of Hong Kong's future tax landscape remains a highly contentious issue. In the meantime, the short-term future appears clear—maintain the status quo and rely upon an old, outmoded, Colonial-style system of direct taxation. But, in the long-term, the future appears to resemble Hong Kong's air quality—murky. Thus, contrary to current public opinion, this stasis and opposition to GST in particular and seemingly

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[96] Compare Tang Shu-hung, "The Political Economy of Tax Reform in Hong Kong" (2005) 9(2) Asia Pac. J. Tax'n 52, who provides a well-reasoned analysis arguing that appointing an independent taxation review committee would be the best way to address the issue of broadening the tax base in Hong Kong. This theme is further developed in Professor Tang's article entitled "A Critical Review of the 2006 Consultation Document on Broadening the Tax Base in Hong Kong" (2006) 10(2) Asia Pac. J. Tax'n 37.

[97] It is only fair to note, however, a contrary view held by other observers that the HKSAR Government's abandonment of the GST proposal shows a degree of strength and trust in the democratic process by taking heed of, and accepting, public opinion.

[98] See Halkyard, "The Hong Kong Tax Paradox Or Why Jurassic Park Exists in the Pearl River Delta" (1998) 8 Revenue L.J. 1. Again, it is only fair to note that Hong Kong's tax system has always been pragmatically focused, that Hong Kong should be proud of the success of its taxation policies, and other countries may do much worse than reflect on why this is so.

to tax reform in general is "not the end, it is not even the beginning of the end, it is just the end of the beginning".[99]

VI. Can the Taxation Systems in Hong Kong and Singapore Meet the Challenges Posed by the Changed Economic Conditions Prevalent in the 21st Century and What Role will the Common Law Play to Achieve This?

As indicated above, the common goal of both Hong Kong and Singaporean tax policy is to actively promote a fiscal environment that is aligned to encourage investment and economic growth, and to maintain economic and social stability. Given the way fiscal and economic policies have evolved in both places, we believe that any reform in the future is likely to be incremental since the fundamental strategies that have been employed have served them well. In Hong Kong's case, however, legitimate and serious concerns remain about the stability of its taxation base and its handling of the consultation to broaden its tax base as outlined at Part V of this article will be critical to the future of its taxation system. The recent abolition of Estate Duty (notwithstanding the touted comparative advantages achieved thereby) may turn out to be premature, if one accepts that a panoply of 'tax broadening' measures will need to be considered now that GST is no longer part of the HKSAR Government's agenda. Recent events have thus clearly shown how delicate and challenging tax reform can be.

In the legislative context, we expect that the tax statutes in both Singapore and Hong Kong will continue to be refined to promote certainty, maintain a light touch in relation to compliance and taxpayers' costs and, where budgetary constraints allow, minimise the direct tax burden imposed on productive activities.

Besides legislative refinements, both Hong Kong and Singapore will need to upgrade the capacities of their tax administrations. For instance, one of the pressing challenges facing Singapore, given the expected rise in the GST rate to 7%, is that the IRAS should continue to invest and allocate resources prudently to develop a more robust tax administration to minimise tax leakages. While the issue of tax gap has not been systematically analysed in Singapore, it is generally accepted that any rise in GST rate will increase the incidence of tax evasion and avoidance. Some types of transactions are likely to migrate to the cash or black economy to evade taxes.

If one accepts, as both the IRAS and HK-IRD do, that enhancing their commitment to taxpayer service and developing trust and respect between taxpayer and tax collector are vital to modern tax administration, then it is trite to point out that this requires additional resources. Similarly, the disintermediation and dematerialisation arising from electronic commerce may also compromise the ability of tax administrations to monitor, verify and audit flows of money and supplies. This again illustrates the need to maintain a proactive and informed tax administration, rather than one which is under-resourced and reactive.

In addition, as the nature of commercial transactions becomes increasingly global and complex, tax administrators must be vigilant to ensure that tax law and practice

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[99] The authors thank and acknowledge Professor Richard Cullen for reminding us of this phrase (with apologies to Sir Winston Churchill) in relation to the current state of the GST debate.

support rather than impede the economic goals of the society. Both the IRAS and the HK-IRD should continue to be consultative and assist in dealing meaningfully with genuine tax problems without regressing to adopt an inflexible adversarial approach towards a taxpayer's new business models.[100]

A pleasing illustration of the recognition in both Singapore and Hong Kong of the need to develop trust and dialogue between taxpayer and tax collector is the move in recent years to issue consultation papers as well as public invitations to review tax legislation before it is enacted. In Singapore, the IRAS also took the important step to make public guidelines on transfer pricing.[101] The tax administration's response to transfer pricing practices of MNCs will undoubtedly be closely monitored by the business sector. A statement of internationally accepted guidelines and compliance practices will go a long way to mitigate the intensity of objections from trading partners that impose relatively higher headline income tax rates. The IRAS should also continue to be proactive and supplement public rulings with private rulings in circumstances where the certainty of the law is paramount to a business venture.

In Hong Kong, Departmental Interpretation and Practice Notes setting out the HK-IRD's interpretation and assessing practices relating to more controversial tax issues (such as DIPN 42—dealing with the taxation of financial instruments and the taxation of foreign exchange differences) and new legislation (such as DIPN 43—dealing with the Profits Tax exemption for offshore funds) are regularly issued and updated, and electronically accessible.[102]

Taxpayers with global business operations have come to expect that the jurisdictions in which they operate will adopt and uphold basic rules that are widely accepted internationally. A certain degree of harmonisation and convergence in some of the more fundamental taxation concepts seems desirable. In this regard, the corpus of common law rules as it evolves both domestically and in other countries should continue to play an important role. Relevant judicial pronouncements elsewhere should not necessarily be consigned a narrow context as legal precedents. In certain instances, they may act as compelling references to a broader set of global values and standards. It may sometimes be necessary to validate such values where there is a clear global consensus.

A useful example in this regard is to note that judicial pronouncements by common law courts on the distinction between capital and revenue have regularly played a major role in the jurisprudence of other Commonwealth and former Commonwealth countries. A good illustration is the latest tax decision of the Court of Appeal in Singapore, *Comptroller of Income Tax v. IA*.[103] In that case, the Court had to apply the

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[100] For instance, in Singapore the IRAS issued a public consultation paper on 22 November 2006 to invite taxpayers to make recommendations on the deductibility of interest and other expenses associated with debt obligations. It expressly recognizes that borrowing costs today are no longer confined to interest expenses. See IRAS *Consultation Paper on proposed list of other borrowing expenses to be allowed for Income Tax purposes*, online: Inland Revenue Authority of Singapore <www.iras.gov.sg/ESVPortal/resources/consultationpaperonotherborrowingcosts.pdf> (last accessed on 4 June 2007). The background to this consultation can be traced to the Court of Appeal decision in *Comptroller of Income Tax v. IA* [2006] 2 S.L.R. 161. In Hong Kong, there were vigorous debates prior to the abolition of Estate Duty, the enactment of the *Profits Tax (Exemption for Offshore Funds) Ordinance* and the GST proposal during the two years' of public consultation.

[101] See "Transfer Pricing Guidelines", IRAS *e-Tax Guide 2006/IT/2* dated 23 February 2006.

[102] See www.ird.gov.hk (last accessed on 4 June 2007).

[103] [2006] 2 S.L.R. 161.

distinction between capital and revenue to a claim for deduction of interest and related payments in a syndicated loan. It embarked on a careful review of relevant precedents from Australia, Canada, Hong Kong and the United Kingdom. This is but one of the many cases that illustrate that the ongoing development of the common law continues to play a broader important role in the construction and application of domestic statutory provisions. This can be so notwithstanding that the precise details or scope of statutory provisions elsewhere may continue to diverge as countries continue to embark on legislative reform of their tax codes. Interestingly, a similar capital and revenue payment dispute arose in Hong Kong, involving a claim for interest deduction on a construction loan relating to the redevelopment of investment property. Cases from other common law jurisdictions, including the United Kingdom, Australia and Papua New Guinea, were referred to by the Privy Council in concluding that interest paid prior to the building becoming income earning should be capitalised and thus not immediately deductible.[104]

In conclusion, we believe that the common law—even in the context of a statute-based body of law—should continue to play a vital role in the future development and wellbeing of the taxation systems in both Hong Kong and Singapore. In this article, we have examined the taxation systems in both places from the perspectives of legislative process, judicial interpretation, and fair administration. In each of these contexts, the continued adoption of the best common law traditions would promote certainty as well as provide the flexibility for the goals of each taxation system to be constantly aligned with a rapidly changing global economic environment. This surely reflects one of the greatest strengths of the common law—combining all of the advantages of precedent, an ability to adapt and even lead to change within the community, and ensuring at all times that each and every person is treated fairly and in accordance with law. In this unique way, the accountability of the taxation functions of government has been, and will continue to be, significantly enhanced.

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[104] See *CIR v. Wharf Properties Ltd* (1997) 4 HKTC 310.