Tax policy and budget proposals

2019 - 20

Rising to the Challenges and
Staying Competitive

CPA
Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Budget proposals 2019-20

"***Rising to the Challenges and Staying Competitive***"

Summary

The Hong Kong Institute of Certified Public Accountants ("Institute")'s 2019-20 budget proposals, under the heading *Rising to the Challenges and Staying Competitive*, developed by the Institute's Taxation Faculty, focus primarily on tax policies and measures on the revenue side of the budget.

A summary of the proposals is as follows:

A. Smart city measures

1. Enhance Hong Kong's position as a research and development centre

   a. Extend the scope of research and development super deductions to research and development subcontracted to group companies, and also unrelated third parties.

   b. Grant tax credits to startups as they may be in a tax loss position in their initial years of operation and hence not able to benefit the tax super deductions.

2. Clarify the tax treatment of cryptocurrency transactions

   Clarify the tax treatment of income arising from transactions in relation to cryptocurrency trading and initial coin offerings in Hong Kong.

3. Implement time-based electronic road pricing in heavily congested areas and mandatory automatic toll tags.

4. Enhance tax e-filing services

B. Green measures

5. Introduce accelerated commercial and industrial building allowances for those buildings that adopt environmentally sustainable designs.

6. Improve roadside air quality and reduce greenhouse gas emissions

   a. In view of the shortage of electric vehicle charging stations, introduce a scheme for a full refund of vehicle first registration tax on electric private cars if the purchaser also makes arrangements for the installation of a certified charging station. Retain the existing incentive measures for private electric cars, i.e., the general exemption of up to HK$97,500 on the first registration tax and the ceiling of HK$250,000 through the “one-for-one replacement” scheme, after the introduction of this new enhanced incentive.

   b. Consider providing further incentives to encourage early replacement of old diesel commercial vehicles with those that meet current emission standards, in order to reduce roadside pollution and improve air quality.

C. Business and sustainable development

7. Promote Hong Kong as a ship leasing hub:

   Develop tax measures for ship leasing business without impinging on existing tax concessions for the shipping industry, and provide tax concessions for the marine insurance sector.

8. Strengthen Hong Kong's position as an international asset and wealth management centre:

   Formulate a tax framework for a limited partnership regime, and review the existing tax concession arrangements for the fund industry

9. Support for Hong Kong companies going outside Hong Kong (e.g. the Greater Bay Area)

   To support Hong Kong companies with operations outside Hong Kong, such as in the Greater Bay Area, relax the restrictive requirements of section 39E(1)(b) of the Inland Revenue Ordinance, i.e., permit depreciation allowances to be claimed for leased plant and machinery used outside Hong Kong.

10. Adopt competitive tax policies for group entities and other businesses

    Introduce:

    a. Group loss relief.

    b. Loss carry back.

D. Community measures

11. Introduce a home rental deduction

    Provide a tax deduction, capped at HK$100,000, for rental payments by taxpayers on their primary residence. Explore the possibility of covering a Hong Kong taxpayer's primary residence where this is located in other cities in the Greater Bay Area.

12. Encourage people to adopt a healthier lifestyle

    Allow a tax deduction on expenses on approved sports training classes, including expenses incurred by taxpayers or their dependants, to promote a healthier lifestyle. The deduction per taxpayer and his/her dependants should be capped at HK$12,000 per person.

13. Upgrade workforce skill sets

    a. Expand the scope of the deduction for self-education expenditure to cover expenditure incurred by a taxpayer's dependants, if they are not eligible for the same allowance in their own right.

    b. Consider the introduction of additional incentives for employers to invest in upgrading employees' skills through continuous education programmes.

14. Review salaries tax allowances

Review and rationalize the levels of the personal allowances and allowances for children, dependent parents or grandparents, dependent siblings, single parents and disabled dependants.

E. Tax efficiency and public funds

15. Review the tax system and incentives, and stabilize the long-term tax base

a. Conduct a broader and deeper review of Hong Kong's tax system

b. Periodically review the existing preferential treatments and tax incentives in Hong Kong's tax legislation to ensure that they are achieving the objective of maintaining Hong Kong's competitiveness in the global marketplace, and are cost effective.

c. Expand the coverage and expertise of the Tax Policy Unit.

d. Ensure fairness and consistent application of tax policies and legislation.

e. Make unilateral tax credit a feature in the tax system.

f. Allocate more resources to the Inland Revenue Department to enable the department to meet the challenges of international tax developments affecting Hong Kong, and the modernization of domestic tax administration.

Introduction

The Hong Kong SAR Government ("the Government")'s Third Quarter Economic Report 2018[1] indicates that Hong Kong's economy continued to grow solidly by 2.9% in the third quarter of 2018 over a year earlier, while moderating from the 3.5% growth in the second quarter. The Government's updated forecast for the increase in gross domestic product ("GDP") in 2018 as a whole, is 3.2%, at the lower end of the range forecast in the 2018-19 budget (3%-4%), but above the trend growth rate of 2.7% annually over the past decade.

Labour market conditions remained favourable. The seasonally adjusted unemployment rate stayed unchanged at 2.8%, while the underemployment rate edged up to a still-low level of 1.2%. Wages and earnings also registered solid and broad-based gains in real terms.

The pace of export growth decelerated in November, as the impact of the United States ("US")-Mainland trade conflict began to surface. Domestic demand stayed largely resilient in the third quarter. Private consumption expenditure, albeit less buoyant than in the previous quarters, expanded notably, buttressed by favourable job and income conditions. Overall investment expenditure picked up significantly, as machinery and equipment acquisition surged and building and construction activity registered a narrower decline. Yet, the local business sentiment has become more cautious in recent months owing to the increasing external headwinds.

The residential property market showed some cooling down, amid shrinking transactions. Pressures on consumer prices continued to build up alongside sustained above-trend economic growth. Domestically, the rises in fresh-letting residential rentals over the past year or so continued to feed through to consumer price inflation. Consumer inflation went up slightly to a headline rate of 2.5%.

Looking at the fiscal position, as at the end of November 2018, there was a cumulative year-to-date deficit of HK$27.8 billion. Expenditure for the eight-month period amounted to HK$336 billion and revenue HK$308.2 billion. Nevertheless, the fiscal reserves stood at a very healthy HK$1,075.1 billion.

Meanwhile, the Mainland's economy grew 6.5% year-on-year in the September quarter of 2018, after a 6.7% growth in the previous period. While still a level of growth that many countries would envy, it reflects the lowest quarterly growth rate since the first quarter of 2009 during global financial crisis, amid the ongoing trade dispute with the US.

Looking back at the introduction to the Institute's budget proposals last year, many of the issues raised then remain relevant:

- While Hong Kong's tax system still ranks highly in terms of its convenience and relative ease of use, the trend is that it is becoming increasingly more complex and is losing its competitive edge in important areas.

- New incentives are often not as effective as envisaged due to their limitations and complicated anti-avoidance provisions, and also because, to some extent, Hong Kong is playing catch up with jurisdictions that have already had similar incentives in place for some time (e.g., Ireland, in the case of the aircraft leasing

[1] https://www.hkeconomy.gov.hk/en/pdf/er_18q3.pdf

business).

- Hong Kong continues to be preoccupied with implementing international tax developments such as the Organisation for Economic Co-operation and Development ("OECD")'s base erosion and profit shifting ("BEPS") action plans and the Common Reporting Standard for automatic exchange of financial account information, which may not offer direct benefits to Hong Kong taxpayers while increasing the compliance burden.

- The Tax Policy Unit ("TPU") has yet to fulfil some of the expectations practitioners had of it when it was set up, to investigate certain more fundamental tax issues, such as the overall competitiveness of the tax system, its direction of travel, and Hong Kong's long-term fiscal stability.

On top of these issues, we are facing a number of local and external challenges and uncertainties:

- The slowing down of the Mainland's economy, even though it is still growing at a comparatively impressive rate.
- The ongoing trade dispute between the US and the Mainland, the fallout from which may well affect Hong Kong.
- Significant market volatility due, in part, to the above.
- Continuing high property prices, even though they have fallen slightly from their peak.
- Concerns over housing and land supply, and the divisions within society over this and other matters.
- Concerns over the future drivers of the economy, and development of the community, including the seemingly slow take up of the innovation and technology sector.
- Medium- to longer-term challenges, such as an aging population, with its concomitant impact on the cost of healthcare and other services, and an increasing dependency ratio.

Clearly many of these issues cannot be resolved by the tax system alone. However, a good, modern tax system can support the economy, incentivize enterprise and entrepreneurship, ensure the stability of public finances, help to support social policies, influence behaviour and, more generally, help to ensure that Hong Kong continues to be attractive to investors, and to people who come here to work in an environment that is conducive to bringing up their families.

We believe that the recommendations in our proposals can play a part in addressing some of these issues and, hopefully, stimulate discussion on others.

Detailed proposals

A. Making Hong Kong a "smarter city"

1. Enhance Hong Kong's position as a research and development centre

a. Increase the flexibility of the super deductions for research and development

The Government has been promoting Hong Kong as a regional research and development ("R&D") hub. It introduced the Enterprise Support Scheme to encourage the private sector to invest in R&D, by offering funding support of up to HK$10 million for each approved project, on a dollar-for-dollar matching basis. Despite the introduction of this matching fund scheme, it is difficult to compete with Shenzhen for R&D projects, as the more developed supply chain ecosystem in Shenzhen can better cater for the needs of R&D activities.

The introduction of the R&D super deductions in the Hong Kong tax system is generally a positive initiative by the Government to encourage the private sector to conduct R&D activities in Hong Kong. However, the revised section 16B of the Inland Revenue Ordinance ("IRO") inherits certain restrictions from the old provision and, as such, it may not be easy for many taxpayers to claim tax deductions on the R&D expenses they incur.

The revised section 16B imposes the following restrictions on taxpayers who wish to claim tax deductions for R&D expenditure:

(i) The R&D activities have to be carried out by the taxpayer directly, or by universities or colleges, or government-approved institutes; and

(ii) all rights generated from the R&D activities are required to be fully vested in the taxpayer.

The above two conditions make it difficult for many taxpayers to claim tax deductions under section 16B. Firstly, it is quite common for groups of companies to have a clear division of labour within the group, with the R&D functions centralized in one of the companies ("the R&D entity") and other group companies engaging this R&D entity to conduct R&D activities on their behalf. However, under the IRO, the other group companies may claim a tax deduction on relevant expenses paid to the R&D entity only if the R&D entity is an approved institute.

At the moment, there are 18 approved research institutes[2], all of which are public institutions. In order to boost R&D activities by the private sector, the Government should simplify the application procedures and shorten the turnaround time for approving applications for approved research institutes, including applications from private sector institutions.

The "fully vested" requirement can also make it difficult to claim tax

[2] Approved Institutes under Section 16C(1), https://www.ird.gov.hk/eng/tax/bus_16bc.htm

deductions under section 16B. It is not uncommon for businesses to conduct R&D activities on a joint-venture basis. Under these arrangements, the costs and benefits of the R&D activities would be shared among the joint-venture partners. However, none of the partners would be able to claim tax deductions as the benefits of the R&D activities would not fully vest in any one individual partner.

In view of the above, we suggest that the Government relax the "fully vested" requirement to accommodate the genuine business needs of the private sector.

b. Grant tax credits to startups undertaking research and development

As startup companies are commonly in a tax loss position during their early years of operation, it is unlikely that they can take advantage of the R&D super tax deductions. Given that startup companies are often engines for creativity and innovation, the Government should consider expanding the tax policy to encourage startups to undertake R&D by offering them tax credits.

Tax credits are offered to startups in a number of other jurisdictions as a more practical and valuable incentive for them. Given that the primary objective of the revised section 16B is to encourage R&D activities to be conducted in Hong Kong, tax credit arrangements, if implemented, could be limited to "Type B" expenditure under the current legislative regime for R&D tax deductions.

2. Clarify the tax treatment of cryptocurrencies and initial coin offerings

Despite the fact that there is no structured regulatory framework to regulate business activities in cryptocurrencies in Hong Kong, a significant amount of cryptocurrency business is being undertaken here.

Currently, Hong Kong is using securities legislation to regulate some aspects of cryptocurrency activity, which may not be an entirely appropriate tool for this new business. The Securities and Futures Commission ("SFC") released a statement[3] on cryptocurrencies in September 2017 outlining its high-level view on the application of the Securities and Futures Ordinance ("SFO") to initial coin offerings ("ICOs"). The SFC issued further guidance in November 2018 on interim measures regarding how to regulate crytocurrency trading activities in Hong Kong.

There is clearly an active international market for cryptocurrencies. While some other jurisdictions have developed relatively extensive rules or legislation, Hong Kong seems to be lagging behind, particularly given the level of such activity already taking place here. The SFC interim measures could be considered a positive step. However, there is also a need for clarity around the tax implications of cryptocurrency business activities conducted in Hong Kong, and in particular:

[3] Statement on initial coin offerings, https://www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/statement-on-initial-coin-offerings.html

- The proceeds from ICOs

  It is still unclear if the proceeds from ICOs would be subject to profits tax in Hong Kong. Arguably, these proceeds should be considered as capital in nature and, hence, not subject to profits tax in the hands of a Hong Kong issuer. Indeed, the proceeds from an ICO could be regarded as being of the same nature as the proceeds from an initial public offering.

  If, however, the Inland Revenue Department ("IRD") takes the view that these proceeds should be taxable for profits tax purposes, the IRD should provide clarity on how to compute the taxable amount; whether only the net economic profits from an ICO would be taxed, i.e.:

  - after the cost of development of the new business or technology has been deducted; and

  - only at the point when the corresponding "coins" (that is, the new cryptocurrency developed) can be used on a product that is eventually created, or at the point when the coins are traded for profit.

- The tax treatment of profits from trading in cryptocurrencies

  When the Institute met the IRD for its 2018 annual meeting, both parties agreed that it was necessary to provide further clarification on the tax treatment of profits arising from trading activities in crypocurrencies. We would urge the IRD to issue written guidance on this issue in the near future to provide the market with greater certainty.

  Without a greater degree of certainty, the risk is that the business will migrate elsewhere where the environment is more conducive to ICOs and crypocurrency trading. Hong Kong may lose out by default, simply because a position on this issue has not been formulated.

3. <u>Address traffic congestion and vehicle pollution black spots</u>

   In terms of alleviating traffic congestion in Hong Kong, we believe that the introduction of electronic road pricing ("ERP") and automatic toll tags in the busier areas, like the central business district, could be a cost-efficient means of improving the local traffic congestion and roadside air quality problems.

   Introducing a time-based levy should be able to help ease congestion in the busier areas by, in practice, limiting the time that many cars would stay on the roads and also reducing the idling of motor vehicle engines. The experience of London and Singapore indicate that having an efficient public transportation system in the city is one prerequisite for the successful implementation of an ERP system and, in this regard, Hong Kong already has a highly efficient public transportation system.

4. <u>Developing the e-filing system</u>

   The existing e-filing system for annual profits tax return is very restrictive. Taxpayers who are subject to profits tax with a turnover of more than HK$2 million are precluded from using the e-filing services. We consider that HK$2 million is very low as a cut-off point and, as such, many taxpayers filing profits tax returns are not able to use the e-filing services. We believe that, as a first step, the cut-off point should be revised upward to a more practical level of, say, HK$10 million.

As a minimum, an electronic copy of the existing paper returns should be made available to taxpayers so that they can fill in the return on a computer system and, thereafter, print it out for signature and submission to the IRD.

An efficient e-filing system will be particularly important for master file and local file filing under the newly-introduced transfer pricing documentation filing requirements. Taxpayers who are required to submit master and local files are required to prepare these files for submission to the IRD for accounting periods commencing after 1 April 2018. Given that large amounts of data will be submitted to the IRD under this new requirement, it would be more efficient for both taxpayers and the IRD if the relevant documentation could be filed electronically.

We believe the proposals in this section should be seen in the light of a broader "Smart City" plan.

B. Green measures

5. <u>Green facilities</u>

Sections 16H-K of the IRO allow accelerated tax deductions on certain specified capital expenditure incurred by taxpayers for their environmentally-friendly initiatives. "Specified capital expenditure" means any capital expenditure incurred on the provision of any environmental protection machinery or environmentally-friendly vehicles; or the construction of any environmental protection installations, where "environmental protection installation" means any of the following type of installations:

- Solar water heating;
- Solar photovoltaic;
- Wind turbine;
- Offshore wind farm;
- Landfill gas;
- Anaerobic digestion;
- Wave power;
- Hydroelectric;
- Bio-fuel;
- Biomass combined-heat-and-power ;
- Geothermal

While, in principle, these measures can help develop Hong Kong as a greener city, as Hong Kong is primarily an international financial centre, not many taxpayers will employ environmental installations in Hong Kong. Hence, the overall effectiveness of these environmental tax measures is questionable.

Allowing accelerated industrial building and commercial building allowances for new commercial and industrial complexes that adopt approved, environmentally-sustainable, designs could be a more efficient means to encourage developers to build green buildings. This would benefit the vast majority of people living in Hong Kong. We therefore suggest that the Government introduce an accelerated industrial and commercial building allowance mechanism for "green" buildings in the tax system.

6. Improve roadside air quality and reduce greenhouse gas emissions

Ahead of the climate summit in Poland, it was reported that Hong Kong is falling well short of its obligations to combat climate change agreed under the landmark Paris agreement three years ago[4]. In order to help address this issue the Government should explore broadly the role that tax policy can play in efforts to reduce carbon emissions and to conserve energy. In the meantime we recommend certain more specific proposals relating to vehicle emissions.

Vehicle emissions are a main source of air pollutants. In addition to implementing ERP to relieve traffic congestion and improve localized air pollution, as explained above, more wide-ranging and concerted efforts need to be made. In order to improve roadside air quality and reduce greenhouse gas emissions, we believe that the Government should implement the following measures:

a. *Keep promoting usage of electric vehicles and encourage the development of infrastructure (i.e., electric vehicle charging stations) to support usage of electric cars*

In the past, buyers of electric private cars enjoyed a full exemption of first registration tax as a means to promote usage of electric cars in Hong Kong. In the 2017-18 budget, the waiver policy was revised to limit the exemption amount to HK$97,500. In last year's budget, the Government introduced a tax break of up to HK$250,000 for purchasers of electric private cars who scrap an existing non-electric car in a one-for-one replacement scheme. The revised policy initiatives have had the effect of stalling the very rapid rise in the number of electric private cars seen before 2017-18.

In addition to the change in tax policy, the lack of availability of charging stations is another obstacle to electric vehicles becoming more popular in the market. Despite the efforts of an electric vehicle maker, which has recently established a 50-stall charging station in Hong Kong, the total number charging stations in Hong Kong cannot meet the current market demand.

According to the Environmental Protection Department, as of June 2018, there were 1,970 electric vehicle chargers for public use in Hong Kong, in various types of buildings[5], covering all 18 districts. This number is considered insufficient given that there are more than 11,000 electric vehicles registered in Hong Kong[6]. The ratio of 1:5.5 (i.e., one charging station to support almost six electric vehicles) indicates that the supply of charging stations falls significantly below the demand. By way of comparison, the number of publicly-available parking spaces as against the number of private cars in Hong Kong is about 1:3[7].

[4] http://gbcode.rthk.hk/TuniS/news.rthk.hk/rthk/en/component/k2/1431456-20181204.htm
[5] Installation of EV Chargers:: https://www.epd.gov.hk/epd/english/environmentinhk/air/prob_solutions/promotion_ev.html
[6] Monthly Traffic and Transport Digest (9July 2018): https://www.td.gov.hk/filemanager/en/content_4897/1807.pdf (p.68-89)
[7] Number of car parks https://www.td.gov.hk/en/transport_in_hong_kong/parking/carparks/index.html
Number of cars https://www.td.gov.hk/filemanager/en/content_4897/1807.pdf

Accessibility of charging stations is also an issue. A typical example is the 50-stall charging station referred to above. The stalls are all concentrated in one private location and are accessible only when hourly parking is paid for[8].

It appears that purely relying on the Government and real estate developers to develop charging stations may not be fast enough to establish an efficient network for Hong Kong. To expedite the development of an efficient charging station network, the Government should consider introducing a scheme to fully refund the first registration tax on a private electric car if the buyer also initiates the installation of a charging station.
The charging station to be funded by the car buyer should be either in the buyer's residential building, or at a site determined by the Government close to the car buyer's residence, work or area of activity (e.g., within 5km), accessible to the public, and installed/certified by an authorized charging station installer. A full refund of the first tax registration tax could be made to the car buyer once the charging station has been installed and certified. As regards installation in private residential buildings, we understand that, currently, there may be certain practical obstacles to be overcome, in which case the Government may need to take steps to encourage developers/ management companies to facilitate the process of allowing the installation of charging stations in their car parks.

The existing measures, that is the general exemption of up to HK$97,500 and the HK$250,000 "one-for-one replacement" arrangement should remain in place after implementation of this new incentive.

A number of countries have now set target dates for phasing out petrol and diesel vehicles altogether. Hong Kong should play its part in helping to reduce carbon emissions by putting in place an appropriate infrastructure, including readily-accessible charging stations, to cater for an expected growth of electrical vehicles.

b. *Expedite the replacement of diesel commercial vehicles.*

Passenger vehicles account for less than 3% of the total roadside emissions[9], while commercial vehicles account for most of the rest. It is reasonable, therefore, to target raising the emission standards of commercial vehicles as an effective means of improving roadside air quality in the city.

Most passenger vehicles in Hong Kong meet the Euro VI standard, and with the new policy as from October 2017, no new diesel passenger vehicles can, in practice, be registered in Hong Kong. On the other hand, over 99% of goods vehicles and buses on the street are diesel-engine vehicles and they do not meet the Euro VI standard.

We suggest that the Euro VI emission standard should be adopted for all commercial vehicles as soon as possible. Plans should be made to end the use of Euro IV and V commercial vehicles, following the phasing-out of pre-

[8] Tesla opens new Hong Kong electric car charging station, the biggest in Asia https://www.scmp.com/news/hong-kong/transport/article/2168521/tesla-opens-new-hong-kong-electric-car-charging-station
[9] Clean Air Plan For Hong Kong 2013-2017 Progress Report
https://www.enb.gov.hk/sites/default/files/CleanAirPlanUpdateEng_W3C.pdf

Euro IV vehicles[10]. In addition to this, electric commercial vehicles should be explored as a method to remove these major emission contributors from the roads.

We also propose that further incentive measures be considered to expedite the replacement of polluting commercial vehicles.

C. Business and sustainable development

7. Promote Hong Kong as a ship leasing hub

The Chief Executive indicated in her latest Policy Address that the Government will implement a series of measures, including tax measures, to support and enhance the development of high value-added maritime services in order to position Hong Kong as a ship leasing centre in the Asia-Pacific region.

We welcome this initiative but the Government should take the following factors into account during the tax policy formulation process:

- The prevailing tax exemption status of the qualified ship charterers in Hong Kong should not be affected by any proposed tax measures. For example, under section 23B of the IRO, except for the following income, other charter hire income is generally exempt from Hong Kong profits tax:

  - Charter hire income where the ship operates solely/mainly in Hong Kong waters;
  - charter hire income under any charter party, where one of the parties is a limited partnership registered before 3 December 1991, the main asset of which is a ship or an interest in a ship; and
  - half of any charter hire income for a ship operating between Hong Kong waters and the river trade limits.

- The proposed tax measures should be sufficiently competitive to attract ship leasing companies to set up their offices in Hong Kong. In Singapore, ship or container leasing companies, business trusts or partnerships enjoy tax concessions for up to five years on their qualifying leasing income. Hong Kong, therefore, needs to devise its own unique tax measures to attract overseas companies.

- In addition to putting forward attractive tax measures, Hong Kong needs to conclude more double tax agreements ("DTAs") with major shipping jurisdictions, such as Australia and Brazil. Without sufficient DTAs, Hong Kong registered vessels may not be competitive in the global shipping market.

  The Government may wish to make reference to the effectiveness of the corresponding concessionary tax measures on aircraft leasing, which was launched in July 2017. Since the policy was implemented, there have been a few prominent deliveries. For example, ICBC Financial Leasing delivered its first jetliner to a customer[11] in December 2017. In September 2018, China

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[10] Phasing Out Pre-Euro IV Diesel Commercial Vehicles
https://www.epd.gov.hk/epd/english/environmentinhk/air/prob_solutions/Phasing_out_diesel_comm_veh.html

[11] Hong Kong needs more than tax breaks for the aircraft leasing hub to get off the ground
https://www.scmp.com/business/companies/article/2126978/hong-kong-needs-more-tax-breaks-aircraft-leasing-hub-get-ground

Aircraft Leasing Group Holdings Limited delivered its first aircraft under the new tax regime through the Hong Kong leasing platform[12]. However, it seems that so far there have not been any further prominent deliveries.

While Hong Kong's tax concessions may reduce the effective tax rates of lessors to 3-4%, which is significantly lower than the rates in Ireland and Singapore, Hong Kong has concluded is only about the half of the number of DTAs signed by these two countries. In this regard, it is noted the head of Dublin-based SMBC Aviation Capital recently commented that the growth of Hong Kong as a leasing venue was not a threat to the Irish industry, as Ireland has a tax treaty network that covers the bulk of countries where aircraft are leased[13].

The need to have more DTAs chimes with the announcement made in the Policy Address, that the Government hopes to bring the total number of DTAs to 50 over the next few years.

In the current circumstances, therefore, Hong Kong's comparative lack of DTA coverage may, in practice, reduce the effectiveness of the new tax measures in the shipping sector.

- That said, similar tax measures should also be implemented for other supporting services for the shipping sector, such as ship management companies, agency business and marine insurances.

8. <u>To strengthen Hong Kong's position as an international asset and wealth management centre</u>

The Chief Executive also indicated in the Policy Address that the Government has been studying the establishment of a limited partnership regime for private equity funds. Meanwhile, the existing tax concessions for the fund industry are being reviewed to ensure that they are in line with international requirements on tax co-operation and, at the same time, able to promote the development of the sector.

The Government may wish to take the following factors into account:

<u>Establishment of a limited partnership regime</u>

- Competitive conditions should be created for setting up limited partnerships in Hong Kong that are attractive when compared with other global investment fund centres.
- Distributions to partners, like company dividends, should not be taxable in the hand of the partners.
- In terms of DTAs, as mentioned above, Hong Kong should seek to conclude agreements with more major markets and trading partners, such as Australia, in order to enhance the effectiveness of the proposed tax measure.

[12] CALC Delivers its First Aircraft under Hong Kong's New Tax Regime Extending Hong Kong as One of its Major Leasing Platforms http://www.calc.com.hk/?route=press_detail&id=208
[13] Hong Kong's aircraft leasing push not a threat - SMBC chief Barrett, https://www.independent.ie/business/irish/hong-kongs-aircraft-leasing-push-not-a-threat-smbc-chief-barrett-37479607.html

Review of the existing tax concession arrangements for the fund industry

- If the way in which funds are to be defined needs to be changed, all the funds currently eligible for profits tax exemption should continue to be eligible under the new definition.
- Any future amendments should aim to ensure consistency of wording and to adopt the least restrictive variations of similar terms.

9. Support for Hong Kong companies going outside Hong Kong (e.g., the Greater Bay Area)

The restrictions in relation to section 39E(1)(b) of the IRO, i.e., not allowing depreciation allowances for leased plant and machinery ("P&M") used outside Hong Kong, should be reviewed and, potentially, removed. This could be considered in the light of encouraging relevant business development in the Greater Bay Area ("GBA").

According to the Census and Statistics Department, manufacturing activities contributed less than 1.1% to Hong Kong's GDP in 2016[14]. This statistic demonstrates that nowadays Hong Kong taxpayers' manufacturing activities are mostly conducted outside Hong Kong.

The Hon Jimmy Ng, representing the Industrial (Second) Functional Constituency in the Legislative Council, recently sought clarification from the Government on this issue[15]. The Government indicated in its reply that:

- Profits derived from manufacturing activities are not sourced in Hong Kong and hence, the corresponding profits would not be subject to profits tax in Hong Kong. Accordingly, it is reasonable that the IRD does not grant depreciation allowances for P&M used in solely in China for manufacturing activities, by virtue of the "tax symmetry" principle.
- The offsetting mechanism, i.e., selling finished goods at below market price to the Hong Kong entities, as a result of letting the Mainland manufacturing entities use the P&M free of charge, may induce transfer pricing adjustments in Mainland China.

The Government's reply seems to overlook the fact that the commercial objective of the rent-free provision of the P&M is to secure the supply of goods to be traded by the Hong Kong taxpayers. The costs of the relevant P&M should be regarded as being necessarily incurred by such taxpayers for the production of their trading profits, which are generally fully chargeable to tax in Hong Kong.

As for the transfer pricing concern, it should notionally increase the cost of goods purchased by the Hong Kong taxpayer for Hong Kong profits tax purposes. The increase in the purchase price reflects the deemed rent it would have charged the Mainland manufacturing entity for the P&M provided. The deemed rental income accruing to the Hong Kong entity should also be offset against the purchase price of goods and the P&M should be regarded as income-producing assets of the Hong Kong entity.

[14] Gross Domestic Product (GDP) by major economic activity - percentage contribution to GDP at basic prices
https://www.censtatd.gov.hk/hkstat/sub/sp250.jsp?tableID=036&ID=0&productType=8
[15] Reviewing sections 39E and 16EC of the Inland Revenue Ordinance
https://www.ird.gov.hk/eng/ppr/archives/18032102.htm

In view of the above, denial of depreciation allowances claims for leased P&M used outside Hong Kong under section 39E(1)(b) does not adequately take into account business realities and practices in the commercial environment.

This has been a long-standing and hotly-debated issue. Meanwhile, the legislative framework has changed significantly since it was first raised, including the recent introduction of statutory transfer pricing rules. We recommend, therefore, that the Government conduct a comprehensive review of the background to, and implementation of, section 39E of the IRO.

10. <u>Adopt more competitive tax policies</u>

While a recent report on 190 tax jurisdictions, published by PricewaterhouseCoopers and the World Bank[16], found that Hong Kong has the most business-friendly tax system, we cannot afford to be complacent, particularly given the increasing complexity being introduced into Hong Kong's tax regime, as noted elsewhere. Instead, tax measures should be periodically reviewed to ensure that Hong Kong's competitiveness is maintained.

a. Hong Kong has long promoted itself on the basis that it has a simple tax system and the tax rates are low. However, the once-low profits tax rate of 16.5% may no longer be as attractive as it was to foreign investors, given the global trend to reduce the rates of direct tax, in particular corporate tax. To ensure that Hong Kong remains competitive, it is important that Hong Kong aligns its tax treatment on tax losses with norms in major international financial centres.

Group tax loss relief is available in other international financial centres, including the United Kingdom ("UK"), the US, Australia and Singapore. Indeed, the Institute has proposed for a long time that a form of group loss relief be introduced in Hong Kong. While we appreciate that there would be administrative costs associated with the introduction of group tax loss relief, this simple measure would be an efficient tool for private groups to manage the tax and financial arrangements within the group.

In order to avoid any abuse of group tax loss relief, anti-avoidance provisions could be introduced into the relevant legislation, including qualifying conditions such as:

- the relevant companies have to be under 90% common shareholding;
- the tax losses incurred for the current year of assessment can be used to offset only the current year assessable profits of other companies within the group.

b. At present, a company can carry forward a tax loss incurred in the current year of assessment to offset against assessable profits of the company for subsequent years of assessment. However, this tax loss carry forward provision alone is insufficient to cater for the modern business environment.

Economic cycles and product life cycles for many businesses are shorter nowadays than they were even two decades ago. A successful company

[16] HK has world's most business-friendly tax system, says PwC report, https://www.brandhk.gov.hk/html/en/HongKongsAdvantages/MostBusinessFriendlyTaxSystem/MostBusinessFriendlyTaxSystem.html

could find itself sustaining substantial losses due to introduction of new legislation, trade sanctions, etc. or, e.g., the recall of a popular product that fails to meet certain safety requirement (such as the worldwide recall of the latest model of popular brand of mobile phone a few years ago).

The effects of fluctuations in a company's results could be exacerbated, particularly during economic downturns. Having steady a cash flow could enable companies to weather the storm in periods of uncertainty. This is also when a tax loss carry-back mechanism would help.

Tax loss carry-back mechanisms are a feature of the tax systems of many advanced economies. The Institute first proposed the introduction of a tax loss carry-back mechanism in the Hong Kong tax system a number of years ago in order to make it more competitive.

D. Community measures

11. <u>Introduce a home rental deduction</u>

As property prices in Hong Kong remain very high, many taxpayers cannot afford to buy their own properties and rely on the rental market. The private domestic rental indices published by the Ratings and Valuation Department indicate that the overall index rose from 95.4 in Jan 2009 to 197.8 in September 2018. This is a clear indication that rental payments are becoming an increasingly heavy burden for many taxpayers. By virtue of section 26F of the IRO, home loan interest is a tax deductible item for taxpayers. However, there is no similar provision to allow taxpayers to claim a deduction for their rental payments.

As previously proposed by the Institute, the Government should consider allowing a tax deduction for rental payments made by taxpayers on their primary residence, subject to an annual limit of HK$100,000 (i.e., same amount as the home loan interest deduction). We understand that the Government was considering adopting this policy last year, but did not proceed due to certain outstanding technical issues at the time tax returns were issued. We hope that these outstanding technical issues have now been resolved and that the measure can be introduced in the year of assessment 2018/19. If, however, the Government still needs more time to implement this initiative, a timetable for its implementation should be provided.

The Government is promoting better integration and collaboration between cities in the GBA. The concept of a "one hour life circle" has sparked the interest of Hong Kong people. It is expected that more people will be commuting regularly between Hong Kong and other cities in the GBA in future and the location options for living and working will expand. Some Hong Kong people, including those working periodically in the Mainland, may want to maintain their residence elsewhere in the GBA. With this in mind, the Government should consider increasing the flexibility of the home loan interest deduction, and the proposed rental deduction, if implemented, so as to cover Hong Kong taxpayers whose principal dwellings are located in other GBA cities.

12. Encourage people to adopt a healthier lifestyle

Prevention is better than cure! There is a designated page in the Department of Health website that talks about the benefits of undertaking regular exercise. The Government has also been using television commercials to promote the idea that everyone should spare 30 minutes per day for physical exercise. Undoubtedly, the overall medical expenditure of the community would be reduced if people adopted healthier lifestyles.

It is clear that there is growing awareness of, and interest in, major participation sport events in Hong Kong, such as the Hong Kong marathon, and the various charity and trail runs. In order to capitalize on this and encourage greater interest and participation in sport activities among the general population, we recommend that a salaries tax deduction be allowed for expenditure incurred by taxpayers and their dependants on approved sports training classes or activities, at an annual cap of HK$12,000 per taxpayer and his/her dependants.

13. Upgrade workforce skill sets

With the transformation of the economy in the last two decades, the ability to innovate is becoming a more relevant and important determinant of how an economy can outperform its competitors. Among the jurisdictions studied in the World Economic Forum's Global Competitiveness Report 2018, Hong Kong ranks seventh overall and third in Asia. The report, however, indicates that Hong Kong performs poorly in its ability to innovate and, therefore, improving in this area is necessary. Innovation may seem to be an abstract idea but the generation of new ideas is really the first step in the innovation process.

Ideas may lead to inventions but only a few of these will be find commercial application. Consequently, it may take years before Hong Kong can catch up with its competitors, despite the fact that the Government has been investing more extensively in this area. In our view, more still could be done to cultivate an innovation and technology culture. Our suggestions include:

a. *To allow the deduction for self-education expenditure to be used not only by the taxpayer but also by the taxpayer's dependants, if they are not eligible for the allowance in their own right*

The Institute recommends reviewing the scope of the deduction for self-education expenses currently capped at HK$100,000, and making the deduction more flexible, to support members of the workforce who want to upgrade their skills and so improve their opportunities and competitiveness.

We recommend that a taxpayer's dependants be eligible to take up any amount not used by the taxpayer. It would therefore be available to the taxpayer's spouse, e.g., for training to join or rejoin the workforce, or the taxpayer's children between 18 to 25 years old, who are not in full-time education and not taxpayers themselves, or not earning enough to be able to claim the deduction in their own right.

In the light recent economic and technological trends, the deduction should be usable for courses offered by reputable providers on innovation and technology, or starting a business and entrepreneurship, which, may not fall squarely within the existing criteria in the IRO, of being undertaken "for the purpose of gaining or maintaining qualifications for use in any employment."

b. *To consider additional incentives for employers to send employees on courses to upgrade their skills*

   Specific tax incentives could also be considered for employers to send employees on qualifying courses to upgrade their skills, particularly in the innovation and technology field. This training should also not be treated as a taxable perquisite in the hands of employees.

14. <u>Review salaries tax allowances</u>

The salaries tax allowances, especially those for children and other dependants, have been revised a number of times over recent years, but not necessarily at the same time as one another, or with the same levels of increments. For example, while allowances and additional allowances for dependent parents and grandparents have increased only by around 8.5% since 2017/18, child allowances have increased by 20%. The basis for these adjustments should be made more transparent. The level of the existing allowances for single and married persons, children, dependent parents or grandparents, dependent siblings, single parents and disabled dependants should be reviewed and rationalized.

Thereafter, any adjustments should be made on a more transparent and consistent basis. Where there are sound policy, or other, reasons for differential adjustments, these should also be made clear. Pending a review, we propose that these allowances should all be increased broadly in line with inflation.

E. Tax efficiency and public funds

15. <u>Review the tax system and incentives, and stabilize the long-term tax base</u>

a. *The Government should conduct a broad and deep review of Hong Kong's tax system*

   The Lantau reclamation project has recently been announced by the Government. The entire project is expected to cost at least HK$500 billion, or the equivalent of half of the city’s current fiscal reserves.

   While offering long-term benefits, the reclamation project could create an additional financial burden on the community. Bearing in mind that (i) Hong Kong society is facing population ageing and rising healthcare costs for the elderly; and (ii) the increasing volatility and unpredictability of key sources of revenue, including land premiums, Hong Kong's fiscal reserves, and hence the community's financial health and wellbeing could be adversely impacted. Furthermore, if the Government is relying on high land prices to help fund the cost of the project, this could also be courting controversy. High land prices have helped to sustain high property prices and are often perceived as a burden and hidden tax on the community at large.

   Therefore, other means of broadening the tax base should also be explored to secure the long-term fiscal health of Hong Kong.

   While proposals for a goods and services tax ("GST") received only limited support in the past, this issue has not been reviewed for over a decade. We are not suggesting that a GST is the only option for Hong Kong. Instead, a more extensive review of options to broaden the tax base should be conducted.

b. *The Government should periodically review its tax incentives to ensure that they are cost effective and appropriate for maintaining Hong Kong's competitiveness*

We understand that no unified methodology is currently available for assessing the effectiveness of tax incentives in general. Given that the range and number of tax incentive measures have increased in recent years, it is time to examine the question of evaluating their effectiveness. The Government should develop objective indicators for determining the costs and benefits of tax incentive policies and measures.

For instance, the IRO and the Stamp Duty Ordinance were amended in 2013 to facilitate the development of Islamic finance and an Islamic bond ("sukuk") market in Hong Kong. Since then, three sukuks have been issued under the Government bond programme[17]. While no one would doubt that the initial intention of the tax policy was to make Hong Kong more competitive by providing for a full suite of financial services, it is questionable just how effective the policy has been. Therefore, the Government should review the policy and investigate why sukuks are not popular in Hong Kong and whether anything can be done to improve the incentive. Periodic reviews would help to identify tax incentives that have not been commonly used in Hong Kong, enable consideration of whether any steps could readily be taken to improve the situation and, if not, whether they should be retained.

The Government should also aim to provide details of the costs and benefits of new tax proposals. The analyses disclosed in the Legislative Council briefings are informative but not sufficient. For example, when the Government put forward the Inland Revenue (Amendment) (No. 3) Bill 2018, intending to support R&D activities in Hong Kong, the implications of the bill from different perspectives were only briefly explained. In terms of the economic implications, projections for deductions of R&D expenses and the increase in R&D investments in Hong Kong could usefully have been provided.

c. *The Government should expand the coverage and expertise of the Tax Policy Unit*

Since it was established, the Tax Policy Unit ("TPU") has conducted research into R&D incentives and other specific projects, but it does not seem to be taking up broader more strategic tax issues that could help support the economic development and competitiveness of Hong Kong.

Now that the TPU has completed its initial tasks of helping implement the two-tier tax system and R&D super-deductions proposed by the Chief Executive, its scope of work and expertise should be expanded so that Hong Kong’s economic growth can benefit more extensively from the support of

[17] A Legislative Council Question on development of an Islamic financial market in Hong Kong: https://www.info.gov.hk/gia/general/201802/28/P2018022700769.htm

appropriate tax policies.

It is time to examine Hong Kong's tax system from a more fundamental perspective. A low rate and simple system used to be Hong Kong's competitive edge. However, many jurisdictions around the world have reduced corporate tax rates in the past few years and moved towards an increased emphasis on indirect taxation. With the recent raft of new tax legislation, particularly in relation to the codification of international tax standards in the tax system, such as such as the BEPS minimum standards and the Common Reporting Standard, Hong Kong's tax system can no longer be considered to be simple. In addition, looking around the world, UK's corporate tax rate has dropped from 30% in 2005/06 to 19% now. The US has reduced the federal corporate tax rate from 35% to 21%. Singapore's rate has decreased from a high of 26% in 1998 to 17% now and the tax rate on trading profits in Ireland is 12.5%. In this context, Hong Kong's profits tax rate of 16.5% cannot be seen these days as the jewel in the crown of our tax system.

On different note, it has been suggested above that Hong Kong may not be doing enough to address the increasing challenges of climate change. The escalating intensity of typhoons passing close to Hong Kong in recent years and storms occurring in other parts of the world, has been attributed by many scientists to the effects of global warming. In order for Hong Kong to play a more active role in addressing the effects of climate change, the Government should explore the role that tax policy can play in efforts to reduce carbon emissions and to conserve energy. The TPU could be asked to look into ways in which tax policies are being used to serve this objective in other jurisdictions.

d. *The Government should ensure that tax policies are applied consistently to taxpayers and their tax representatives*

Taxpayers who engage tax representatives are eligible to apply for an extension of time for filing their profits tax returns under the block extension scheme. However, the block extension scheme is not applicable to taxpayers who are not represented. It is, therefore, reasonable to consider offering extended deadlines across the board to all taxpayers.

e. *To provide unilateral tax credits*

While the Government's efforts to extend Hong Kong's DTA network in recent years should be applauded, we still do not have tax treaties with some of our major trading partners, including the US and Australia. If Hong Kong taxpayers receive royalties from enterprises residing in major trading partners where no tax treaty is in place, they will not be able to claim a tax credit in respect of any withholding taxes paid. To this end, allowing a unilateral tax credit claim in these situations would be fair to taxpayers and welcomed by them.

A unilateral tax credit should also be considered to offset tax that may be imposed by other countries in relation to the digital economy. This is proposed in the light of the growing number of countries that are levying, or proposing to levy, digital taxes on internet companies, based largely on the location of the users of the services.

In view of the challenges of the digital economy and possible tax loopholes, the OECD recently published an interim report on Tax Challenges Arising from Digitalisation – Interim Report 2018 (the Interim Report)[18]. According to the report, various types of digital taxes are being imposed by different countries, to safeguard their tax revenue. Some examples of these are indicated below.

1. Expanded definition of permanent establishment	• To expand the definition of permanent establishment by incorporating significant economic presence. India and Israel have adopted this measure.
2. Turnover taxes	• India's equalization levy (6% on advertising) • France's online and physical audio-video content tax (2%/ 10% tax on defined content) • Hungary's advertisement tax (5% /5.3%/ 7.5% tax on the value of taxable advertising services • Italy's levy on digital transactions (3% on digital service transactions)

f. The Government should consider increasing manpower resources for tax administration

Hong Kong's tax system is becoming more complicated, as a large number of bills relating to codification of international tax standards, and domestic tax measures to improve Hong Kong's competitiveness, have been introduced into the Legislative Council over the past two or so years. We note that the existing manpower of the IRD seems to be very stretched and may not be able to cope fully with all the challenges arising from implementation of the new tax measures. This may be one reason why, for example, projects such as the further development of e-tax have stalled. An expansion of the resources of the IRD would seem to be called for. Allocating more resources to IRD could also enhance the quality and consistency of enforcement, facilitating a more predictable tax system and business-friendly environment.

However, simply increasing the headcount may not resolve the problem as we understand that, generally, IRD, like many other government departments, may not hire staff at more senior levels. Experienced tax professionals would be better placed to help in handling the complicated issues associated with the new tax legislation. Therefore, the Government should explore the feasibility of the IRD being able to hire a certain number of experienced tax professionals from the open market to help bridge the gap in terms of experienced and expert manpower.

[18] Tax Challenges Arising from Digitalisation – Interim Report 2018 by OECD

Appendix 1: Proposed changes for salaries tax allowances and deductions

Allowances and deductions	Existing (HK$)	Proposed (HK$)
Allowances[19]:		
- Basic	132,000	135,300
- Married person	264,000	270,600
- Child (annual, each dependant, the 1st to 9th child)	120,000	123,000
- Child (initial, each dependant, the 1st to 9th child)	120,000	123,000
- Dependent brother or sister (each dependant)	37,500	38,438
- Dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the Government's disability allowance scheme	50,000	51,250
- aged 55 or above but below 60	25,000	25,625
- Additional dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the Government's disability allowance scheme	50,000	51,250
- aged 55 or above but below 60	25,000	25,625
- Single parent	132,000	135,300
- Personal disability	75,000	76,875
- Disabled dependant (each dependant)	75,000	76,875
Deductions, maximum limit:		
- Self-education expenses	100,000 limited to claims by taxpayer	100,000 extended to claims by the taxpayer's spouse, or children (aged 18 to 25 studying part-time, or not earning enough to claim directly themselves)
- Private healthcare insurance premiums	8,000	8,000
- Approved sports training activities	-	12,000
- Rental payment for taxpayer's primary residence	-	100,000

[19] For illustration purposes, the proposed allowances are increased on the assumption that the benchmark is set at current levels and the inflation rate is 2.5%.

Appendix 2: Proposed changes in salaries tax allowances and deductions - impact on a typical individual

Example: Single person

This example illustrates the impact of[20]:

- an increase of basic allowance to HK$135,300
- a deduction for an approved sports training activities with annual limit of HK$12,000
- a deduction of rental payment with annual limit of HK$100,000

	Existing (HK$)		Proposed (HK$)		Savings (HK$)	Savings (%)
Income		300,000		300,000		
Allowances/ deductions:						
Basic allowance	132,000		135,300			
Mandatory MPF contribution	15,000		15,000			
Approved sports training activities	-		12,000			
Private healthcare insurance	8,000		8,000			
Rental payment	-		100,000			
Total allowances/ deductions		155,000		270,300		
Net chargeable income		145,000		29,700		
Tax payable		11,150		594	10,556	95%

[20] Assumptions are as for Appendix 1.

Appendix 3: Proposed changes in salaries tax allowances and deductions - impact on a typical family

Example: Married person with spouse separately assessed, two children who are not newborns, and living with two dependent parents over 60 years of age throughout the whole year

This example illustrates the impact of[21]:

- an increase of basic allowance to HK$135,300
- an increase in child allowance to HK$123,000
- an increase in dependent parents allowance and additional allowance to HK$51,250
- a deduction for an approved sports training activities with annual limit of HK$12,000

	Existing (HK$)			Proposed (HK$)			Savings (HK$)	Savings (%)
Income			750,000			750,000		
Allowances/ deductions:								
Basic allowance		132,000			135,300			
Child allowance	2 children 120,000 each	240,000		2 children 123,000 each	246,000			
Dependent parent allowance and additional allowance	2 parents 100,000 each	200,000		2 parents 102,500 each	205,000			
Mandatory MPF contribution		18,000			18,000			
Approved sports training activities		-			12,000			
Private healthcare insurance	1 taxpayer and 2 children 8,000 each	24,000		1 taxpayer and 2 children 8,000 each	24,000			
Total allowances/ deductions			614,000			640,300		
Net chargeable income			136,000			109,700		
Tax payable			9,620			4,970	4,650	48%

[21] Assumptions are as for Appendix 1.