Tax policy and budget proposals

2017 - 18

Joining the Dots …Connecting the tax system with the needs of the economy and the community

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

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Key proposals

The Hong Kong Institute of CPAs' 2017-18 budget proposals, under the heading, *Joining the Dots …Connecting the tax system with the needs of the economy and the community,* developed by the Institute's Taxation Faculty, focus on tax policies and measures on the revenue side of the budget.

With a focus on enhancing the competitiveness and effectiveness of the tax regime, to benefit the economy and the community, among the Institute's key proposals, it is recommended that a tax policy unit be established to complement the work of different government agencies. Comprising taxation and industry experts, economists, academics, and government representatives, it should study how taxation could help drive the economy, with the aim of achieving a more holistic system that balances the need to maintain a healthy revenue base, while supporting a strong economy and community. A summary of the proposals is as follows:

Tax policy and the economy

1. Set up a tax policy unit or group comprising tax and industry experts, academics and government officials (including those on the investment promotion side). Its priority tasks would be to study and make recommendations on:
   - the competitiveness of Hong Kong's tax system
   - the need to modernise the Inland Revenue Ordinance ("IRO")
   - the potential impact of international tax developments.

2. To support small and medium enterprises, reduce the corporate profits tax rate to 15% for companies whose gross income does not exceed HK$5 million.

3. To encourage entrepreneurship and assist startups in the innovation and technology sector, reduce the corporate profits tax rate to 10% for start-up companies in the first two years that they generate assessable profits.

4. To encourage new investments and expansion, introduce loss carry-back provisions.

5. To strengthen Hong Kong's role as an international financial centre, consider tax measures to help attract a critical mass for different financial services, such as extending the offshore fund

exemption to certain Hong Kong-resident funds.

6. To promote Hong Kong as an intellectual property ("IP") hub:
   - Allow "super deductions" of 150% for research and development ("R&D") conducted in Hong Kong
   - Allow R&D activities sub-contracted to entities outside Hong Kong for a fee, to be entitled to the deductions under section 16B of the IRO, where the control and risk-taking activities take place in Hong Kong
   - Expand the range of tax deductible IP rights, to attract more investment from multi-national enterprises to Hong Kong
   - Provide incentives to support R&D in renewable energy and "green" industries.

7. Expand the network of Comprehensive Avoidance of Double Taxation Agreements, including with relevant "Belt and Road" countries; and consider the resource requirements of the Inland Revenue Department ("IRD"), given the increasing demands of international and cross-border taxation.

8. Put in place processes to ensure that proposed tax incentives can achieve their objectives and, post-implementation, that such incentives are kept under review to confirm that they remain effective.

9. To streamline tax administration and the ease of doing business in Hong Kong, improve the interface with taxpayers, by:
   - Introducing electronic filing for all returns
   - Shortening the time-bar period
   - Finalising the status of tax losses within a definite period.

10. To give businesses confidence in the tax system:
    - Review the need to make more timely legislative changes
    - Update IRD departmental interpretation and practice notes and Stamp Office interpretation and practice notes, consulting practitioners on the changes
    - Encourage more use of the advance ruling system
    - Strengthen the Board of Review (IRO) system to ensure more expert involvement in complex cases.

11. Study options for broader based taxation, given the narrowness of the tax base and future demands on the tax system.

For the community

12. To assist those who cannot afford to buy their own homes (and who do not qualify for subsidised housing), allow a deduction for rental payments for a taxpayer's primary residence, with an annual cap of HK$100,000.

13. To promote the benefits of an

active lifestyle and "healthy body, healthy mind" through sports, allow a deduction for expenditure on children's sports training courses, with an annual cap of HK$12,000.

14. Review and rationalise the level of the different salaries tax allowances. Meantime, increase the allowances broadly in line with inflation.

15. To encourage a more efficient use of public and private health care services, allow a deduction for private healthcare insurance premiums, with an annual cap of HK$12,000, and additional deductions for premiums paid to cover dependent spouses and children at a similar cap per dependant.

16. To help people plan better for their retirement, allow deductions for individual taxpayers' voluntary contributions to their mandatory provident fund schemes, with an annual cap of HK$60,000.

17. To support the upgrading of skill sets, make the deduction for self-education expenses more flexible, so that any amounts up to the ceiling unused by a taxpayer can be used by the taxpayer's dependants, who are not in full-time education and not otherwise able to claim it for themselves; and extend the type of courses eligible for the allowance to include reputable courses on innovation and technology and starting a business/ entrepreneurship, which may not meet the existing criteria.

Introduction

Hong Kong's tax system remains an important part of the city's attractiveness to investors. In the World Bank's latest report on the ease of doing business, Hong Kong ranks an impressive fourth out of 190 economies. The survey covers 10 topics. In relation to the topic of *paying taxes*, Hong Kong ranks third and ahead of the three countries above it in the overall rankings (namely, New Zealand, Singapore and Denmark).[1]

While it remains the case that Hong Kong has few taxes, generally low tax rates and a comparatively short piece of tax legislation in the Inland Revenue Ordinance (Cap. 112, "IRO"), pressures are mounting on the system and the situation is changing quite rapidly. Tax developments taking place internationally, such as the Organisation for Economic Co-operation and Development ("OECD")'s base erosion and profit shifting ("BEPS") initiative and action plans, are already having an impact on Hong Kong; but are we fully prepared for this? Various decisions of the courts and changes in non-tax-related legislation, which have implications for the tax regime, have been dealt with in a stopgap way, pending amendments to the IRO, for which there is, seemingly, no clear timetable. Numerous changes to the IRO in recent years, on the one hand, to accommodate international standards in areas such as exchange of taxpayer information, and on the other, to introduce tax concessions (often accompanied by specific anti-avoidance provisions) have added complexity and, in some instances, uncertainty into the system. Other aspects of the tax system, such as the further development of electronic filing, have had to take a back seat and Hong Kong finds itself lagging behind many other jurisdictions in updating its tax administration procedures.

Pressures on the system also arise from various other sources, including budgetary constraints, the inherent limitations of the tax system, the ageing population, the narrow tax base, as well as difficulties in achieving consensus on changes that may need to be made.

Action is needed to take stock of where we are and to ensure that a more considered, holistic and responsive approach can be taken to the future development of Hong Kong's tax regime.

As regards Hong Kong's economy and business confidence, mixed signals are emerging. The government's figures indicate that the signs are fair, with positive growth, a low rate of unemployment and relatively benign inflation. At the same time, the latest GDP forecast of 1.5%[2], which is within expectations based on the 2016-17 budget, is well below the 10-year trend growth rate of 3.4%[3]. Low growth rates will undoubtedly affect the government's revenues and its ability to spend on vital community services, particularly given the emphasis on fiscal discipline and Basic Law article 107, which entails:

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[1] World Bank. 2017. *Doing Business 2017: Equal Opportunity for All*. Washington, DC: World Bank. DOI: 10.1596/978-1-4648-0948-4, p.7, p.212, http://www.doingbusiness.org/reports/global-reports/doing-business-2017

[2] Hong Kong SAR Government ("the government") presentation materials on *Third Quarter Economic Report 2016* & updated economic forecasts for 2016 (11 November 2016), p. 2, http://www.hkeconomy.gov.hk/en/pdf/16q3_ppt.pdf

[3] Government background information pack, *Consultation on the 2017-18 Budget* (January 2017), p.4, http://www.policyaddress.gov.hk/consultation16/eng/pdf/info_pack.pdf

i. Following the principle of keeping expenditure within the limits of revenues
ii. Striving to achieve a fiscal balance, avoid deficits
iii. Keeping the budget commensurate with the growth rate of GDP.

In a fairly positive analysis of the current state of Hong Kong economy, the International Monetary Fund ("IMF") stated[4]: "The vibrant Hong Kong SAR economy has been supported by low interest rates and Mainland China's growth over the past decade. But the external environment is more challenging with the U.S. rate cycle edging up, global trade growth tepid and Mainland China rebalancing." The statement also referred to three downside risks that could cloud the outlook**,** namely (i) rising U.S. interest rates and global market volatility; (ii) stresses from exposures in the Mainland: While expanding connections offer large potential for further growth, "these linkages through trade, tourism, and finance (through lending to Mainland corporates, offshore renminbi activity, securities issuance and asset management) create channels for the transmission of shocks"; and (iii) property market risks, where "there is the risk of an accelerated price adjustment should interest rates rise faster than expected." This could in turn result in risks to the real economy. The IMF believes that these risks can be tackled, provided that interest rates rise at a moderate pace, and Mainland China's transition to a more sustainable growth path remains orderly.

However, perceptions are also important and the findings of the Hong Kong General Chamber of Commerce's latest Business Prospects Survey are somewhat negative[5]. They indicate that 73% of respondents felt that Hong Kong's competitiveness had deteriorated over the past 12 months, up six points from 2015 and compared with from 42% in 2011. In terms of investment plans, 53% said they were not planning to invest in 2017 compared with 41% who said that they would invest further. 56% of respondents said that they would freeze hiring or cut jobs, while 44% indicated that they planned to hire more staff in the next 12 months.

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[4] Peoples Republic of China—Hong Kong Special Administrative Region: Staff Concluding Statement of the 2016 Article IV Consultation Discussions (3 November 2016), http://www.imf.org/en/News/Articles/2016/12/07/MS120716-Hong-Kong-2016-Article-IV-Concluding-Statement

[5] The Hong Kong General Chamber of Commerce, Press Releases, *Business Forecast Difficult 2017* (6 December 2016), http://www.chamber.org.hk/en/media/press-releases_detail.aspx?ID=3578

Detailed proposals

A. Tax policy and the economy

1. In today's world, technology is ubiquitous and the changes that it has introduced into the business and social environment, and its influence in our daily lives, naturally leads to questions about how government and regulatory policies should accommodate this "megatrend". Tax policies should be part of the discussion in Hong Kong, as they are elsewhere.

2. At the international level, the spread of the digital economy was one of the factors that gave impetus to the OECD's BEPS initiative. With the publication of the BEPS final reports, tax policy makers worldwide are under pressure to review their existing systems and adapt to the changes. It is expected that tax systems everywhere will change much more rapidly and, perhaps, more radically, in the next five years than they have in the past five[6].

3. In addition, the fluid digital world means businesses operate and transact beyond traditional borders. They are competing intensely on a global platform, no longer confined to competition within their domestic or regional boundaries. Corporate income tax rates are predicted to resume their long-term fall as tax competition re-emerges, but businesses will focus on the effective tax rates, taking incentives and allowances into account, when choosing where to invest[7]. In view of this trend, Hong Kong's tax rate of 16.5% may no longer seem so low and attractive as it has in the past, considering that the headline corporate tax rates in Singapore and Taiwan are now at 17%[8]. Japan has also been steadily lowering its corporate rate and the United Kingdom ("UK")'s corporation tax rate is set to fall to 17% by 2020[9].

4. While Hong Kong remains fundamentally a good place for doing business, as evidenced by the World Bank report, referred to above, there is a question mark over whether, compared with other jurisdictions in the regional and globally, we are doing enough to prepare ourselves for the "new economy". In this regard, we welcome the government's commitment to developing Hong Kong into a smart city and its plan to develop a smart city blueprint [10], with the objective of driving economic development and improving the quality of life.

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[6] KPMG, 2015 Global Tax Rate Survey, p.5, https://assets.kpmg.com/content/dam/kpmg/pdf/2015/11/global-tax-rate-survey-2015-v2-web.pdf

[7] Ibid.

[8] PwC, Worldwide Tax Summaries, Corporate Taxes 2016/17, p.310 and p.314, http://www.pwc.com/gx/en/tax/corporate-tax/worldwide-tax-summaries/assets/wwts2017-asia-pacific.pdf

[9] HM Treasury, Autumn Statement 2016 Policy paper, section 5.7, https://www.gov.uk/government/publications/autumn-statement-2016-documents/autumn-statement-2016

[10] news.gov.hk, Smart city development planned (12 September 2016), http://www.news.gov.hk/en/record/html/2016/09/20160912_133537.shtml

Tax policy unit

5. The formulation of tax policies that are in alignment with and support the future direction of Hong Kong's economy is important. Given the pace of change, Hong Kong needs to be proactively exploring possible tax initiatives and incentives, which may be specific or, given the government's stated preference not to favour specific industries, broader in nature, but still conductive to sustaining Hong Kong's role as a financial and commercial centre, as well as fostering an environment supportive of entrepreneurs and start-up businesses. While there is no single approach to formulating responsive tax policies (see Appendix 1 for a brief discussion on the processes in Singapore and United Kingdom), the Institute renews its call for a tax policy unit ("TPU") to be established, along the following lines:

   i. Structure: We propose a permanent unit, within the administration, but it could be set up initially as a project-orientated group.

   ii. Composition: Taxation and industry experts, economists, academics, as well as representatives from the Financial Services and the Treasury Bureau ("FSTB"), the IRD and investment promotion agencies. In developing the recommendations, the unit should also communicate with and complement the work of other bodies, such as the Economic Development Commission. It should be able to invite specialists to join particular projects and could have a full-time, non-government head, akin to the arrangement for the Central Policy Unit.

   iii. Priority projects: These should include studying and making recommendations on:

      a. Possible measures to enhance the overall competitiveness of Hong Kong's tax regime, including the setting of tax rates and desirability of industry/ market specific tax incentives.

      b. The need to modernise the IRO, to accommodate new business models and to provide clarity of treatment, where necessary.

      c. The impact of emerging international tax developments, such as BEPS and automatic exchange of information ("AEOI"), with a view to helping Hong Kong to anticipate such changes and position itself accordingly.

6. Currently, FSTB oversees the development of tax policy and is advised by IRD. For the proposed tax policy unit to be effective and to develop tax policies that are coherent with the scheme of taxation in Hong Kong and with the aim of driving economic growth, we believe that, although the IRD should be appropriately represented, the responsibilities for developing tax policies and the drafting of legislation and regulations to implement these should be separate from that of administering the tax system. IRD input will be vital in terms of advising on the practical application of proposed measures from the revenue perspective, as the department is closest to the operational aspects of

tax and has substantial knowledge on Hong Kong tax law and its interpretation. However, the TPU's primary focus should be on economic growth rather than enforcement and collection of revenue.

Drivers of Hong Kong's economy and the new economy: Innovation and technology and intellectual property

7. In the 2016-17 budget speech, the financial secretary referred to the "New Economic Order", and touched upon a number of technology-related measures. He said: "Over the years, Hong Kong has sustained its competitive edge because our trade network is highly internationalised, our market is transparent and open, and our society is clean and law-abiding. Under the "new economic order", we must act swiftly, get prepared, identify development opportunities and position Hong Kong as a key player in the competition. Building on our strengths, together with Hong Kong people's flexibility, resourcefulness and market acumen, we shall, as always, be able to stand out in the face of stiff global competition."[11]

8. We agree that Hong Kong cannot simply rely on the long-standing pillars of the economy and assume that they can continue to drive growth indefinitely. For example, we have already seen that we cannot over-rely on constantly increasing numbers of Mainland and other tourists. With other options becoming available to Mainland tourists, exchange rate fluctuations, and capacity issues in Hong Kong, we may need to encourage higher end rather than mass tourism. Meanwhile, as noted in a Legislative Council research brief, the growth rate in trade and logistics has been slowing "amid the waning trade intermediation role of Hong Kong upon the continuing integration of the Mainland with the global economy and intense competition from the neighbouring ports in the Pearl River Delta"[12].

9. Innovation and technology ("I&T") will clearly be important in the future development of Hong Kong's economy. It is worth noting that, in a recent survey of young people aged 16-30 in Hong Kong[13], the I&T industry was identified as the most significant opportunity that Hong Kong needs to grasp before 2030. This was followed by the creative industry and education.

10. We note the recent announcement of Hong Kong-Shenzhen Innovation and Technology Park, earmarked in the Lok Mau Chau Loop, which promises to provide new opportunities for I&T development in Hong Kong. However, reports suggest that

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[11] The 2016-17 Budget, paras.39-42, http://www.budget.gov.hk/2016/eng/budget08.html

[12] Legislative Council Secretariat, Research Brief Issue No.3, 2014-15, *Four Pillars and Six Industries in Hong Kong: review and outlook* (February 2015), http://www.legco.gov.hk/research-publications/english/1415rb03-four-pillars-and-six-industries-in-hong-kong-review-and-outlook-20150209-e.pdf

[13] AIESEC YouthSpeak Insights Report (Hong Kong 1.0)(11 October 2016)

this project may take up to seven years to come to fruition and, in the meanwhile, the I&T sector could benefit from some more immediate support.

11. We propose the following:

i. To support the small and medium enterprises ("SME") sector, we propose that the corporate profits tax rate be reduced to 15% for companies whose gross income does not exceed HK$5 million. In addition to the various financial and other programmes initiated by the government, this would help to realise the potential of SMEs, which account for over 98% of all businesses in Hong Kong[14].

ii. In addition, to encourage and assist the budding I&T sector, we propose that I&T start-up companies should enjoy a 10% corporate profits tax in the first two years that they generate assessable profits (i.e., after using up any carried forward losses). As regards the definition of "start up" company, if there is currently no suitable agreed definition in the Hong Kong context, references could be sought elsewhere. For example, in the contest of offering concessions, including an exemption from profits tax in its first three years, the Indian government has recently defined a "startup" as in following way:

a. Up to five years from the date of its incorporation/ registration.

b. Its turnover for any of the financial years has not exceeded INR250 million (around HK$29 million).

c. It is working towards innovation, development, deployment, or commercialisation of new products, processes, or services driven by technology or IP.

d. Other conditions apply, including that it cannot be an entity formed by splitting up or reconstructing a business already in existence[15].

iii. To encourage new investment ventures and business expansion, provision for loss carry-back should be introduced. This could help relieve businesses of the financial burden arising from new investments, should they end up sustaining losses while gauging the viability of the investment. While we note that the government considers that loss carry-forward should be able to assist enterprises to manage their losses[16], the effectiveness of this facility is dependent on a company

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[14] http://www.gov.hk/en/about/abouthk/factsheets/docs/trade%26industry.pdf.

[15] KPMG Tax Flash News (22 February 2016), https://home.kpmg.com/content/dam/kpmg/pdf/2016/04/KPMG-Flash-News-Government-notifies-startup-definition-1.pdf

[16] LCQ2: Enhancing Hong Kong enterprises' competitiveness (16 March 2011), http://www.info.gov.hk/gia/general/201103/16/P201103160178.htm

becoming profitable and viable again, after experiencing losses, which may limit the appetite for starting new businesses. Loss carry-back would also improve business viability, as it could reduce the impact of fluctuations in a company's results, particularly during economic downturns, which could otherwise result in cash flow difficulties.

iv. The Institute welcomes the initiatives announced in the 2016-17 budget speech to support FinTech[17] and bolster Hong Kong's position as an international financial centre.

Tax measures to strengthen Hong Kong's role and help establish a critical mass in different financial service areas should also be considered. These could include extending the offshore fund exemption to certain Hong Kong-resident funds, which would put offshore and onshore funds on a more equal footing. Singapore, for example, also provides an income tax exemption for onshore funds that meet certain requirements.

v. As IP is critical to the development of new technology, to promote Hong Kong's role as an IP trading hub[18], consideration should be given to a range of possible tax measures. For example:

a. For royalties, a unilateral tax credit should be granted for all foreign withholding tax paid where the same income is subject to tax in Hong Kong and there is no Comprehensive Avoidance of Double Taxation Agreement ("CDTA").

b. For R&D conducted in Hong Kong, "super deductions" of 150% of the cost should be considered. Super deductions are offered in the Mainland, Australia, Singapore and the UK. The Innovation and Technology Bureau, should engage stakeholders, with a view to developing a co-ordinated set of policies, including on support and incentives for innovation and R&D in Hong Kong.

c. The current deduction under section 16B, IRO is quite restrictive, in that the R&D activities must take place in Hong Kong. We suggest that, instead, the test adopted should be where the “control”, i.e., the so-called DEMPE (development, exploitation, maintenance, protection and enhancement) activities take place. This is would also be consistent with the BEPS Action

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[17] The 2016-17 Budget, para.56-63, http://www.budget.gov.hk/2016/eng/budget11.html

[18] The 2014-15 Budget, para.99, http://www.budget.gov.hk/2014/eng/budget24.html

Plans. The R&D activities could be sub-contracted for a fee to entities outside Hong Kong, but the control and risk-taking activities would remain in Hong Kong.

d. To encourage the creation and commercialisation of IP, at present, certain types of capital expenditure on prescribed IP rights are deductible under sections 16(1)(g), 16E and 16EA of the IRO. There are however, various other types of capital expenditure that would not fall under any of the IP rights, which may necessary for different industries, e.g., the telecommunications industry, where significant expenditure may be incurred to provide for certain rights to operate in Hong Kong; and such expenditure cannot be amortised as deductions. We propose, therefore, that the range of tax deductible IP rights be reviewed, and the policy towards the creation and commercialisation of IP should be made more flexible to order to attract more investment from multi-national enterprises to Hong Kong.

e. "Green industries" should be supported and incentivised. As the world takes steps to realise its commitment to lower carbon intensity in accordance with the Paris climate agreement, following ratification by the US and China, among others, Hong Kong should also increase its efforts to encourage energy conservation. This may include constructing more energy-efficient buildings, supporting investment and R&D in renewable energy and environmental/ green industries, and promoting recycling. While some incentives are already in place, such as the waiver of first registration tax on electric vehicles and enhanced deductions for capital expenditure on environmental protection facilities, further incentives should be explored.

vi. The government has done an effective job in expanding the network of CDTAs from virtually none ten years ago to over thirty today. In terms of future CDTAs, as well as focusing on Hong Kong's traditional trading partners, we note that, as the Mainland Government develops its "One Belt One Road" initiative, the Hong Kong SAR Government intends to seek CDTAs with some of the countries included with the initiative. These efforts should focus on markets that are potentially more relevant and important given Hong Kong's role and positioning. This should lend support to the initiative and serve as an additional incentive to further economic exchanges with relevant countries.

With the introduction of legislation in AEOI and, in the context of adopting the minimum BEPS standards, the anticipated introduction of country-by- country reporting, the government should carefully consider its negotiation strategy to ensure that Hong Kong can continue to expand its CDTA network. Once some of our trading partners are able to obtain information on their residents in Hong Kong without entering a CDTA, they may be less inclined to negotiate an agreement. The government needs to be able to address this situation. While we understand that this, and other expanding areas of work, may be resource intensive, Hong Kong's tax regime has been and remains an important element in our success. The IRD should be adequately resourced to deal with the increasingly complex issues in international and cross-border taxation. We suggest that the future staffing needs of the IRD, in terms not only of numbers of staff but also expertise, be studied carefully.

Monitoring the effectiveness of incentives

12. Policies should be monitored for their effectiveness in achieving their objectives. We would suggest, therefore, that there should be a process in place to review all tax incentives periodically. Firstly, it should be considered whether the balance is right between implementing tax incentives to facilitate certain areas of business, while also introducing extensive and often complex anti-avoidance measures aimed at closing all possible loopholes. As mentioned above, we consider that, in some instances, the introduction of specific anti-avoidance measures has made the tax legislation much more complex, probably, unnecessarily so, bearing in mind that there are already quite effective general anti-avoidance provisions in the IRO. This view has been expressed by tax practitioners and industry specialists in relation to e.g., recent concessions for corporate treasury centres, offshore fund exemptions for private equity funds and, prior to these, deductions for R&D and IP rights. This is another area of work which, in the longer term, could be taken up by the proposed TPU but, meanwhile, where there may be scope to relax some of the restrictions, without clearly opening the door to a substantial leakage of revenue, this should be explored.

13. Secondly, post-implementation, incentives should be assessed to see how useful they have been in generating more economic activity; for example, it is unclear whether there has been any significant positive impact arising from reducing the profits tax rate for captive insurers. The findings of such studies could provide valuable information to help rationalise existing incentives and to inform discussion on future possible incentives.

Streamlining tax administration and ease of doing business

14. Streamlining tax administration includes updating technology, improving processes and expanding options, in terms of the interface between taxpayers and the IRD. Addressing the ease of filing returns, expediting processing and finalising tax positions are among the areas that need to be addressed. We recommend:

    i. Moving more rapidly towards the introduction of comprehensive arrangements for electronic filing of tax returns. While e-filing of simple tax returns was introduced some years ago, little progress has been made since then. The framework needs to be further extended to all taxpayers and accommodate existing practices (e.g., filing by tax representatives), so that e-filing of tax returns becomes a common, and even the preferred form of filing, as it is in other jurisdictions. Many jurisdictions provide for more extensive e-filing of tax returns and encourage or even, in some cases, mandate e-filing; these include the US, Canada, the UK, Australia, New Zealand, Singapore, Japan, Ireland, South Africa, India and Malaysia, to name just a few.

ii. With a more well-connected e-filing and communications system, it may also be possible in the future, to speed up processing and finalise tax affairs earlier. We recommend:

a. The statutory time limit for reopening an assessment should be shortened from the current six years to three years. Cases involving fraud should retain a ten-year limitation period. Shortening the time-bar period would mean taxpayers could finalise their tax affairs more promptly and reduce the time and effort required to address queries relating to historical data and records. Numerous jurisdictions, including the UK, Australia, the US and Singapore, adopt a shorter time-bar period than Hong Kong.

b. Statements of loss should be issued within a definite period, and accorded the same status as notices of assessment. When statements of loss are not treated as assessments, it is unclear whether losses are available for setting off against future profits. It also means that the clock on the statutory time limit does not start when such statements are issued. Consequently, taxpayers' affairs can remain open significantly longer than six years, and require records to be kept well beyond the statutory period of seven years. The uncertainty about the status of losses can also complicate discussions between taxpayers and their auditors, as it is unclear whether such losses can be booked as deferred tax assets.

15. Other important and basic features of the tax system also warrant attention in order to improve the level of certainty, as businesses have a legitimate desire for a clear, predictable and fair tax system. Given the apparent reluctance to legislate, or the practical difficulties of so doing, increasingly the proper application of important areas of the existing regime is being left to be determined by, e.g., successive decisions of the courts or Inland Revenue Board of Review ("BOR") and the subsequent interpretation of these, IRD Departmental Interpretation and Practice Notes ("DIPNs") or, even, in some case, ad hoc administrative arrangements. This does not help to improve certainty or inspire confidence in taxpayers in relation ensuring they are tax compliant. We recommend, therefore:

i. Reviewing the need to make more timely legislative changes, where there are gaps in the law or uncertainties arising from a series of court judgments or BOR decisions on related matters, which may not all appear to point in the same direction; and producing regular updates of DIPNs and Stamp Office Interpretation and Practice Notes, and inviting input from practitioners on the proposed changes. While, for example, an interim administrative measure has been put in place to reflect the CFA's decision in the case of *Nice Cheer Investment Ltd. v. CIR*[19], this has not been reflected in DIPN No. 42 and there is no timetable for dealing with the matter through legislative changes. In the *Nice Cheer* case, Lord Millett, the same non-permanent judge of the CFA who delivered the judgment in the 2001 case of *CIR v. Secan Ltd. and Another*[20], pointed out that the government had misread his judgment in the 2001 case. This affects the important issue of whether unrealised gains (such as mark-to-market gains on securities) are taxable. Another example would be the tax treatment of court-free amalgamations of companies under the new Companies Ordinance (Cap. 622), which has been addressed through brief guidance posted on the IRD's website. The tax implications of new legislation should be considered while the legislation is under discussion and, if necessary, consequential amendments made to the IRO or to subsidiary legislation under the IRO. Again the issue of sufficiency of resources in the IRD, referred to above (paragraph 11.vi) may be relevant.

ii. Similarly, the cases of *ING Baring Securities (Hong Kong) Ltd. v CIR*[21], on source of profits, and *CIR v Goepfert*[22], on the source of employment income, should have clarified the law but, due to subsequent differences of view over their interpretation, it is doubtful whether they continue to do so. This suggests the need to consider codifying in law some of the main tests or criteria for determining source, as set out by the court. This could be achieved by the introduction of appropriate amendments to the Inland Revenue Rules.

iii. Encouraging wider use of the advance ruling system. The IRD should be prepared to accept applications and to publish advance rulings, wherever possible, even where there may be difficult or contentious points of law to consider.

iv. Establishing a full-time panel of tax experts to hear the more complex tax cases before the BOR. The question of whether the BOR is equipped to handle complex cases, of which there is an increasing number, was raised by the CFA in the *ING Baring* case. Given that the panel would be employed full time, this would equip the BOR with a high level of expertise whilst addressing potential conflicts of interest. The existing part-time general panel of members should continue to deal with the non-complex cases. When members of the full-time, expert panel are not engaged in complex cases, they could sit as chairmen to hear non-complex cases, thus improving cohesion in the BOR's administration and making it more likely that the decisions of previous BORs would be followed or distinguished. The Institute's views on this matter were set out in its submission on the Inland Revenue

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[19] FACV 23/2012

[20] FACV 9/2000

[21] FACV19/2006.

[22] (1989) 1 HKRC

(Amendment)(No.3) Bill 2015[23].

Hong Kong's tax base

16. The longer-term pressures on the Hong Kong's tax system continue to be a concern. The Report of the Working Group on Long-Term Fiscal Planning (Phase One) recommended avoiding excessive reliance on direct taxation[24]. Most jurisdictions are actively working to widen their tax bases, reducing deductions and allowances and bringing new streams of income into the tax system[25]. As such, options for broadening and stabilising the tax base should continue to be considered. The government's consultation materials[26] on the 2017-18 budget again emphasise the point, noting that, in 2014-15, 52% of the working population did not need to pay any salaries tax and, of the remainder, the top 5% of taxpayers (about 90,000 people) contributed 63% of the salaries tax revenue. Around 86% of the revenue was contributed by less than 15% of taxpayers. As regards profits tax, about 86% of revenue was contributed by the top 5% of companies (about 5,000 companies) and around 91% of registered companies (about 1,048,100) did not need to pay any profits tax. Together profits and salaries tax contribute around 40% of government revenue.

17. The ageing of the population and the associated pressures on the tax system (e.g., rising health care costs), and the increasing volatility and unpredictability of key sources of revenue, including land premiums (bearing in mind that the government is committed to increasing the land supply by holding on a regular auctions, etc.), all mean that the existing system is likely to come under increasing strain. While proposals for a goods and services tax received only limited support in the past, this issue has not been looked at for over eight years and, in any event, a goods and services tax is not the only option; other means of broadening the tax base should also be studied.

B. Tax measures and the community

18. Tax measures can also be important in improving people's livelihoods, given that costs continually rise and given, in particular, the problem of the unaffordability of housing. Greater efforts should also be made to engage the community and encourage individuals to pay more attention to their own health and wellbeing. We suggest introducing measures to promote participation in sports by children and young people, and to help more people develop the appropriate skill sets to participate in the

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[23] See: http://www.hkicpa.org.hk/file/media/section4_cpd/Specialist%20Faculties/pdf-file/submission/2015/sub-tfec-ir-bill-2015.pdf

[24] Report of the Working Group on Long-Term Fiscal Planning (Phase One), p.168, para.7.31, http://www.fstb.gov.hk/tb/en/docs/english_report_online_version.pdf.

[25] KPMG, 2015 Global Tax Survey, p.5, https://assets.kpmg.com/content/dam/kpmg/pdf/2015/11/global-tax-rate-survey-2015-v2-web.pdf.

[26] See footnote 3.

workforce; as well as longer-term measures that would encourage people to plan ahead for their retirement and future healthcare needs. More specifically, the Institute recommends introducing the measures outlined below.

<u>Home rental deduction</u>

19. Many taxpayers cannot afford to buy their own homes now and may not be able to do so in the foreseeable future. Home purchase affordability (i.e., the ratio of mortgage payment for a 45-square metre flat to median income of households, excluding those living in public housing) worsened again, to 59%, in the third quarter of 2016[27], compared with 56% in the second quarter, significantly exceeding the long-term average of 46% over the period 1996-2015[28].

    Therefore, we propose that taxpayers be offered an allowance equivalent to the home loan interest deduction that can be used for rental payments in relation to the taxpayer's primary residence, subject to an annual limit of HK$100,000. Employees who are already claiming a housing allowance from their employers, and taxpayers who have previously claimed their full entitlement of the home loan interest deduction, would not be eligible for this benefit.

<u>Sports training deduction</u>

20. During and after the Rio Olympics, interest in sport increased and this momentum should be encouraged to develop. There is more interest in sport in Hong Kong in recent years, as evidenced by the growth in participation of events, both international and local, including, for example, the growing number of people taking part in events such as the annual Standard Chartered Hong Kong Marathon. Participation in sport offers long-term physical and mental health benefits. It can help relieve stress, build team work and a positive competitive spirit. It also helps foster other good qualities, such as sense of sportsmanship and fair play, and respect for others. Given the increasingly sedentary lifestyle of many younger people, who spend more time than previous generations on computers and personal devices, it is important to find ways to channel some of their energy into other more active, recreational outlets. With the increasingly strong performances in international and, particularly, regional events, of Hong Kong's elite athletes, who can serve as role models, this is an opportune time to encourage children and young people to develop a sporting culture.

    We propose, therefore, introducing a new deduction for expenditure by parents on children to attend approved extra-curricular sports training classes or activities. This

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[27] Government of the Hong Kong SAR, Third Quarter Economy Report 2016, p.44, para. 3.5, http://www.hkeconomy.gov.hk/en/pdf/er_16q3.pdf

[28] Government of the Hong Kong SAR, Half-yearly Economic Report 2016, p.48, para.3.5, http://www.hkeconomy.gov.hk/en/pdf/er_16q2.pdf

should be subject to an annual cap of HK$12,000 per child.

Salaries tax allowances

21. In recent years, increases in the allowances for children and other dependants have not been revised in alignment with one another and have been implemented at different times, with different levels of increases. For example, child allowances have doubled since 2008-09, while allowances and additional allowances for dependent parents and grandparents, although increasing progressively, are still only 53% higher than in 2008-09; and the allowances for dependent siblings and disabled dependants have gone up only by 10% during this period. 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 rationalised. Thereafter, adjustments should be made on a more transparent basis and aligned, where appropriate. Where there are good policy or other reasons for differential adjustments, this should also be made clear. Pending the above review, we propose that these allowances should all be increased broadly in line with inflation.

Private health care premiums

22. Although the government consulted on proposals for a voluntary health insurance scheme in 2014-15, and there is talk of the government putting forward revised proposals, it still unclear whether and, if so, what specific measures will be implemented within the next few years. We also consider that the proposed tax deduction under the original proposals may not have been sufficient. Therefore, in order to encourage more efficient utilisation of both public and private health care services, given that more than half of the population does not have employer medical benefits or coverage by medical insurance[29], we propose that taxpayers be allowed a deduction for the cost of private health insurance premiums, subject to an annual cap of HK$12,000 per taxpayer. In addition, the government should consider allowing taxpayers to claim deductions for premiums paid on behalf of dependent spouses and children, subject to a similar cap per dependant. If there are reservations about introducing this as a long-term measure while the government may be putting forward revised proposals for a voluntary health insurance scheme, we would propose that the deduction be offered in the coming year and that it may be introduced subject to an annual review.

[29] Census and Statistics Department, Hong Kong SAR, Thematic Household Survey Report No. 58, p.103, para.7.24, *"At the time of enumeration, some 3 510 600 persons or 51.3% of the total population covered in the survey were not entitled to any medical benefits provided by employers / companies and were not covered by medical insurance purchased by individuals….",* http://www.statistics.gov.hk/pub/B11302582015XXXXB0100.pdf.

Voluntary mandatory provident fund contributions

23. It is commonly accepted that the statutory mandatory provident fund ("MPF") contributions cannot at present provide an adequate nest egg for people's retirement. Debate is continuing on possible alternatives, such as a universal pension scheme, and the government conducted a public engagement exercise on retirement protection earlier this year. It has recently been reported that the government will propose enhancements to the old age allowances, as well as the ending of offsetting mechanism, which currently allows employers to offset severance and long-service payments due to employees against the employers' MPF contributions for those employees. However, given the different views on these issues in the past, it is not clear that agreement will be reached quickly on the way forward. Meanwhile taxpayers are not given any specific incentives to save more for their own retirement. If taxpayers, particularly from middle income groups, can save more while they are working, this will put less strain on the public purse in the long run, which is important in the face of an aging population. Therefore, in order to encourage people to save more and earlier for their retirement, we propose that taxpayers be allowed an additional deduction for voluntary contributions to their MPF accounts, of up to HK$60,000 annually. To avoid any misuse, the contributions could be made taxable again if withdrawn for non-approved purposes before retirement.

Self-education expenses

24. To support those who wish to further their job-related education and training, and upgrade their skills in order to increase their employment opportunities, the Institute recommends making the application of the deduction for self-education expenses more flexible. Specifically, we propose that any amount of a taxpayer's maximum deduction, of HK$80,000, not taken up by the taxpayer him or herself should be available for use by the taxpayer's dependants. It should be permitted to be used for the self-education expenses of the taxpayer's spouse, for training to join or re-join 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. This may stimulate more adults to consider undertaking further training and study, especially given that the proportion of those currently expressing interest in doing so, relative to the population, is fairly low at 14%[30].

The self-education deduction should also be made available for courses offered by reputable providers on I&T, starting a business, entrepreneurship, and related matters, which, technically, may not meet the criteria of being undertaken "for the purpose of

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[30] Census and Statistics Department, Hong Kong SAR, Thematic Household Survey Report No. 56, p.118, para. 7.2, *"The survey results showed that some 848 200 persons aged 15 and over were interested in taking programmes / training courses to upgrade educational attainment or enhance vocational skills at the time of enumeration, constituting 14.0% of all persons aged 15 and over in Hong Kong.…",*
http://www.statistics.gov.hk/pub/B11302562015XXXXB0100.pdf

gaining or maintaining qualifications for use in any employment."

Appendix 1: Tax policy formulation in Singapore and United Kingdom

1. Various approaches towards tax policy formulation are adopted in other jurisdictions. Two different examples, from the UK and Singapore, are discussed briefly below.

2. In Singapore, there are several key governmental statutory bodies that drive tax policy, namely, the Economic Development Board ("EDB"), which focuses on business and economic development generally, the Monetary Authority of Singapore ("MAS"), which focuses on financial services policy, and the Maritime and Port Authority of Singapore ("MPA"), which focuses on shipping. The EDB through its planning and policy unit, however, leads the development of tax policy and does so in the context of its mandate to drive and execute strategies necessary to attract foreign direct investment and spur economic growth.

3. The Inland Revenue Authority of Singapore ("IRAS") is the tax administrator in Singapore and maintains and administers, rather than develops, the tax policies and incentives. One of IRAS' main competencies is to administer and ensure the compliance in respect of the statutory incentives (those that are broadly based and available to all taxpayers). Sometimes it does this in collaboration with the associated government agency. Discretionary tax incentives are administered by the government statutory boards themselves including the EDB, MAS and MPA. Businesses seeking discretionary incentives apply directly to the relevant boards. IRAS and EDB have complementary functions – the EDB focuses on development of incentives and satisfaction of incentive conditions, whilst the IRAS administers the tax treatment and focuses on how tax incentives interact within the wider tax framework (e.g., treatment of expenses or transfer pricing issues).

4. In the UK, Her Majesty's Treasury ("HMT") is responsible for driving tax policy as the government's economic and finance ministry. It is responsible for strategic oversight of the UK tax system, including direct, indirect, business, property, personal and corporation tax. Its main priorities include making corporate taxes more competitive. Her Majesty's Revenue and Customs ("HMRC") is the tax administrator in the UK and administers taxes, but has a limited role in policy making.

5. In the UK, as an example, all new tax legislation is accompanied by Tax Impact and Information Notes that set out, amongst other things, the anticipated impact on tax revenue over the coming five years (certified by the Office for Budget Responsibility), the economy, individuals and households and businesses, as well as any change in operational costs for HMRC.

6. In other jurisdictions, arrangements may also be in place to seek the input of business and other stakeholders into the development of tax policy. For example, the HMT has set up a Business Forum on Tax and Competitiveness (see: https://www.gov.uk/government/groups/business-forum-on-tax-and-competitiveness) which is chaired by the financial secretary to the treasury and includes finance directors,

chief financial officers, chief executives or chairmen of some of the UK's leading companies, the director-general of the Confederation of British Industry, as well as the economist heading the Oxford University Centre for Business Taxation. The forum meets three or four times a year. Officials from HMT and HMRC attend meetings in order to test policy direction and possible proposals, share information on government views and listen to forum members' views.

7. The role and scope of the forum are as follows:

- To facilitate an open discussion of the issue of tax in the context of the UK's international competitiveness.

- To provide the UK Government with views from a range of different multinational businesses that can be used to inform the tax reform process and proposals.

- The focus of the forum is on long-term and strategic tax issues in the context of the UK's international competitiveness.

- The forum complements wider consultation as part of the UK Government's aim to have an open and transparent approach to tax policy.

Appendix 2: Proposed changes for salaries tax allowances and deductions

Allowances and deductions	Existing (HK$)	Proposed (HK$)
Allowances[31]:		
- Basic	132,000	135,300
- Married person	264,000	270,600
- Child (annual, each dependant)	100,000	102,500
- Child (initial, each dependant)	100,000	102,500
- Dependent brother or sister (each dependant)	33,000	33,825
- Dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the government's disability allowance scheme	46,000	47,150
- aged 55 or above but below 60	23,000	23,575
- Additional dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the government's disability allowance scheme	46,000	47,150
- aged 55 or above but below 60	23,000	23,575
- Single parent	132,000	135,300
- Disabled dependant (each dependant)	66,000	67,650
Deductions, maximum limit:		
- Self-education expenses	80,000 limited to claims by taxpayer	80,000 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)
- Voluntary MPF contributions	-	60,000
- Private healthcare insurance premiums		
- taxpayer	-	12,000
- additional dependent spouse/ children (each dependant)	-	12,000
- Rental payment for taxpayer's primary residence	-	100,000

[31] 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 3: Proposed changes in salaries tax allowances and deductions - impact on a typical individual

Example: Single person

This example illustrates the impact of[32]:

- an increase of basic allowance to HK$135,300
- a deduction for voluntary MPF contributions of HK$15,000 (annual limit of HK$60,000)
- a deduction for private healthcare insurance premiums 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			
Voluntary MPF contribution	-		15,000			
Private healthcare insurance	-		12,000			
Rental payment	-		100,000			
Total allowances/ deductions		147,000		277,300		
Net chargeable income		153,000		22,700		
Tax payable		14,010		454	13,556	97%

[32] Assumptions are as for Appendix 2.

Appendix 4: 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[33]:

- an increase of basic allowance to HK$135,300
- an increase in child allowance to HK$102,500
- an increase in dependant parents allowance and additional allowance to HK$47,150
- a deduction for voluntary MPF contributions of HK$18,000 (annual limit of HK$60,000)
- a deduction for private healthcare insurance premiums with annual limit of HK$12,000

	Existing (HK$)			Proposed (HK$)			Savings (HK$)	Savings (%)
Income			650,000			650,000		
Allowances/ deductions:								
Basic allowance		132,000			135,300			
Child allowance	2 children 100,000 each	200,000		2 children 102,500 each	205,000			
Dependent parent allowance and additional allowance	2 parents 92,000 each	184,000		2 parents 94,300 each	188,600			
Mandatory MPF contribution		18,000			18,000			
Voluntary MPF contribution		-			18,000			
Private healthcare insurance		-		1 taxpayer and 2 children 12,000 each	36,000			
Total allowances/ deductions			534,000			600,900		
Net chargeable income			116,000			49,100		
Tax payable			7,920			1,437	6,483	82%

[33] Assumptions are as for Appendix 2.