Budget proposals

Developing a sustainable community, economy and environment

2011 - 12

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

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Developing a sustainable community, economy and environment

Key measures proposed

The Institute's 2011-12 budget proposals, developed by the taxation committee, place emphasis on tax measures and the revenue side of the budget. Under the heading "Developing a sustainable community, economy and environment", our recommendations cover three broad, but very important areas. While, clearly, Hong Kong cannot hope to resolve the major challenges it faces through tax system, a favourable system, in terms of both policies and administration, can make a useful contribution.

Our focus is on underlying issues, such as the need to support strategic sectors in Hong Kong’s future economic development and long-term economic and social challenges. The latter include preparing for an ageing population, with its associated needs in terms of healthcare services and funding of retirement years, and also helping young couples with the financial burden of setting up homes and raising families. Given that the issues identified and the measures contained in our proposals are not simply short-term, this year we are not proposing any specific, one-off tax reliefs.

We have reflected on the current tax system and Hong Kong's future direction. Given our basically healthy fiscal situation, we believe that there is scope to make further adjustments to the tax system to the benefit of Hong Kong's long-term social and economic interests.

Below are the main measures proposed by the Institute in the areas of community, economy, environment and also broadening the tax base.

A. A sustainable community

1. Addressing the ageing population and community needs

   (i) Allow deductions for individual taxpayers' voluntary contributions to their mandatory provident fund schemes, subject to an annual cap of HK$48,000 (i.e., additional to their mandatory contributions of up to HK$12,000).

   (ii) Allow deductions for private medical insurance, subject to an annual cap of HK$12,000 per taxpayer.

   (iii) Increase annual allowances by 20% for dependent parents, grandparents, brothers, sisters and disabled dependants (to HK$18,000 for dependent (grand)parents, aged 55-59, not residing with the taxpayer, through to HK$72,000 for dependent (grand)parents aged 60 or above residing with the taxpayer and for disabled dependants), and increase the limit on the deduction for elderly residential care expenses by 20% (to $72,000).

   (iv) Increase initial and annual child allowances by 20% (to HK$60,000) for the 1st to 3rd child.

2. Housing market

   (i) Adjust the price thresholds for the different rates of stamp duty on the sale or transfer of immovable property, in line with property price inflation.

   (ii) Home loan interest deduction:

      (a) Expand this benefit into a home loan interest/ home rental deduction, which can also be used towards rental payment for the taxpayer's primary residence, for the same maximum duration, and subject to the same annual cap, as the home loan interest deduction.

      (b) Increase the duration of the deduction from 10 years to 15 years.

   (iii) Exempt stamp duty for first-time home buyers, who are Hong Kong permanent residents, on properties costing up to HK$6million for use as their principal residence.

3. Helping the disabled

   (i) Grant employers "super deductions" of 150% for the salary costs of employing disabled persons.

   (ii) Grant 100% allowances in the year of purchase for facilities to cater for the disabled.

B. A sustainable economy

1. Support to small and medium enterprises

   (i) For small companies with gross income that does not exceed HK$2million, reduce corporate profits tax rate to 15%, in line with the rate for unincorporated businesses.

2. Hong Kong's competitiveness in the global business community

   (i) Expand Hong Kong's network of comprehensive double taxation agreements.

   (ii) Conduct a study on the long-term competitiveness of Hong Kong's tax system.

3. Hong Kong as a hub for financial services

   (i) Extend the rules relating to the exemption from profits tax for qualified offshore funds.

   (ii) Introduce exemptions for onshore funds that meet specific criteria.

   (iii) Introduce further tax incentives for the insurance sector.

4. Hong Kong as a hub for intellectual property use and development

   (i) Extend the 100% deduction for acquisition costs to additional types of intellectual property.

   (ii) Offer unilateral tax credits for withholding tax on royalties where no double taxation agreement exists.

   (iii) Grant “super deductions” of 150% for research and development expenditure.

5. Hong Kong as the base for regional operations

   (i) Grant a 10% concessionary rate of profits tax for regional offices in Hong Kong.

   (ii) Exempt interest received by regional offices (except for financial institutions) on loans made to overseas associates.

C. A sustainable environment

1. Building design

   (i) Introduce accelerated commercial and industrial building allowances for new buildings adopting approved environmental designs.

2. Road traffic

   (i) Consider introducing a higher first registration tax and annual licence renewal fees for polluting vehicles.

D. Other issues: broadening Hong Kong's tax base

1. Broadening Hong Kong's tax base

   (i) Continue to explore options to broaden the tax base and so reduce the potential volatility and uncertainty in the revenue stream.

<u>Developing a sustainable community, economy and environment</u>

Introduction

1. Hong Kong's economy is back on track with solid growth and relatively low unemployment. Real GDP growth was 6.8% in the third quarter of 2010, following on from growth of 6.5% in the second quarter. Hang Seng Bank predicts overall GDP growth of around 6.5% for the whole of 2010, compared with the 4-5% forecast contained in the 2010-11 budget speech. Unemployment has moderated from 4.4% at the end of the first quarter of 2010 to 4% (provisionally) for the three-month period ending in 31 December 2010.

2. The Hong Kong stock market maintained its position as the top market worldwide for fund raising in 2010, with a record HK$445billion raised in 113 initial public offerings, which is substantially more than in 2009. Given the high level of activity on the stock market and an extremely buoyant real property market, government revenue from stamp duty and land premiums has been well above the financial secretary's original forecast. This, alongside higher GDP growth than projected, means that, instead of a deficit of HK$25.2billion, as forecast at the time of the 2010-11 budget, the outturn for 2010-11 is likely to be another very substantial surplus, exceeding the HK$26billion surplus achieved in 2009-10. By 31 March 2011, the fiscal reserves are likely to be in the range of HK$565 - $585billion, which is equivalent to around 24 months of government expenditure and a very robust fiscal position.

3. Given Hong Kong’s externally-orientated economy, any uncertainties in major markets overseas will always potentially have an impact on Hong Kong. Nevertheless, the fears of a double-dip recession seem to have subsided. The Mainland economy continued to grow substantially in 2010 and there are indications that the United States economy is recovering slightly faster than previously expected. There is now more concern about imported inflation arising from a combination of the Hong Kong dollar peg to the US dollar and price rises in the Mainland and elsewhere. Excessive inflation would lower standards of living, particularly for those on fixed incomes, and could lead to interest rate rises which, in the situation of Hong Kong's current property market could have very negative consequences.

4. While Hong Kong’s relatively simple, low-rate tax system remains an advantage, from a tax perspective our competitiveness is being eroded, as other jurisdictions seek to attract more business through changes in their own tax regimes. In addition to reducing their corporate profits tax rates, which are, in some cases, now close to Hong Kong's, some of Hong Kong’s competitors are prepared to provide more specific incentives to attract particular kinds of business. While we are not specifically advocating the adoption of similar policies, Hong Kong needs to look at how its effective rates of tax compare with competing locations.

5. By comparison Hong Kong has made only relatively minor adjustments to its tax regime and incentives over the past years. In some cases, the value of incentives and concessions that were introduced some years ago has diminished over time due to, e.g., changes in business practices - the 50:50 profits tax apportionment arrangement for manufacturing in the Mainland would be one example - without any corresponding updating of, or increased flexibility in the tax regime.

6. It is in Hong Kong's interests to encourage and support pillar industries and also expand investment from new, value-added businesses so as to expand the number and range of businesses that contribute to profits tax revenue. While the identification by the government of six new industries in which Hong Kong has the capacity to excel is a move in the right direction, more may need to be done to formulate and set out Hong Kong's long-term strategic aims and goals. The consideration of tax incentives and other measures should be part of the framework of support for Hong Kong's chosen economic direction.

7. It is frequently observed that Hong Kong faces a number of other long-term economic challenges, including an ageing population, which will need to be supported by relatively smaller proportion of working population, and a wealth gap between the rich and the poor, which is proving difficult to resolve and which reflects, in part, a mismatch between skill sets and employment opportunities within the labour market.

8. While tax system cannot hope to resolve all the major challenges Hong Kong faces, a favourable tax environment can make a useful contribution. The Institute's 2011-12 budget proposals, developed by its taxation committee, cover three broad, important areas, under the heading "Developing a sustainable community, economy and environment".

Details of proposed measures

The following are the details of the proposed measures in the areas of community, economy, environment and broadening the tax base.

A. <u>A sustainable community</u>

The policy address and the financial secretary's invitation for budget views have identified, amongst the challenges currently facing Hong Kong, (i) a long-term concern about how to provide adequately for an ageing population, with a lower proportion of people in the workforce supporting a higher proportion of economically inactive retirees and (ii) a more immediate concern about an asset price bubble and subsequent price collapse. The Institute believes that there is a need for practical and direct measures to be considered to help address these issues.

1. <u>Addressing the ageing population and community needs</u>

   To prepare for the challenges of an ageing population, it is imperative that those still active in the workforce plan ahead in relation to matters such as retirement and healthcare. In the more immediate term, additional support should be extended to families to assist them in providing better care for elderly relatives and to encourage families to have children. The Institute suggests:

   (i) In view of the trend towards a longer life expectancy, individuals need to ensure that they have adequate funds to maintain a reasonable lifestyle throughout their retirement. Given the relatively low compulsory rate of contributions to the mandatory provident fund (MPF) schemes, individuals should be encouraged to make additional voluntary contributions. The Institute, therefore, proposes allowing tax deductions for voluntary contributions to MPF schemes, subject to an annual cap of HK$48,000 over and above their mandatory contributions. If any additional voluntary contributions are subsequently withdrawn before retirement, they should become taxable.

(ii) The government has recently conducted a second consultation on its proposal for healthcare reform, and indicated that public expenditure on healthcare has been on a sharp increase. While the government should continue to provide adequate funding for the public healthcare service, the Institute considers that individuals should also be encouraged to plan for their own future healthcare needs. With this mind, we propose that taxpayers be allowed a deduction for the cost of private healthcare insurance, subject to an annual cap of HK$12,000 per taxpayer. This should help to bring about a more efficient utilisation of both public and private healthcare services.

(iii) The 2010-11 policy address considered measures to improve community and home care services for the elderly[1]. In this connection, the Institute recommends increasing by 20% annual allowances for dependent parents, grandparents, brothers, sisters and disabled dependants; and the limit on the deduction for elderly residential care expenses. Most of these allowances have not been increased for more than ten years (the main exception being the HK$15,000 allowance for dependent (grand) parents aged 55-60, which was introduced only in 2005-06).

(iv) In order to encourage families to have more children, which would help boost the population replacement rate and create a more sustainable community, the Institute recommends providing further financial support through a 20% increase in initial and annual child allowances for the 1st to 3rd child.

(v) The proposed revised allowances are reflected in Appendix 1. Appendix 2 illustrates the impact of our proposed changes on salaries tax for a typical family.

2. Housing market

In recent months, the government has introduced several measures to mitigate the risk of a housing price bubble. However, while it appears that property prices are no longer increasing at the rapid rate they were previously, prices remain high and it is difficult for first-time buyers to get onto the first rung of the property ladder. To assist the community meet its housing needs, which is a fundamental livelihood issue, appropriate additional measures should be put in place in relation to home ownership and accommodation. We propose the following:

(i) Adjust the price thresholds at which different levels of stamp duty apply on the sale or transfer of immovable property, in line with property price inflation. Periodic reviews are needed to monitor whether the stamp duty thresholds are reflective of the property price inflation.

(ii) The home loan interest deduction should be:

(a) Expanded into a home loan interest/ rental deduction, so that it may also be claimed against rental payments by taxpayers, who may not be in position to purchase a property, i.e. the deduction should be allowed to be used in relation to either home loan interest or rental payments in respect of a taxpayer's primary residence (or a mix of these two, if the taxpayer moves from renting to purchasing a property, or vice versa) subject to the same overall duration and monetary limits.

[1] 2010-11 policy address, paragraph 70.

(b) Increased in duration from 10 to 15 years, as 15 years is a common mortgage term, while maintaining the annual cap at HK$100,000.

(iii) Exempt stamp duty for first-time home buyers on properties costing up to HK$6million for use as their principal residence. In order to ensure that this concession targets long-term residents of Hong Kong, consideration could be given to confining it to permanent residents.

3. Helping the disabled

Many people with disabilities have the desire and capacity to contribute significantly as members of the workforce. However, the physical infrastructure in Hong Kong is often not geared to cater for the needs of the disabled and this may discourage employers from considering the disabled when recruiting. The Institute proposes, therefore, that tax incentives should be provided for:

(i) Employers to recruit and integrate such employees into the workforce. We propose "super deductions" of 150% for salary costs of employing disabled persons.

(ii) Such employment may require fixtures or equipment to be put in place for use by disabled employees, which, in certain businesses, can also be of benefit to disabled customers. It is recommended that 100% allowances in the year of purchase be granted for facilities and equipment to cater for people with disabilities.

B. A sustainable economy

Hong Kong is recognised globally as an international and regional business hub. It has a competitive edge because of its well-established infrastructure, including its legal framework and orderly financial markets, and its pool of skilled manpower. However, Hong Kong cannot afford simply to rely on the existing infrastructure, and needs to further strengthen its role as a preferred business location in order to sustain the economy over the longer-term and create more jobs. Hong Kong's growing role in the internationalisation of reminbi is one such development. Amidst the competition, Hong Kong should take a range of appropriate measures to consolidate its position in key industry sectors with potential growth opportunities, and tax is a useful tool that the government can employ to attract inbound investment. The Institute recommends the following measures:

1. Support to small and medium enterprises

The 2010-11 policy address identified the need for support to be provided to small and medium enterprises (SMEs)[2], which constitute an important segment of the Hong Kong business sector, comprising of over 90% of total businesses[3]. Against the background of the international trend to lower corporate taxes, and to give support to SMEs through the tax system the Institute recommends that:

[2] 2010-11 policy address, paragraphs 107 to 109.
[3] http://www.success.tid.gov.hk/english/lin_sup_org/gov_dep/service_detail_6863.html

(i) For companies with gross income that does not exceed HK$2million, corporate profits tax rate should be reduced from 16.5% to 15%. Subject to meeting certain requirements, businesses of up to this size are regarded as small business by the IRD (which do not need to submit supporting documents when filing their profits tax returns). This proposed measure would enable smaller businesses that chose to operate through a corporate structure, to enjoy the same tax rate as unincorporated businesses. A number of jurisdictions around the world set lower tax rates for companies that fall within specified income or profit thresholds, although the specific mechanisms adopted vary from place to place. These include Canada, United States, United Kingdom, Taiwan, South Korea, Singapore, Malaysia, Indonesia and Luxembourg.

2. <u>Hong Kong's competitiveness in the global business community</u>

The Institute proposes the following to enhance Hong Kong's competitiveness:

(i) Double taxation agreements: The Institute is supportive of the government's efforts to negotiate comprehensive double taxation agreements (DTAs), as a result of which, Hong Kong has, in a relatively short space of time, concluded a significant number of DTAs. The more equitable and extensive DTAs that Hong Kong has in place with its major trading partners, the more this helps to reinforce Hong Kong's position as an international business centre. The Institute would encourage the government to continue its efforts to expand the network of DTAs, prioritising major trading partners globally and regionally.

The importance many countries attach to DTAs has been highlighted by a recent Greek ministerial decision to include Hong Kong on a list of "non-cooperative" jurisdictions, with effect from 1 January 2011. "Non-cooperative" jurisdictions, as explained in a Hong Kong Trade Development Council (HKTDC) alert of 7 January 2011, are those which have not concluded an agreement on administrative assistance in tax matters with Greece. The repercussions of this labelling can be very serious, as the HKTDC alert also explains. Greek businesses may be reluctant to trade with Hong Kong companies, as they will not be able to get a tax deduction for any expenses accruing from dealings with Hong Kong entities[4].

While this points to the value of DTAs, which generally also include provisions on exchange of information, on this specific issue the Institute is concerned about such unilateral action taken by Greece and the precedent that this sets. We would urge the government to consider pursuing this matter with the appropriate authorities, as this action in effect imposes an unjustified trade restriction on Hong Kong, which could have implications for Hong Kong's trade agreements under the World Trade Organisation.

(ii) Study on Hong Kong's long-term tax competitiveness: A study should be conducted of the long-term competiveness of Hong Kong's tax system. This should include an international comparison with the corporate tax rates in other jurisdictions, which looks at effective rates after incentives, amongst other things. When companies assess the viability of setting up a business in Hong Kong, our overall effective tax rate may be less attractive than jurisdictions that offer a range of tax incentives.

[4] http://www.hktdc.com/info/mi/a/baeu/en/1x07a0r9/1/business-alert-%e2%80%93-eu/new-tax-law-makes-hong-kong-invoices-less-attractive-to-greek-importers.htm

3. <u>Hong Kong as a hub for financial services</u>

In the 2010-11 policy address, the chief executive indicated that becoming a major asset management centre was one of Hong Kong goals, so as to provide world-class, comprehensive and quality financial services in the Asian time zone[5]. The Institute proposes that additional measures be introduced to underpin Hong Kong's status, given the competition from various emerging markets that also aim to develop as asset management centres. These include measures to expand concessions for existing financial services industries and also to facilitate and attract new types of businesses in this sector. Specifically, we propose the measures outlined below.

(i) To encourage offshore investors to invest in Hong Kong, consideration should be given to extending the offshore fund exemption rules and ensuring that income generated from the normal operations of an offshore fund is covered. Our proposals include:

(a) allowing offshore funds to use Hong Kong-based trustees.

(b) relaxing the exemption restriction on offshore funds investing in offshore private companies other than property holding companies.

(c) extending the definition of "specified transactions" to include income from certain fixed income financial instruments as qualified transactions.

(d) expanding the list of specified stock and future exchanges to include Mainland exchanges.

(ii) Furthermore, it is an opportune time to consider some longer-term initiatives for the financial services sector, including:

(a) granting an exemption for Hong Kong resident funds, similar to that currently granted to offshore funds, to provide a more level playing field for onshore and offshore funds. Singapore, for example, also offers favourable treatment for domiciled funds, the salient features of which are indicated at Appendix 3.

(b) reviewing the existing interest expense deduction rules to encourage international companies to use Hong Kong as their "cash pooling hub".

(c) reviewing the existing charging section, that is, section 23 of the Inland Revenue Ordinance (IRO) for life insurers, as the current provision is no longer in line with the development of the industry. For instance, income relating to the investment portion of unit link products should not be included as insurance premiums for computing the 5% deemed assessable profits.

(iii) The government should proceed with tax legislation to ensure equality of treatment between Islamic finance products and conventional products, taking care to avoid any distortions from a tax perspective. This will enable Hong Kong to offer a fuller range of financial services and products and improve its standing as an international financial market.

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[5] 2010-11 policy address, paragraph 98.

(iv) Given the lack of broad-based taxes in Hong Kong, we would not suggest abolishing stamp duty on stock transactions at this time. Nevertheless, we recommend that certain stamp duty-related measures be considered, such as, simplifying the application process for stamp duty relief on stock borrowing and lending transactions and providing an exemption from stamp duty for intermediaries conducting equity transactions on behalf of clients (as in the United Kingdom, for example).

4. Hong Kong as a hub for intellectual property use and development

In the policy address 2010-11, the chief executive stated that he will continue to monitor the development of the six new industries, as part of the long-term development plan[6].

Given this aim, it should be considered whether the existing tax regime sufficiently supports this policy direction. Current concessions are not particularly favourable, either for encouraging more research and development (R&D) activities to be done in Hong Kong or for facilitating Hong Kong to become a hub for the ownership and licensing of intellectual property (IP). Meanwhile other jurisdictions are also developing similar business areas, e.g., innovation and technology, and cultural and creative industries, and are offering tax concessions to reinforce their policy decisions.

The Institute proposes that the current tax concessions in relation to IP be extended. The following measures should be considered (together with suitable anti-avoidance provisions):

(i) The 100% deduction for the cost of acquiring IP should not be restricted to patents and know-how, but should be extended to a range of other IP-related assets. While the Institute welcomes the government's proposal in the 2010-11 budget to extend the deduction to registered trademarks, copyrights and registered designs, we consider that the extension should not be limited to these three categories only. It should cover the full range of IP rights, including brand names and licensing rights.

(ii) In respect of withholding taxes paid on royalties, a wider network of DTAs, as proposed above, should enable taxpayers to enjoy lower rates of withholding taxes. Where no DTA exists, the Institute proposes that a unilateral tax credit be granted for all foreign tax paid on royalties that are subject to tax in Hong Kong.

(iii) To promote R&D, the Institute recommends that "super deductions" of 150% of the actual cost incurred be allowed for R&D expenditure, subject to a suitable definition of what constitutes R&D. This is done elsewhere to encourage R&D activities. For example, Australia, Singapore, the Mainland and the UK all offer bonus deductions for R&D expenditure.

(iv) The place where IP is exploited or "place of use", should be adopted to determine the source of royalty income instead of the place of acquisition and grant of a licence or right of use. Where a taxpayer has a financial interest in the use of the licensed property, adopting place of use is supported by the case law in *HK-TVB International v. CIR* and *ING Baring Securities (Hong Kong) v. CIR*. Apart from anything else, the existing test poses difficulties in practice where the acquisition, grant and use of a right take place in different locations.

[6] 2010-11 policy address, paragraph 97.

(v) Disposals of IP rights are specifically treated as trading receipts under section 16E of the IRO and, as such, are fully taxable without any reference to the quantum of the expenditure deducted on acquiring them. This is not consistent with the basic philosophical approach of Hong Kong's tax system not to tax capital gains, which is often referred to as a significant advantage of the system. Further, this treatment is inconsistent with gains on the disposal of R&D rights, which are currently taxed, but capped at an amount equal to the prior year deductions claimed by the taxpayer in respect of the rights disposed of. Therefore, the Institute considers any gain on the disposal of IP rights should be taxed only up to the amount of any deductions allowed previously in respect of the relevant IP.

5. <u>Hong Kong as a base for regional operations</u>

While Hong Kong has proved attractive as a hub for regional headquarters and offices, and a treasury centre for international businesses, due to its good legal and physical infrastructure, factors such as high property prices, rentals and living costs, tend to erode Hong Kong's advantages. To attract businesses to continue to choose Hong Kong over competing locations, encourage more job creation and expand the pool of professionals and skilled personnel, additional tax incentives can help to shift the balance back in Hong Kong's favour, so that, on an overall basis, the cost for multinational groups to establish their regional headquarters and treasury centre in Hong Kong remain competitive. Against this background, the Institute proposes the following:

(i) A concessionary rate of 10% for profits tax should be granted to regional offices/ headquarters in Hong Kong in respect of management and consultancy income derived by the Hong Kong entity from associated entities overseas. Appropriate anti-avoidance provisions can be introduced to safeguard against potential abuses.

(ii) Hong Kong is well equipped to be a regional centre to handle the financial management of overseas associates within a group of companies. However, as financial margins are usually thin, tax measures could provide a further incentive for international businesses to establish their treasury function in Hong Kong. Currently section 15(1)(f) of the IRO, deems the interest derived from Hong Kong by a corporation carrying on a trade or business in Hong Kong to be subject to profits tax at the standard corporate rate. The Institute recommends that, other than in the case of financial institutions, the interest received by regional offices from loans made in Hong Kong to their overseas associates be exempted from profits tax.

C. <u>A sustainable environment</u>

It is not only the cost of doing business and the overall cost of living in Hong Kong that are eroding its competitiveness, the poor quality of the environment, which is quite regularly commented upon in the international media, is making Hong Kong a less attractive place to live and bring up a family. The community increasingly expects that companies should adopt responsible practices and be accountable from an ethical, if not legal, standpoint to a broader range of stakeholders. This reflects another dimension of sustainable economic growth and the business community is becoming more conscious of this dynamic. The 2010-11 policy address also identified areas of environmental protection aimed at achieving a better quality of life[7]. The

[7] 2010-11 policy address, paragraphs 111 to 124.

Institute welcomes this and proposes consideration of the measures outlined below to support improving Hong Kong's environment.

1. Building design

   In line with the 2010-11 policy address to promote green buildings in Hong Kong[8], accelerated industrial building and commercial building allowances should be granted for new commercial and industrial complexes adopting overall approved environmentally sustainable designs (in contrast to the existing allowances which are for installations and equipment only). For example, the allowances for industrial and commercial buildings should be accelerated to ten years from the current 20 and 25 years for industrial and commercial buildings respectively. The proposed rate of the allowances would be as follows:

	Initial Allowance		Annual Allowance	
Building type	Existing	Proposed	Existing	Proposed
Industrial	20%	25%	4%	7.5%
Commercial	NIL	25%	4%	7.5%

2. Road traffic

   A public opinion survey on air pollution on Hong Kong conducted in mid-2010 by the Hong Kong Transition Project on behalf of Civic Exchange, found that one in four Hong Kong residents is considering emigrating due to air pollution, which is up from one of five in 2008. The study found that those considering leaving are often well educated professionals and managers[9]. This is a cause for concern.

   Road transport continues to be a major source of pollution in Hong Kong. While there are currently tax incentives in place to purchase approved "environment-friendly" vehicles and grants to retire old Euro II diesel commercial vehicles in favour of new commercial vehicles, overall change does not seem to be happening fast enough. Therefore, in addition to these and other measures to encourage positive changes (e.g., developing a more extensive infrastructure of charging stations for electric vehicles), we suggest a "carrot and stick" approach be adopted. As regards the latter, we propose that consideration be given to introducing additional higher rates of first registration tax and annual licence renewal fees for categories/ models of vehicles that are polluting, including older commercial vehicles and fuel-inefficient private cars. Separately, we would also urge the government to proceed quickly with legislation to discourage the use of idling engines.

3. Other possible measures: pollution from the Pearl River Delta

   Factories and power plants in the Mainland remain one of the major sources of pollution in Hong Kong. The Institute considers that in order to deal with critical problems, innovative ideas and bold action should be considered. We suggest, therefore, that the government

[8] 2010-11 policy address, paragraph 40.
[9] *Less Talk, More Action* Public Opinion Survey on Air Pollution in Hong Kong, Civic Exchange, December 2010.

discuss with the Guangdong authorities measures that could help to alleviate the situation, which could include the feasibility of offering tax incentives to factories and power generators in the Pearl River Delta to install facilities and equipment which significantly reduce polluting emissions. From the Hong Kong tax perspective, in order to benefit from any incentives, the installation of approved facilities and equipment in Hong Kong-owned factories would have to be verifiable.

D. Other Issues: broadening Hong Kong's tax base

1. Broadening Hong Kong's tax base

In the government publication inviting views on the 2011-12 budget, the financial secretary asked, *Do we need to broaden the tax base?* [10]. The Institute's response is that the government should continue to explore options to broaden the tax base. The narrowness and volatility of Hong Kong's tax base, and the limited number of persons, legal and natural, providing the bulk of profits and salaries tax revenue will remain a concern and a risk, given the challenges faced by Hong Kong, including increasing competition from other markets, an ageing population, increasing healthcare costs, the need to improve the environment and to adopt policies that have regard to longer-term sustainability, not just short to medium-term economic growth.

In our view, one effect of the potential volatility of the revenue base is that, although the government may be willing to invest large sums on capital expenditure, including infrastructure projects and other one-off items (e.g., the HK$50billion that may be used to subsidise insurance premiums under the government's proposed voluntary insurance scheme for health care financing), there is, understandably, much greater reluctance to commit additional recurrent expenditure in key areas of public services. In practice, budget surpluses are being generated fairly consistently and these could be used to improve public services on an ongoing basis. However, until the tax base is regarded as sufficiently broad, and the main sources of revenue as less volatile, this situation is unlikely to change.

Whilst the Institute concluded, in response to the 2007 consultation on broadening the tax base, that no single option would be better than a goods and services tax in meeting the key objectives of broadening the base, causing minimal economic distortions, achieving a substantial yield at low rates of tax, etc., our submission also suggested that other options could be further explored. These included payroll and social security taxes; a single stage retail sales tax; a surcharge on utility supplies and green taxes. Further details of the possible options for broadening the tax base are contained in the Institute's March 2007 submission to the government[11].

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[10] The 2011-12 budget, The Financial Secretary invites your views, pg. 27.
[11] *Broadening Hong Kong's Tax Base*, Hong Kong Institute of CPAs, March 2007 (http://app1.hkicpa.org.hk/oldsite/professionaltechnical/taxation/submissions/GST_Final_FSTB.pdf).

Appendix 1

Proposed changes for salaries tax allowances and deductions

Allowance/ deduction	Existing (HK)	Proposed (HK)
Dependent parent/ grandparent allowance		
- Parent/ grandparent aged 60 or above <u>or</u> is eligible to claim an allowance under the government's disability allowance scheme	$30,000	$36,000
- Parent/ grandparent aged 55 or above but below 60	$15,000	$18,000
Additional dependent parent/ grandparent allowance		
- Parent/ grandparent aged 60 or above <u>or</u> is eligible to claim an allowance under the government's disability allowance scheme	$30,000	$36,000
- Parent/ grandparent aged 55 or above but below 60	$15,000	$18,000
Dependent brother/ sister allowance	$30,000	$36,000
Disabled dependent allowance	$60,000	$72,000
Child allowance (initial in the year of birth)	$50,000	$60,000
Child allowance (annual)	$50,000	$60,000
Elderly residential care expenses	$60,000	$72,000
Private medical health insurance	-	$12,000
Voluntary MPF contribution	-	$48,000

Appendix 2

Example of impact of proposed changes in salaries tax allowances and deductions

Example: Married person with two children and two parents above 60 years residing with the taxpayer (spouse separately assessed)

This example illustrates the impact of an increase in child and parent allowance by 20%, a deduction for private medical insurance premiums (subject to a HK$12,000 annual cap) and a deduction for voluntary MPF contributions (subject to a HK$48,000 annual cap).

	Existing (HK$) 2010-11				Proposed (HK$) 2011-12				Dollar savings (HK$)	Per-centage savings
Income				$500,000				$500,000		
Allowance:										
Basic allowance			$108,000				$108,000			
Child allowance	$50,000 per child	2 children	$100,000		$60,000 per child	2 children	$120,000			
Parent allowance above 60 years	$60,000 per parent	2 parents	$120,000		$72,000 per parent	2 parents	$144,000			
Private medical insurance			-		$12,000	1 individual taxpayer	$12,000			
Voluntary MPF contribution			-		$48,000	1 individual taxpayer	$48,000			
Total allowance				$328,000				$432,000		
Net chargeable income				$172,000				$68,000	$104,000	
Tax payable				$17,240				$2,760	$14,480	84%

Appendix 3

A) Main requirements for Singapore domiciled fund exemption

Criteria for exemption include the following

- Singapore incorporated and resident company, managed by Singapore fund manager and using a Singapore-based fund administrator.
- The fund must have at least one foreign investor.
- It must incur at least S$200,000 expenses in each financial year.
- Prior approval from the Monetary Authority of Singapore (MAS) is required and income a tax return and an annual declaration need to be lodged annually.
- Anti-tax avoidance measures apply in respect of transfer of assets.

Scope of exemption

Fund

- “Specified income” from “designated investments”, which excludes shares of private companies that are mainly in the business of trading or holding of Singapore immovable properties (other than the business of property development).

Investors

- Non-qualifying investors, which broadly covers Singapore corporate entities that beneficially own, alone or with their associates, more than 30% (or 50% if the fund has 10 or more investors) of the total value of the issued securities of the qualifying fund, do not enjoy tax exemption on their share of the fund’s income and gains.
- "30/50 rule" is applied to non-individual investors with a presence in Singapore to prevent "round-tripping" of the exemption

B) Singapore enhanced-tier fund tax incentive

Criteria for exemption

- Fund can be a company, limited partnership or trust (with certain exclusions) with a minimum fund size of S$50 million upon application, which if it is a company incorporated in Singapore, uses Singapore-based and resident fund administrator.
- It must be managed or advised directly by a qualifying fund management company, which employs at least three investment professionals, and incur at least S$200,000 expenses in each financial year.
- Prior approval from the MAS is required and an income tax return and an annual declaration need to be lodged annually.

Scope of exemption

Fund

- As for Singapore domiciled fund incentive.

Investors

- No "30/50" rule.