Budget proposals

2012 - 13

Supporting three pillars of Hong Kong's success: the economy, the community and the competitiveness of the tax system

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

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Table of contents

Supporting Three Pillars of Hong Kong's Success - The Economy, the Community and the Competitiveness of the Tax System

Key measures proposed

The Institute's 2012-13 budget proposals, developed by the taxation committee, place emphasis on tax measures and the revenue side of the budget. Under the heading "Supporting Three Pillars of Hong Kong's Success - The Economy, the Community and the Competitiveness of the Tax System", our recommendations cover three broad, but very important, areas.

Our focus continues 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 the community with the financial burden of setting up homes and raising families.

Below are the main measures proposed by the Institute in the areas of the economy, community, and the competitiveness of the tax system.

A. The first pillar – A business-friendly tax system

1. Support for small and medium enterprises

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

2. Asset management and financial services centre

   (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.

3. Innovation and technology sector

   (i) Allow deduction of costs relating to research and development (R&D) activities outsourced to external parties and IP provided to third parties to produce goods outside Hong Kong.

   (ii) Grant “super deductions” of 150% for expenditure on R&D conducted in Hong Kong.

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

4. Regional operations for trading, headquarters and treasury

   (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.

(iii) Allow "approved" treasury companies to qualify for deductions of interest paid to associates

B. <u>The second pillar – A harmonious community</u>

1. <u>Salaries tax allowances</u>

    (i) Increase the annual allowances for dependent siblings and disabled dependants by 20%.

    (ii) Increase the basic and married personal allowances by 10%.

2. <u>Housing market</u>

    (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, on properties costing up to HK$6million for use as their principal residence. Consider limiting this to Hong Kong permanent residents.

3. <u>Rates</u>

    (i) Waive rates for 2012-13 with a ceiling of HK$1,500 per quarter for each rateable tenement.

4. <u>Electricity subsidy</u>

    (i) Grant an electricity charge subsidy for 2012-13 of HK$2,400 to each residential electricity account.

5. <u>Ageing population</u>

    (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 a deduction for private healthcare insurance premiums, subject to an annual cap of HK$12,000 per taxpayer.

(iii) For those not covered by healthcare insurance, permit a deduction up HK$12,000 per person annually for essential in-hospital treatment.

6. 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.

C. The third pillar – The competitiveness of Hong Kong's tax system

1. Tax research and policy unit: Inland Revenue Ordinance review/ comparative studies

(i) Consider setting up a tax research and policy unit within the Administration to:

(a) assess the merits of conducting a review of the Inland Revenue Ordinance;

(b) conduct comparability studies with the tax regimes and developments in Hong Kong's competitors.

Supporting Three Pillars of Hong Kong's Success - The Economy, the Community and the Competitiveness of the Tax System

Introduction

1. Hong Kong's real GDP growth has been solid in 2011, albeit slowing to 4.3% in the third quarter (from 5.3% in the second quarter and 7.5% in the first quarter). However, on a quarter-by-quarter basis, Hong Kong narrowly avoided a technical recession of two consecutive quarters of negative growth. The threat of increasing inflation seems to be subsiding as consumer prices, measured by the composite consumer price index increased by 5.8% in October compared with that of one year earlier, the same increase as in September 2011.

2. Due to a deteriorating external environment, including the continuing saga of the Euro-zone debt crisis, a sluggish economy in the United States and slowing growth in Mainland China, HSBC cut its forecast of Hong Kong's growth rate from 6.5% to 5.4%. Hang Seng Bank is projecting overall GDP growth of 4% in 2012, which is in line with the medium range forecast for 2012-15 in the 2011-12 budget speech. While the unemployment rate declined from 4.2% in the third quarter of 2010 to a low 3.2% in the third quarter of 2011, it has begun to rise again and stood at 3.4% in the period from September to November, which may be indicative of the general malaise and uncertainty in the global economy.

3. During 2011, the Hong Kong stock market remained one of the most active markets for fund raising in the world. However, particularly over the second half of the year, like other world markets, it was highly volatile. Trading volumes dropped due to uncertainties and some initial public offerings were deferred. Overall, in 2011, the Hang Seng Index dropped significantly. However, given the level of stock market and property market activity in the early part of the year and a number of successful land sales, government revenue from stamp duty and land premiums has held up. This, alongside reasonable GDP growth, means that, instead of a deficit of HK$8.5 billion, as forecasted by the financial secretary, the outturn for 2011-12 is likely to be another quite substantial surplus, in the range of HK$45 - $50 billion. By 31 March 2012, fiscal reserves are likely to be over HK$640 billion, equivalent to around 20 months of government expenditure - a very robust fiscal position.

4. The issues of housing, the ageing population and income inequality remain the main concerns of the community. Inflation which peaked at 7.9% in July was also causing disquiet as rapid inflation can lower standards of living, particularly for those on fixed incomes. Given that Hong Kong's monetary policy is inextricably linked to the low-interest-rate environment of the US dollar, as long as the peg is maintained, the worry is always that there are very few weapons in the armoury to tackle high levels of imported inflation in Hong Kong. However, the immediate threat seems to have subsided for the time being. With the general uncertainties in the global economy and the government's introduction of special stamp duty on certain, primarily short-term, property transactions, property prices in Hong Kong appear to have plateaued and even started to decease.

5. While Hong Kong’s relatively simple, low-rate tax system remains an advantage, from a tax perspective our competitiveness continues to be 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.

6. 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.

7. It is in Hong Kong's interests, therefore, to encourage and support pillar industries and also increase investment from new, value-added businesses, so as to expand the number and range of businesses that contribute to profits tax revenue. Doubts have been expressed within the community about Hong Kong's long-term role and direction, and whether the areas of business that have been our economic strengths in the past can remain competitive. These include logistics, support services for manufacturing, as well as financial and professional services. While the identification by the government of the six new industries in which Hong Kong has the capacity to excel is a positive initiative, more should 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.

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

9. The Institute's 2012-13 budget proposals have been developed by its taxation committee and the emphasis is on tax measures and the revenue side of the equation. Under the heading "Supporting Three Pillars of Hong Kong's Success - The Economy, the Community and the Strength of the Tax System", they cover three broad, but very important areas and a mix of more immediate, medium- and-longer-term measures. While, clearly, Hong Kong cannot hope to resolve the major challenges it faces purely through the tax system, a favourable system, in terms of both policies and administration, can make a useful contribution.

Details of measures proposed

A. <u>The first pillar - A business-friendly tax system</u>

The chief executive, in his recent policy address, indicated that new development opportunities should be explored to maintain Hong Kong's competitiveness[1]. He also stated that Hong Kong should continue to follow the fundamental principle of maintaining a low and simple tax regime and a market-led economy, recognising the importance of taxes to enterprises[2].

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[1] 2011-12 policy address, para.147.
[2] 2011-12 policy address, para.193.

On a broader view, as Hong Kong looks to integrate international standards of regulation and governance, such as introducing competition law and extending anti-money laundering measures, it should consider measures via its tax system to ensure Hong Kong remains a prime business hub. A business-friendly tax system can help to counter the effect of higher costs that can be expected to arise from increased regulation.

Hong Kong's low-rate, simple tax system has been repeatedly affirmed as one of the important factors for its economic success. However, today's success factors may not be sufficient to guarantee success tomorrow in an ever-changing environment. Although Hong Kong still ranks highly in global business and economic surveys, other places in the region are catching up and, some areas, overtaking Hong Kong. Singapore, for example, is seen by foreign investors as a favourable place to live and work and it is making concerted efforts to attract certain types of business, including financial services and fund management, which has traditionally been one of Hong Kong's strengths. Tourism is another area in which Singapore has been expanding its offering substantially. As growth propels Asia, capacity may warrant more than one major business hub in the region. Nevertheless, there are pitfalls in adopting a wait-and-see approach while competitors act decisively and purposefully. It is also important to be mindful of the fact that changes in fiscal policy take time and the effect cannot be felt overnight. Hong Kong, therefore, needs to keep a close watch on developments in the region and globally and consider timely measures via the tax system in response to market trends.

In the policy address, the chief executive outlined various different initiatives across the different sectors to help chart a course towards strengthening the economy. To complement these initiatives, the Institute proposes tax measures that aim to support policies to develop some of these economic sectors. The following proposals look at measures for small and medium enterprises (SMEs), asset management, research and development, regional operations, and sustainable economic growth.

1. <u>Support for SMEs</u>

In his policy address, the chief executive identified the challenges faced by SMEs[3], which constitute an important segment of the Hong Kong business sector, comprising 98% of our business establishments and employing about 50% of our workforce in the private sector[4]. Many SMEs face cost pressures in both the Mainland and Hong Kong. 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:

(i) For companies whose gross profit does not exceed HK$2million, the corporate profits tax rate should be reduced from 16.5% to 15%. This proposed measure would enable smaller businesses that choose 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.

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[3] 2011-12 policy address, para.171.
[4] http://www.tid.gov.hk/english/smes_industry/smes/smes_content.html

2. <u>Asset management and financial services centre</u>

The 2011-12 policy agenda[5] initiatives included stepping up the promotion of Hong Kong's asset management industry with a view to enhancing Hong Kong's position as a major asset management centre.

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 their financial services industry. These include measures to expand concessions for existing financial services industries and to facilitate and attract new types of businesses within this sector. Specifically, we propose the measures outlined below.

(i) To encourage offshore investors to invest in Hong Kong, the rules on exemption of offshore funds should be further extended to ensure that income generated from the normal operations of offshore funds is covered. These funds include private equity funds, which are becoming an increasingly prominent and influential player in the market. Our proposals include the following:

   (a) Allow offshore funds to use Hong Kong-based trustees;

   (b) Relax the restriction on offshore funds investing in offshore private companies, except those holding Hong Kong property, so that transactions in offshore private companies (other than those holding Hong Kong property) will be treated as "specified transactions" under the Inland Revenue Ordinance, Cap.112 (IRO);

   (c) Extend the definition of “specified transactions” to include income from certain fixed income financial instruments as qualified transactions; and

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

(ii) Furthermore, longer-term initiatives for the financial services sector, as one of Hong Kong's pillar industries, should also be considered, including:

   (a) Granting an exemption for Hong Kong resident funds, similar to that currently enjoyed by 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 1; and

   (b) Reviewing the existing charging section of the IRO (i.e. section 23) 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) Measures relating to stamp duty should also be considered, such as, providing an exemption from stamp duty for intermediaries conducting equity transactions on behalf of clients (as in the United Kingdom, for example).

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[5] 2011-12 policy agenda, p.25.

3. Innovation and technology sector

The innovation and technology sector is still very small in Hong Kong. Its value added was less than 1% of GDP in 2009[6]. Hong Kong, with its strong legal framework for protection of intellectual property (IP) and research talent, has the basis to develop this industry. However, 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 IP.

The Institute proposes that the following measures should be considered:

(i) When expanding concessions, it is important to ensure that they are consistent with the way in which business is commonly conducted. For example, it is common for businesses to develop IP in house; engage with other associated companies in cost-sharing arrangements for IP; provide/ license IP to third parties, such as contractors to produce goods outside Hong Kong, and outsource R&D activities to external parties, which are quite likely to be outside of the limited[7] list of approved research institutes. Yet, the current interpretation of section 16B of the IRO and the new section 16EC(4)(b), introduced into the IRO by the Inland Revenue (Amendment) (No.2) Ordinance 2011, create a regime that is overly restrictive. Section 16B limits deductions to R&D payments made to approved research institutes or to R&D conducted in-house by the taxpayer. Meanwhile section 16EC(4)(b) denies taxpayers a deduction where a person hold rights as a licensee under licence of the IP rights, and the IP rights are used wholly or principally outside of Hong Kong by a person other than the taxpayer. As a result of these limitations, any increase in R&D and IP-related activities by Hong Kong-based businesses is likely to be limited.

A distinction should be made between the entities that assume the risks and benefits of an R&D investment and the entities that are simply paid to provide R&D work or services. The R&D investor is the entity that makes the investment, directs the project, undertakes the risk on the investment and, ultimately, owns the resulting IP, whereas the R&D service provider does not undertake any risk, acts according to the direction of the R&D investor and may perform only a certain element of the R&D project. The latter may be off shore because the particular skills needed and issues of cost may favour those activities being undertaken in that off shore location. However, the investing taxpayers should not be penalised or disadvantaged for making that commercial decision and it is not in the interests of the development of Hong Kong's economy that they should be. This dynamic is recognised by, and accommodated in, the tax systems of a number of other jurisdictions.

(ii) To promote R&D, the Institute recommends that "super deductions" of 150% of the actual cost incurred be allowed for expenditure, where the R&D is conducted in Hong Kong. Such bonus deductions are offered to encourage R&D activities in Australia, Singapore, the Mainland and the UK, among other places.

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[6] http://www.censtatd.gov.hk, Hong Kong statistics, The six key industries in the Hong Kong economy, Value added of the six industries as percentage to GDP.
[7] A list of Approved Institutes under Section 16B and 16C of the Inland Revenue Ordinance is available at http://www.ird.gov.hk/eng/tax/bus_16bc.htm

Where R&D is conducted offshore, a 100% deduction should be allowed with a more liberal regime than now exists, subject to a suitable definition of what constitutes R&D.

(iii) 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.

(iv) In respect of withholding taxes paid on royalties, a wider network of double taxation agreements (DTAs), 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.

While suitable anti-avoidance provisions may also need to be considered along with some of the changes proposed above, these should not be such as to diminish the practical value of the benefits to which they relate.

4. Regional operations for trading, headquarters and treasury

While Hong Kong has proved attractive as a hub for regional operations, 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, additional tax incentives can help to shift the balance back in Hong Kong's favour, so that, the overall cost for multinational corporations (MNCs) to establish their regional operations in Hong Kong remain competitive. Against this background, the Institute proposes the following:

(i) Hong Kong's geographical location is an advantage for multinational groups with supply chains in Asia, in particular for those manufacturing in the Mainland. It is typical for such MNCs to set up a principal office which acts as a procurement intermediary between suppliers and distributors/ customers. In Hong Kong, these companies would normally take the form of processing trade arrangements, either as contract or import processing. The prevalence of import, rather than contract processing due to the requirements of the Mainland authorities, means fewer and fewer Hong Kong companies can now obtain the benefit of the 50:50 profits tax apportionment and, hence also, obtain a deduction of half of the depreciation allowances on plant and machinery. For Hong Kong import processors, which are taxed on all of their profits and receive no depreciation allowances for plant and machinery, this form of business is increasingly non-viable.

The Institute proposes that consideration be given to provide incentives to encourage the establishment of principal offices in Hong Kong by MNCs. The Institute believes that, as a matter of policy, import processing should enjoy the same treatment as contract processing in order to provide a continuing level of support for Hong Kong manufacturers. For example, Singapore offers a global trader programme that allows a 10% concessionary tax rate on companies' qualifying trade income and, under this programme, over 260 companies base their offshore trading activities in Singapore.

These include the Hong Kong company Li & Fung, one of the world's leading trading and distribution firms, and the Noble Group, one of Asia's largest commodity groups.[8]

(ii) Hong Kong is equipped with a pool of skilled manpower that is attractive for international businesses to set up regional offices/ headquarters. 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.

(iii) The interest rate deduction rules should be reviewed to encourage international companies to use Hong Kong as their "cash pooling hub". Hong Kong's well established financial system is 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.

(iv) Specifically for group treasury operations, if their interest income is taxable they should be able to deduct interest that they pay on monies received from overseas associated companies. While, in principle, they may be able to claim a deduction under section 16(2)(c) of the IRO, this may not always be clear cut, in the context of case law and Inland Revenue Department (IRD) practice. We propose that "approved" treasury companies should qualify directly for deductions of interest paid to associates, without having to rely on section 16(2)(c).

5. <u>Sustainable development</u>

While the policy address identified the need to promote development of environmental industries[9] and to protect the environment for a quality city life[10], the government should consider concurrent incentives for businesses, in general, to be environmentally friendly. 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, which the business community is beginning to take on board. The Institute welcomes this development and proposes consideration of the following measure to support improving Hong Kong's environment:

(i) Building design: To promote green buildings in Hong Kong, accelerated industrial building and commercial building allowances should be granted for new commercial and industrial complexes adopting overall, approved, environmentally-sustainable designs (in

[8] http://www.guidemesingapore.com/industry-guides/trade/singapore-global-trader-scheme
[9] 2011-12 policy address, para.155.
[10] 2011-12 policy address, para.123-127.

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%

B. The second pillar - A harmonious community

Alongside economic development, it is equally important to promote harmony in the community by addressing the needs and supporting the aspirations of the people. In the policy address, the chief executive identified, among other areas, housing policy, the ageing population, education development and supporting the underprivileged, as issues that needed attention. The rate of inflation has also been a matter of concern this year, although, as noted above, the level of inflation seems to have peaked. Against this background, the Institute recommends the following tax measures, which would complement the government's initiatives in some of the relevant areas and help to prevent the standard of living of middle-income earners from dropping:

1. Salaries tax allowances

Last year, the Institute called for a 20% increase in personal allowances for children and other dependants. Some of these allowances had not been increased for more than ten years. We also called for a 20% increase in the deduction for elderly residential care expenses. We were pleased to note that the financial secretary took up a number of these suggestions in the 2011-12 budget.

(i) However, the allowances for dependant siblings and disabled dependants were not revised. We suggest, therefore, that these allowances be increased by 20% in the forthcoming budget.

(ii) We also propose that the basic individual and married person's personal allowances, which have remained the same since 2008-09, be increased by 10%. The allowances proposed in (i) and (ii) are reflected in Appendix 2. Appendix 3 illustrates the impact of our proposed changes on salaries tax for a typical family.

2. Housing

Housing continues to be a pressing issue for the community, including for first-time buyers in the private housing market, who cannot get on the first rung of the ladder. To assist the community meet its housing needs, which is a fundamental livelihood issue, the following measures could be put in place in relation to home ownership and accommodation.

(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 property price inflation at any given time.

(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. Therefore, the deduction should be allowed to be used in relation to either home loan interest or rental payments (or a mix of these two, if the taxpayer moves from renting to purchasing a property, or vice versa), in respect of a taxpayer's primary residence, subject to the same overall duration and monetary limits.

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

(iii) Exempt first-time home buyers from stamp duty 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.

(iv) While the issue of removing the Special Stamp Duty measures has been raised in the media, we would not favour such a move, at this time. The measures have been in place only for around one year and their removal would send a signal to the market that the door is being re-opened to speculative activity in the property market. Purchasing property in the private residential market is still beyond the means of many in Hong Kong and any action that could lead to property price inflation again would not be welcomed by most people.

3. Rates

(i) In view of the concerns about the impact of the global economy on Hong Kong in the coming year and what that may mean for the community, we propose that rates continue to be waived for 2012-13, subject to a ceiling of HK$1,500 per quarter for each rateable tenement.

4. Electricity subsidy

(i) For further immediate support to the community, we suggest that an electricity charge subsidy of HK$2,400 be granted to each residential electricity account for 2012-13.

5. Ageing population

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 addition, support should be extended to families to assist them in providing better care for elderly relatives. 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, in its second consultation on healthcare reform, indicated that public expenditure on healthcare was 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 premiums, subject to an annual cap of HK$12,000 per taxpayer. This should help encourage a more efficient utilisation of both public and private healthcare services.

(iii) In addition, taxpayers and their dependants, who are not covered by healthcare insurance, should be permitted to claim a deduction of up to HK$12,000 per person, annually, for essential in-hospital treatment (i.e. excluding purely cosmetic surgery), against actual receipts. The deductions proposed in (i), (ii) and (iii) above are reflected in Appendix 2. Appendix 3 illustrates the impact of our proposed changes on salaries tax for a typical family.

(iv) The 2011-12 policy address considered measures to improve the mode of elderly care[11]. As regards the annual allowances for dependent parents and grandparents, as well as other dependants, we suggest that a review be conducted to establish an appropriate base year for adjusting such allowances on a continuing basis in line with inflation.

6. 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 welcomes the initiative in the policy address to commence upgrade barrier-free features in selected government premises and facilities[12]. At the same time, the Institute considers that more should be done, by providing the following tax incentives:

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[11] 2011-12 policy address, para.62-74.
[12] 2011-12 policy address, para.98.

(i) To encourage employers to recruit and integrate such employees into the workforce, we propose "super deductions" of 150% for the 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 some cases, may 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.

C. The third pillar - The competitiveness of Hong Kong's tax system

The IRO and the associated tax regime were last subject to an extensive review in the 1970s. In view of changes that have taken place since then, and which are continuing to occur, in both the external and domestic environments, there is a case for conducting another review and updating exercise and a need to ensure that Hong Kong's tax law and administration remains efficient, effective and up to date on an ongoing basis.

1. Tax research and policy unit: IRO review/ comparative studies

(i) We suggest that consideration be given to setting up a tax research and policy unit under the Financial Services and the Treasury Bureau to conduct research and look at the need for changes in tax policy on an ongoing basis. Outside experts could be invited to join the unit on a contract basis, akin to the operation of the Central Policy Unit. The first major task of this unit could be to look at the need for a general review of the IRO, which, at root, is an elderly piece of colonial legislation that has served Hong Kong well over the years, but which may need a general updating and streamlining. Another potentially important task for the unit would be to study the fiscal policies, laws and practice of Hong Kong's competitors, including regional competitors, e.g. Singapore, Shanghai, Taiwan, Korea, and global competitors, e.g., US (New York) and UK (London), to see what lessons can be learned. What are Hong Kong's comparative advantages and disadvantages? What could be done to enhance comparative advantages and eliminate/ minimise any disadvantages in terms of Hong Kong's tax law and administration? The study should assess the long-term competiveness of Hong Kong's tax system and include an international comparison with the corporate tax rates in other jurisdictions. Amongst other things, this should compare effective rates after incentives, because 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.

Hong Kong Institute of CPAs
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Appendix 1

Features of exemptions for Singapore-domiciled funds

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 an income 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 a 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 incurs 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.

<u>Appendix 1</u>

Scope of exemption

<u>Fund</u>

- As for Singapore-domiciled fund incentive.

<u>Investors</u>

- No "30/50" rule.

Appendix 2

Proposed changes for salaries tax allowances and deductions

Allowance/ deduction	Existing (HK)	Proposed (HK)
Basic allowance	$108,000	$118,800
Married person's allowance	$216,000	$237,600
Dependent brother/ sister allowance	$30,000	$36,000
Disabled dependant allowance	$60,000	$72,000
Voluntary MPF contributions	-	$48,000
Private medical health insurance premiums	-	$12,000
Deduction for essential in-hospital treatment (for those not covered by healthcare insurance)	-	$12,000

Appendix 3

Example of impact of proposed changes in salaries tax allowances and deductions on a typical family

Example: Married person with two children (spouse separately assessed), living with their two dependent parents throughout the whole year

This example illustrates the impact of an increase in basic allowance by 10%, 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$) 2011-12				Proposed (HK$) 2012-13				Dollar savings (HK$)	Per-centage savings
Income				$500,000				$500,000		
Allowance:										
Basic allowance			$108,000				$118,800			
Child allowance	$60,000 per child	2 children	$120,000		$60,000 per child	2 children	$120,000			
Dependent parent allowance (parents over 60 years of age)	$72,000 per parent	2 parents	$144,000		$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				$372,000				$442,800		
Net chargeable income				$128,000				$57,200	$70,800	
Tax payable				$9,760				$2,004	$7,756	79%