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PRIVATE AND CONFIDENTIAL
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Financial Secretary
25/F, Central Government Office
2 Tim Mei Avenue
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11 January 2016

Dear Mr. Tsang,

2016-2017 BUDGET PROPOSALS

There was a slowdown in the economic growth of Hong Kong in the third quarter of 2015 due to a decline in export of both goods and services[1]. However, supported by an increase in the domestic demand, it is expected that the real GDP for 2015 will still grow moderately at 2.4%, as compared to the Government's range forecast of 2% to 3% announced in August 2015.

Amid the volatility of the global capital market brought about by the US interest rate rise and the slowly recovering global economy, a closer economic and trade cooperation with China would be a major impetus to the economic growth in Hong Kong in the coming years. In order for Hong Kong to act as a "super connector" between China and the rest of the world under China's "Belt and Road" initiative and to pursue a deeper cooperation with the pilot free trade zones in the Guangdong Province, the Government should perform a comprehensive review of the current tax policies and tax law in Hong Kong with an aim of creating a tax environment that is more conducive to doing business in Hong Kong and more competitive within the region.

With the release of the final reports of the Base Erosion and Profit Shifting ("BEPS") project by the Organisation for Economic Co-operation and Development ("OECD") in October 2015, Hong Kong will also need to consider the appropriate response in terms of what recommendations to adopt and how to prioritise their implementation. The Institute believes that in considering any course of action, the Government should balance between the need of complying with the latest international tax standards and the competitiveness of Hong Kong as a place of doing business.

Domestically, the persistent issues of narrow tax base and volatile government revenue have yet to be resolved. Going forward, the aging population, the demand on an improved retirement protection system in Hong Kong, the 15-year free education in Hong Kong and the future

[1] *Source: The economic situation in the third quarter of 2015 and latest GDP and price forecasts for 2015 released by the Government on 13 November 2015.*

implementation of the voluntary health insurance scheme ("VHIS") will all put increased pressure on the public finance.

In order to attract more foreign investment to Hong Kong amid the fierce competition within the region and deal with the long-term fiscal challenges arising from the aging population and the society's increased demands on other government services, the Institute believes that the Government should formulate tax/revenue policies for Hong Kong that create sustained competitiveness, foster economic growth and reduce fiscal volatility. For examples, a comprehensive review of the Inland Revenue Ordinance ("IRO") should be carried out to bring the Hong Kong tax legislation in line with the modern business environment and international tax practices, tax incentives should be provided to core and strategically important industries/sectors that present opportunities for further economic growth of Hong Kong, options for broadening the existing tax/revenue base in Hong Kong should be explored, and viable healthcare financing reform options should be worked out without further delay.

Some of the tax measures and policies set out below have been advocated by the Institute for a number of years whereas some others are new suggestions made this year. We believe that the proposals included in this submission, which all aim to improve our competitiveness and make our tax system more conducive to businesses, should be considered seriously by the Government.

Our proposals for 2016-2017 cover the following areas:

A Specific tax measures to enhance Hong Kong's competitiveness

B Promoting greater fairness and certainty of our tax system

C Reviewing the tax law to make it more compatible with modern business environment and international tax rules

D Tax incentives for individuals

E Broadening our tax base

A Specific tax measures to enhance Hong Kong's competitiveness

A1 Conducive tax regime for the aircraft leasing industry

In the 2015-16 Budget, the Financial Secretary mentioned that Hong Kong should ride on the experience of other jurisdictions and explore possible measures that can promote aerospace financing business in Hong Kong.

However, the current tax rules in Hong Kong are not conducive to the development of the aircraft leasing/financing business. This is because a Hong Kong aircraft owner cannot claim depreciation allowances on aircrafts leased to a party unless that party is a Hong Kong based aircraft operator but can be taxed on all aircraft lease income derived. This tax depreciation denial, together with lack of any tax incentives (such as a concessionary tax rate), adversely impact the development of aircraft leasing business in Hong Kong.

As the aircraft leasing market in Asia Pacific (in particular China) is now experiencing a fast growth and there is fierce competition from countries such as Singapore and Ireland (which allow aircraft lessors to claim depreciation allowances on the leased aircrafts and impose a tax rate lower than that in Hong Kong on aircraft lease income) for capturing this potentially lucrative opportunity, Hong Kong cannot afford any further delay in revising its tax rules to create a more conducive tax environment for the aircraft leasing industry.

Our proposal

We suggest that top priority be given to address the issues of tax depreciation denial and lack of special tax incentives for the aircraft leasing industry and the work on this area be expedited in order for Hong Kong to seize the business opportunities brought about by the rapidly growing aircraft leasing market in Asia Pacific.

A2 Extending the charging scope for interest income of a group corporate treasury company would render the legislative proposal less attractive to multinational corporations

We note that the Government has recently introduced a bill to the Legislative Council seeking to (i) remove the anomaly that while interest income from on-lending by a group corporate treasury company ("CTC") would normally be taxed in Hong Kong, the corresponding interest expense paid to overseas group companies by the CTC would be disallowed and (ii) tax qualifying profits of a qualifying CTC at a concessionary tax rate of 8.25%.

The Institute will make a separate and detailed submission to the Bills Committee on the current drafting of the bill, which appears to the Institute to be unduly complicated or onerous in terms of certain conditions for the deduction of interest and granting of the concessionary tax rate, namely the "standalone entity" approach and the "safe harbour" rules.

Apart from the above issues, our another concern is that the bill also seeks to widen the tax net for interest income derived from an intra-group financing business of a corporation.

The taxability of interest income derived from a business of intra-group financing by a corporation has been well established by case-law principles. As such, we see no justifiable reasons for the Government to introduce two deeming provisions in the bill so as to purportedly "codify" but in fact extend the charging scope for such interest income derived.

The introduction of the two deeming provisions cannot be justified by the proposed relaxation of the interest deduction rule. This is because if based on the current case-law principles, the interest income of a corporation is not taxable; the corresponding interest expense would be disallowed, regardless of the proposed relaxation of the interest deduction rule.

These two deeming provisions to extend the charging scope for the relevant interest income may also render the bill, which is meant to grant tax incentive and relief, to be negatively perceived by multinational corporations, thus lessening the attractiveness of the bill.

These two deeming provisions may also be said to be discriminatory in the sense that they only apply to an intra-group financing business of a corporation, but not to other on-lending business of a corporation, which is not a financial institution.

Our proposal

Subject to our detailed comments on the bill to be submitted to the Bills Committee, we propose excluding the aforesaid two unnecessary deeming provisions so as to make the bill more appealing and attractive to multinational corporations contemplating to establish a CTC in Hong Kong.

A3 Improving the competitiveness and certainty of taxation of core and strategically important industries in Hong Kong

In recent years, the Inland Revenue Department ("IRD") has adopted an increasingly stringent approach in interpreting and applying the source rules of various types of income. In addition, no apportionment is allowed for certain profits such as trading profits. Inconsistent application of the source rule (e.g. what are regarded as profit-generating activities and what are regarded as auxiliary/incidental activities) also adds further uncertainties to companies carrying on businesses in Hong Kong.

The current approach adopted by the IRD effectively encourages companies to carry out almost all of their substantial business operations outside Hong Kong as in doing so, they may be eligible for an offshore claim in Hong Kong on their profits. This, in our view, is not conducive to keeping Hong Kong's economy growing.

In order to mitigate the adverse impact of uncertain and costly offshore claims on taxpayers and make the Hong Kong tax regime more competitive and certain, we are of the view that similar to the financial services industry where there are tax incentives (e.g. tax exemption for offshore funds and concessionary tax rate for captive insurance business), appropriate tax incentives should also be provided to selected non-financial services industries that are considered as the pillar and strategically important industries in Hong Kong.

Trading industry is one of them as Hong Kong has long been relying on external trade as one of the growth engines for its economy.

Another one is the headquarters economy. In a recent speech of the Secretary for Financial Services and the Treasury at the Legislative Council for introducing the Bill on CTCs in Hong Kong to the Council, the Government indicated that attracting more companies to set up their CTCs in Hong Kong would contribute to the development of headquarters economy in Hong Kong. We strongly agree to that as it is common for multinational corporations to locate their regional headquarters and CTCs in the same location. As such, we consider that tax incentive should be provided to regional headquarters in Hong Kong alongside with the proposed tax incentives for CTCs in Hong Kong so as to encourage more multinational corporations to set up their regional headquarters (as well as their CTCs) in Hong Kong. Attracting more multinational companies to set up their regional headquarters in Hong Kong can also help building up a critical mass of key management and finance professionals in Hong Kong and driving the growth of the related professional service sectors (e.g. banking, legal and accounting services) in Hong Kong.

The innovation and technology industry is another industry that is regarded as being strategically important to Hong Kong. The Innovation and Technology Bureau ("ITB") was recently setup by the Government with an aim to develop Hong Kong into a knowledge-based economy and an innovation hub for technology and its application in the region. The ITB has identified a few technology areas with development potential, such as communication technologies, integrated circuit design, biotechnology and Chinese medicines. In this regard, the Government should also consider providing tax incentives for promoting the development of these industries/sectors.

Vis-à-vis other countries in the region (e.g. Japan, Malaysia and Singapore), Hong Kong appears to be lagging behind in providing incentives to attract foreign investment and promote the development of core / strategically important industries / sectors.

Our proposal

We suggest that the Government provides tax incentives for selected non-financial services industries/sectors that are of strategic importance to Hong Kong, such as trading, headquarters operation and innovation and technology industry so as to make the taxation of such industries/sectors more competitive and certain. Concessionary tax rate on profits derived from such industries/sectors should be considered as one of the possible incentives to be provided.

A4 Legislative change to section 15(1)(ba) and concessionary tax rate for overseas licensing income in order to promote Hong Kong as an intellectual property hub

For certain sub-licensing arrangements, section 15(1)(ba) of the IRO could be an impediment to Hong Kong becoming an intellectual property ("IP") trading hub as envisioned in the Report of the Working Group on Intellectual Property Trading chaired by the Secretary for Commerce and Economic Development.

Section 15(1)(ba) of the IRO provides that a non-resident recipient is liable to withholding tax in Hong Kong in respect of certain royalty payments made by a Hong Kong payer. The withholding tax is applicable even where the right granted by the non-resident for the use of the relevant IP can only be exercised by the Hong Kong payer exclusively outside Hong Kong.

This section was enacted in 2004 to nullify the Court of Final Appeal's decision in the *Emerson* case[2]. The enactment of section 15(l)(ba) in 2004 was perceived by many as a breach of the territorial source rule of Hong Kong. This was because the legislation intended to charge withholding tax on a non-resident recipient in respect of his granting the use of intellectual property rights ("IPRs") exclusively outside Hong Kong.

[2] CIR vs Emerson Radio [2000]

For a manufacturing and trading scenario such as in the *Emerson* case, the royalty payment would generally not be subject to any withholding tax in the place where the IPRs are actually used in the manufacturing process outside Hong Kong, or in the overseas markets where the manufactured goods are sold. This is because it is the Hong Kong taxpayer (as a trader who sub-contracted out the manufacturing work) who would make the royalty payment, not any other entities located in the place of manufacturing or sales outside Hong Kong, thus avoiding double taxation.

However, in the case where the Hong Kong payer is a sub-licensing company, double or even multiple layers of taxation on the royalty income stream in more than one jurisdiction could arise.

For example, a Hong Kong sub-licensing company, which has obtained the use of IPRs exclusively in the PRC from a US licensor, can sub-licence the same to an end-user in the PRC.

In this case, the royalty payment from the PRC end-user to the Hong Kong sub-licensing company will suffer withholding tax in the PRC. Furthermore, based on the IRD's assessing practice of applying the controversial *TVBI case*[3], the net royalty income of the Hong Kong sub-licensing company (i.e. the spread between the royalties it receives from the PRC end-user and the royalties it pays to the US licensor) could potentially also be liable to tax in Hong Kong under section 14 of the IRO.

Where the royalty payment made by the Hong Kong sub-licensing company to the US licensor would be tax deductible in Hong Kong, the US licensor would be liable to a withholding tax in Hong Kong under section 15(1)(ba) in respect of the payment. This is the case despite that the IPRs granted by the US licensor can only be used exclusively outside Hong Kong in the PRC.

Effectively, the royalty stream in respect of the use of the same IPRs in the PRC would suffer double taxation in terms of withholding tax - i.e. in the PRC and Hong Kong (in addition to the Hong Kong sub-licensing company being taxed on the spread).

This effective double taxation in terms of withholding tax on royalties is not conducive to Hong Kong becoming an IP trading hub. Nor do we believe that the resulting double taxation in the circumstances is the legislative intent of section 15(1)(ba).

Our proposal:

A non-resident recipient should be excluded from the charge to withholding tax under section 15(I)(ba) of the IRO in Hong Kong, provided that (i) the Hong Kong payer is a sub-licensing company and overseas withholding tax is paid or payable on the royalties received by the Hong Kong payer; (ii) the relevant IPRs are as a matter of fact used exclusively outside Hong Kong; and (iii) the licensing fees paid to the non-resident are in respect of the same IPRs covered by the sub-licensing income of the Hong Kong payer. The revenue loss to the Government as a result of this proposed specific exemption from withholding tax would be minimal.

[3] CIR vs HK-TVB International Ltd. [1992]

Furthermore, as an added incentive for promoting Hong Kong as an IP trading hub, the royalty income for IPRs used exclusively outside Hong Kong should only be taxed at a concessionary tax rate of say, 50% of the normal profits tax rate in Hong Kong.

A5 Unilateral tax credits allowed for overseas withholding tax suffered on royalty income

We consider that the captioned proposed tax measure would further promote Hong Kong as an IP trading hub as envisioned in the Report of the Working Group on Intellectual Property Trading.

Hong Kong taxpayers who grant the use of IPRs to persons outside Hong Kong will normally suffer overseas withholding tax in respect of the royalty income. This is because such income will likely be regarded as being sourced in the overseas jurisdictions concerned.

However, such royalty income of the Hong Kong taxpayers could potentially also be liable to tax in Hong Kong under section 14 of the IRO following the assessing practice adopted by the IRD in this regard after the controversial *TVBI* case. This has the effect that the royalty income earned by the Hong Kong taxpayers will be taxed twice.

At present, Hong Kong taxpayers can generally only claim a tax deduction in Hong Kong for their overseas withholding taxes paid on royalties under section 16(1) of the IRO. There is no tax credit of the overseas taxes paid against the Hong Kong profits tax payable on the same royalty income unless a relevant tax treaty is in force to govern the situation.

Unlike a full tax credit, a tax deduction for overseas taxes is only a partial tax relief and does not fully eliminate double taxation. Since Hong Kong has not yet established a wide enough network of tax treaties, unilateral tax credit should be allowed to taxpayers under the IRO in respect of their overseas withholding taxes suffered on royalties. This proposal will give more incentives for Hong Kong businesses to exploit fully the overseas markets and for international companies to invest in Hong Kong.

In this regard, we note that Singapore grants unilateral tax relief to certain offshore royalty income in its tax legislation in cases where the income is derived from jurisdictions which have not concluded tax treaties with Singapore.

Our proposal:

Unilateral tax credit should be allowed to taxpayers under the IRO in respect of their overseas withholding taxes suffered on royalties. This proposal will give more incentives for Hong Kong businesses to exploit fully the overseas markets and for international companies to invest in Hong Kong.

A6 Tax relief to be granted for capital expenditures incurred on the acquisition of intangible property rights including franchises, licences and indefeasible rights of use etc.

In line with the recommendations in the Report of the Working Group on Intellectual Property Trading, we propose expanding the scope of tax deduction for capital expenditure incurred for the acquisition of IPRs under section 16EA of the IRO.

Under section 16EA of the IRO which was enacted in 2012, tax deductions would be granted for costs incurred for the purchase of registered trademarks, copyrights and registered designs. We however consider that the types of IPRs covered by section 16EA are not wide enough. In particular, we consider that costs incurred by service industries on the acquisition of franchises, licences or concessions and indefeasible rights of use (commonly incurred by the telecommunication industry) should also be eligible for tax relief.

In a survey conducted by the Institute in late 2013, the respondents indicated their preference for the granting of tax relief incurred for the acquisitions of other types of IPRs not currently covered by the existing legislation in this order of priority: (1) franchises and licenses (48.5%); (2) unregistered trademarks and designs (20.6%); (3) indefeasible rights of use (20.2%); (4) customer lists (8.6%); and (5) others (2.1%).

Apart from section 16EA which only grants tax deductions for three limited categories of IPRs, there are also many other anomalies contained in the legislation.

Firstly, only costs incurred for the purchase of registered trademarks and registered designs qualify for a tax deduction under the legislation. The reason for restricting the tax deduction for trademarks and designs to registered ones is, we understand, to screen out those without genuine commercial value. We however consider that the reasoning is questionable since it is quite feasible to register a valueless trademark or design. Conversely, many valuable trademarks or designs may not be registered for various commercial reasons, e.g. the marks cannot be registered because it is a generic or personal name.

Whether a trademark or design has a genuine commercial value is a matter of fact to be ascertained according to circumstances. Furthermore, the legislation itself has already contained provisions to adjust any inflated consideration paid for an IPR. As such, we do not believe that there is a need to restrict the tax deduction to registered trademarks and registered designs only. Unregistered trademarks or designs should also qualify for tax relief on the same basis as registered ones.

Secondly, section 16EC (4)(b) of the legislation effectively seeks to deny a tax deduction when the use of an IPR is granted royalty-free by a Hong Kong owner to its contract manufacturer outside Hong Kong, specifically for the limited purposes of the latter manufacturing goods ordered by the owner. For example, the Hong Kong owner of a trademark may grant its overseas contract manufacturer to use the trademark by affixing the marks to the goods ordered by the owner. This denial of the tax deduction is unwarranted given that generally the profits derived by the owner from the trading of goods so manufactured by its overseas contract manufacturer with the use of the IPR concerned outside Hong Kong are fully chargeable to tax in Hong Kong.

Our proposal:

To expand the scope of section 16EA so as to grant tax relief for other types of IPRs including those preferred by the respondents in the recent survey conducted by the Institute, and remove the unreasonably restrictive provisions of section 16EC(4)(b) of the IRO as identified above.

A7 Tax incentives for research and development activities

The Government is determined to develop Hong Kong into a knowledge-based economy and an innovation hub for technology and its application in the region. The recent set up of the ITB can clearly demonstrate Hong Kong’s commitment to create an ecosystem for innovation and technology development.

Currently, only 0.7% GDP has been spent on research and development (“R&D”) in Hong Kong, which is far below 2.1% in Singapore and 4% in our neighbour city, Shenzhen. Many studies have highlighted that R&D expenditure is very effective for long term economic growth.

The Institute considers that the injection of R&D expenditure should not only be led by the Government. The Government should consider introducing tax incentives to attract more investment and commitment from the business sector to spend on R&D. For example, the Government should consider granting a super tax deduction (say, deduction at 150%) on costs incurred for R&D, a measure that many countries have long adopted.

Furthermore, as a result of the IRD narrowly interpreting the section, the scope of section 16B(1)(b), under which tax deductions for R&D expenditure are normally claimed, is not as wide as it appears to be. The IRD’s interpretation is that where the R&D activities are sub-contracted out by taxpayers, expenditure incurred on such sub-contracted out R&D activities would not qualify for a tax deduction under section 16B(1)(b). This is the case regardless that such taxpayers would own the proprietary interest of any outcome of such sub-contracted out R&D activities and can, therefore, commercially exploit the same to produce their profits which are chargeable to tax in Hong Kong.

Our proposal:

To allow (i) a 150% super tax deduction for R&D costs incurred by taxpayers in Hong Kong; and (ii) the IRD should interpret section 16B(1)(b) such that sub-contracted out R&D expenditure also qualifies for a tax deduction provided that other general conditions for deductions are also met.

A8 Tax loss relief for business

Under the current provisions of the IRO, a company can generally carry forward the tax losses it suffers in a year of assessment indefinitely to offset against its assessable profits in subsequently years. The tax losses cannot however be carried back to offset against the assessable profits made by the company in the previous years. Nor can the tax losses be transferred to offset against the assessable profits made by other group companies (commonly known as group loss relief).

We consider that to enhance the competitiveness of the Hong Kong tax system, there is a case for introducing a regime for allowing group loss relief and carry-back of tax losses. The case for allowing group loss relief is based on the view that a corporate group is essentially an economic entity and individual corporate entities within such group are more akin to divisions within a single company.

The case for allowing the carry-back of tax losses is one based on fairness and equity. This is so because the inability of a company to carry back the tax losses it suffers in a year of assessment to offset against the assessable profits it made in the previous years could result in the company effectively paying taxes on profits which it has not overall made.

This would happen when a company has paid taxes on assessable profits it made in earlier years and then suffered tax losses in subsequent years before it ceased its business, the company however sustaining overall losses during the whole life time of the business.

Our proposal:

Having regard to the international norm and practice, the Government should consider introduce in Hong Kong (i) group loss relief in the form of transfer of tax losses between group companies and (ii) the carry-back of tax losses for two years. For the purposes of the transfer of tax losses between group companies, we recommend that the companies involved must be 90% or more associated with each other similar to the threshold for association to be eligible for the stamp duty group relief currently available under section 45 of the Stamp Duty Ordinance. We consider this high level of threshold of association would justify such a corporate group being regarded as an economic entity for tax purposes.

A9 Tax incentives for the green industry

To help reduce waste in Hong Kong in the long term and make the waste management/recycling industry in Hong Kong more sustainable, the Government should put in more effort to encourage waste reduction/recycling and support the development of the waste management/recycling industry. While a scheme to levy a charge on municipal solid waste was proposed by the Council for Sustainable Development in December 2014 to help reduce solid waste production, we believe other measures for managing the waste problem in Hong Kong should also be considered by the Government e.g. tax incentives to support the development of the green industry in Hong Kong.

In a survey conducted by the Institute in late 2013, the majority (83%) of the respondents thought promoting the development of the green industry (e.g. waste management industry/ recycling industry) can help ease the waste problem currently facing Hong Kong.

Our proposal:

To support the development of the green industry, we suggest that the Government grants (i) a super tax deduction of 150% to taxpayers who acquire eligible environmental protection facilities or plant or machinery including electric cars and (ii) government subsidies or tax holidays to taxpayers in the green industry (e.g. taxpayers engaged in waste recycling and resource recovery activities.)

A10 Supporting the small and medium sized enterprises

Small and medium sized enterprises ("SMEs") are the backbone of the Hong Kong economy. As the SMEs in Hong Kong play a vital role in contributing to the development of the local economy and thus the livelihood of the Hong Kong people, we believe the Government should lend more support to the SMEs to help easing their financial burden and maintaining their competitiveness.

In a survey conducted by the Institute in late 2013, the majority (70%) of the respondents agreed that Hong Kong should introduce a lower corporate tax rate for SMEs. Moreover, should a lower tax rate for SMEs be introduced, most respondents (36%) considered the rate should be set at 10%.

The Institute therefore suggests that a two-tiered profits tax rate structure be introduced with a reduced rate for SMEs. Furthermore, to assist SMEs dealing with soaring rent and operating costs in Hong Kong, the Government should consider putting aside certain business and industrial sites for leasing to SMEs at reduced rent.

Our proposal:

To introduce a two-tiered profits tax rate structure with a reduced rate of 10% for companies (i) with annual turnover below HK$20 million; (ii) with net assessable profits below HK$2 million; and (iii) that are not part of a group. To consider putting aside certain business and industrial sites for leasing to SMEs at reduced rent.

A11 Nurturing career development and entrepreneurship of the youth

The issues of training for the youth and youth unemployment were addressed in the 2014-15 Budget. The Institute agrees that the youth are the key to our future and their belief and vision have significant impact on the economic and social development of Hong Kong in the long run.

Notwithstanding certain programs/initiatives on vocational education, career navigation and life planning have been introduced to support the career development of the youth and enhance their real-world opportunities, we believe that the Government should also consider providing tax incentives to encourage the employment of the youth and to nurture entrepreneurship among the young talents.

As over 98% of the business organisations in Hong Kong are SMEs with limited resources and many young people have to start their career with these SMEs, tax incentives can be offered for encouraging SMEs to provide more job opportunities at entry level to the youth when certain specified conditions are met. Such arrangement not only help improve the upward mobility of the youth by facilitating them to enter into the job market, develop and grow themselves through experience in working but will also help SMEs to fulfil their corporate social responsibility and improve their corporate image.

To cultivate young talents in the information technology and other innovative industries to become entrepreneurs, tax incentives can also be offered for new businesses started by young entrepreneurs.

Our proposal:

We suggest that the Government grants a 150% tax deduction for a maximum of 12 months to organizations on the monthly remunerations paid to youth newly hired by them where the following conditions are met: (i) the youth are with the age between 18 to 25 (inclusive) and (ii) the monthly remuneration of each qualified newly hired employee does not exceed $12,000 for the first year of employment.

We further suggest that the Government grants a tax holiday of 50% exemption of the profits generated in the first one or two profit-making years of new businesses started by young entrepreneurs who have been identified as gifted young people by various education and training programs launched or sponsored by the Government.

B Promoting greater fairness and certainty of our tax system

To promote greater fairness and certainty of our tax system is a recurrent proposal of our annual budget submission as these features are important for Hong Kong to continue functioning as a leading business and financial centre.

B1 Granting tax relief for plant and machinery (in particular moulds) of Hong Kong taxpayers used outside Hong Kong, otherwise Hong Kong risks losing out to Singapore

In recent years, the IRD has been denying tax depreciation allowances on plant or machinery, including moulds provided by Hong Kong taxpayers to their sub-contractors in mainland China under import processing arrangements by invoking section 39E of the IRO.

An import processing arrangement generally takes the form of a Hong Kong taxpayer buying goods manufactured by its sub-contractor. The goods are manufactured by the sub-contractor under specific orders placed by the Hong Kong taxpayer for specified goods. Typically, profits derived by the Hong Kong taxpayer from its trading of the goods so manufactured are fully chargeable to tax in Hong Kong.

Under such an arrangement, the provision of plant or machinery in particular moulds by the Hong Kong taxpayer to its sub-contractor is often necessary so that the sub-contractor can manufacture the goods to the specifications ordered by the Hong Kong taxpayer. For various reasons, the Hong Kong taxpayer has to own the plant or machinery. These reasons include its sub-contractor not willing to make investments in plant or machinery which the sub-contractor cannot use for purposes other than manufacturing the specified goods ordered by the Hong Kong taxpayer; and the necessity of the Hong Kong taxpayer owning the relevant plant or machinery so that they can consign the same to different sub-contractors at different times.

These arrangements would not involve any tax avoidance, "leveraged leasing", or "sale and leaseback" of the plant or machinery concerned, but may still be unintentionally caught by section 39E as involving "leasing arrangements". As a result of such unintentional application of section 39E, taxpayers' claims for tax depreciation allowances in respect of the plant or machinery in Hong Kong would be denied.

The Treasury Branch has however rejected the persistent calls made over the past few years by tax practitioners, professional bodies and chambers of commerce to amend section 39E in order to remove the aforesaid unintended consequences of section 39E. The main reason given by the Treasury Branch for the rejection was that granting tax depreciation allowances to taxpayers in the circumstances would breach the "territorial source" and "tax symmetry" principles of taxation.

In this regard, we would like to draw the attention of the Treasury Branch to a tax case recently decided in Singapore (the *ATG* case). The facts in the Singapore case were essentially the same as those under our import processing arrangements under discussion. Similarly, the initial arguments of the Singapore tax authorities for denying the tax depreciation allowances were essentially the same as those advanced by the Treasury Branch, i.e., against the "territorial source" and "tax symmetry" principles.

However, the tax tribunal of Singapore held that there was sufficient nexus or connection between the taxpayer's provision of the plant or machinery to its subcontractor and the taxpayer's generation of its own chargeable trading profits in Singapore. Accordingly, the Singapore tax tribunal held that tax depreciation allowances should be granted to the taxpayer, reasoning that doing so would only be in line with the "territorial source" and "tax symmetry" principles. The Singapore tax authorities have now accepted the decision and abandoned its previous stance of denying tax depreciation allowances in respect of manufacturing plant or machinery provided by Singapore taxpayers to their overseas sub-contractors.

Another ground for the Treasury Branch's rejection of the calls to amend section 39E was apparently based on the reason that rentals must be charged either on an actual or a deemed basis under the arm's-length "transfer pricing" principle by a Hong Kong taxpayer to its subcontractors in mainland China, for the provision of plant or machinery in the circumstances described above.

The Treasury Branch seemed to be of the view that if Hong Kong was not to insist on the charging or imputation of the said rentals, this would undermine the taxing right of the Mainland in respect of the notional rental income said to have been derived by the Hong Kong taxpayer in the Mainland.

We would however note that whether Hong Kong grants tax depreciation allowances to its taxpayers is entirely a matter of how Hong Kong interprets and administers its domestic tax law, and is entirely the prerogative of Hong Kong. Furthermore, as a matter of reality, how Hong Kong interprets and administers its domestic tax law cannot undermine the taxing right of the Mainland in this regard, the Mainland tax authorities being able to do what they consider appropriate in the circumstances. In any case, the Singapore tax authorities, in granting tax depreciation allowances to taxpayers following the above mentioned case in Singapore, do not seem to be concerned with whether Singapore has undermined the taxing right of any overseas jurisdictions.

It is also of note that in addition to the normal tax depreciation allowances, Singapore has also introduced in its 2012 Budget an additional tax break in the form of Integrated Investment Allowances for capital spending overseas for outsourced manufacturing arrangements.

We submit that granting tax relief to Hong Kong taxpayers who have incurred capital expenditure on plant or machinery, in particular on moulds under import processing arrangements is only fair and equitable. Otherwise, given the fact that Singapore now grants tax depreciation allowances, and also the Integrated Investment Allowances, to taxpayers in import-processing-type outsourced manufacturing arrangements and that the amounts of money involved are normally substantial, Hong Kong risks losing out to Singapore as a trading or procurement hub, especially for multinational manufacturing and trading groups.

Our proposal:

The Treasury Branch should revisit the section 39E issue again with the relevant stakeholders with an open mind in the light of the recent tax developments in Singapore in this regard - with a view to finding ways of granting tax relief to taxpayers who have incurred capital expenditure on plant or machinery, in particular on moulds used in mainland China under import processing arrangements in circumstances described above. Otherwise, Hong Kong risks losing out to Singapore as a trading or procurement hub, especially for multinational manufacturing and trading groups.

B2 According a "statement of loss" the same legal status as an "assessment"

The Court's decision in the *Common Empire*[4] case has confirmed that the issuance of a "statement of loss" by the IRD is only an administrative measure to inform a taxpayer the amount of tax losses that he may carry forward for offsetting against his future assessable profits. However, since no tax is payable by the taxpayer for the year covered by a "statement of loss", such a "statement of loss" cannot in law be regarded as an "assessment", even though the process of ascertaining tax losses is very much akin to that of ascertaining assessable profits.

Because a "statement of loss" is not in law an "assessment", the IRD is not bound by the 6-year time-barred period for re-opening an "assessment", and can therefore revise the losses

[4] CIR vs Common Empire Ltd. [2006]

shown in a "statement of loss" at any time. As a result, under the current provisions of the IRO, a "statement of loss" would only become final and conclusive 6 years after the tax losses involved are subsequently fully utilized to offset against the relevant assessable profits of the taxpayer.

As such, a taxpayer who has incurred tax losses would face a much longer period of uncertainty as regards the finality of his tax position and a longer period of record keeping would be required in order to substantiate his tax position when he ultimately derives assessable profits. This state of affair is undesirable and does not promote fairness and certainty of our tax system.

The *Aviation Fuel Supply* case recently decided by the Court of Final Appeal has, however, cast doubt on the above legal status of a "statement of loss" established in the *Common Empire* case. The *Aviation Fuel Supply* case indicates that the IRD may not raise an additional assessment if a taxpayer would need to establish facts and evidence that are more than 6 years ago (such as those covered by a "statement of loss") in order to dispute the said additional assessment. In the light of this recent case law development, it is an appropriate time to review the legal status of a "statement of loss".

Our proposal:

To amend the legislation such that a "statement of loss" will be accorded the same legal status as an "assessment", subject to the same 6-year time-barred period.

B3 Purchase of tax reserve certificate on a "group" basis

In a group tax audit situation, the IRD will very often need to issue protective assessments to various companies within the group in the early stage of the audit since at that stage, the IRD may not be certain as to which group company's tax computation will be subject to adjustments after the tax audit. In order not to create hardship for taxpayers, the IRD will very often only request one of the group companies to purchase a tax reserve certificate ("TRC") and holdover the taxes in dispute of the other group companies involved unconditionally.

However, upon finalization of the tax audit, under the current provisions of the IRO, the TRC purchased can only be used to settle the tax in dispute of the particular group company purchasing the TRC.

If the final outcome of the tax audit is that one of the group companies whose tax has previously been heldover (instead of the group company that has purchased a TRC) is subject to a tax adjustment and therefore needs to pay the tax in dispute, the current practice of the IRD is to repay the principal value of the TRC to the group company that has purchased the TRC with interest at a very minimal rate (i.e. around 0.04%) and request the group company with tax adjustment to pay the tax in dispute together with interest at the judgment debt rate (i.e. 8%).

We consider that the above situation is undesirable as it causes unfairness and uncertainty to taxpayers (i.e. taxpayers may still be subject to an interest exposure although they have purchased a TRC to cover the tax in dispute and there is a big differential between the rate of interest charged by the IRD on taxpayers and the rate of interest received by taxpayers from the IRD).

Our proposal:

To allow purchase of TRC on a "group" basis such that the TRC purchased can be used to settle the outstanding tax payment of any companies within the group without giving rise to any interest payments on the outstanding tax amount or alternatively, to align the rate of interest charged by the IRD on taxpayers for outstanding tax payments and the rate of interest paid by the IRD to taxpayers from purchase of TRC.

C Reviewing the tax law to make it more compatible with modern business environment and international tax rules

Although many overseas jurisdictions have constantly reviewed and updated their tax systems to make them more competitive and keep pace with changing business environment and international tax practices, Hong Kong has not carried out a comprehensive review of the IRO since 1976, with only piece-meal legislations enacted to deal only with the pressing issues of the day. Indeed, issues identified in Sections A and B of this submission generally require the Government to take a comprehensive and overall review of the policy consideration, consistency and tax competitiveness of the IRO.

In a survey conducted by the Institute in late 2013, the majority (76%) of the respondents believed that the current tax law and system of Hong Kong should be modernised in light of the modern business environment and regional best practices.

In addition, the OECD released the final reports on all 15 action points in the BEPS Action Plan in October this year. Some of these reports contain new domestic tax measures / introduce new international tax rules to deal with BEPS issues that the OECD expects individual country/jurisdiction to adopt and implement locally. We are of the view that Hong Kong will need to come up with a strategy to respond to BEPS under which the Government will prioritise the issues to be addressed based on their relevancy to Hong Kong and consider the course of actions that are in the best interests of Hong Kong.

In this regard and as part of Hong Kong's response to BEPS, we believe that it is now good time for the Government to revisit certain features (see examples below) of Hong Kong's domestic tax system and consider if any changes are necessary to make it better align with the international tax rules and provide greater certainty to taxpayers.

(i) Comprehensive review of the existing interest expense deduction rules

The interest expense deduction rules under the current Hong Kong tax legislation are very stringent compared to the other jurisdictions. For example, interest expenses paid by a Hong Kong company to an overseas related company (both of which are non-financial institutions), despite on an arm's length basis, will not be deductible at all for Hong Kong profits tax purpose (except for corporations carrying on an intra-group financing business where draft tax legislation has been proposed to provide for deduction for such interest expenses when certain conditions are met) even though the related income of the Hong Kong company is subject to profits tax and the interest income is subject to overseas tax in the hand of the overseas related company. On the other hand, many foreign jurisdictions (e.g. Australia, Canada, China, Japan and Korea, etc.) have enacted thin capitalisation rules under which deduction of interest expenses on intercompany loans are limited based on a prescribed debt-to-equity ratio rather than totally denied. In the final report of BEPS Action 4 dealing with interest deductibility, the OECD has also recommended certain best practice rules for interest expense deduction. We therefore suggest that a comprehensive review be conducted on the existing interest expense deduction rules to make them more in line with international tax practice.

(ii) A specific and comprehensive transfer pricing ("TP") regime

With the ever increasing cross-border transactions and more double tax treaties signed by Hong Kong, TP has become one of the major concerns of taxpayers and our trading partners. The OECD's work on TP under Actions 8 to 10 and 13 of the BEPS Action Plan has also made TP a priority and focus area for many tax administrations around the world.

Even though some of the existing provisions of the IRO (e.g. sections 20 and 61A) may be used by the IRD to deal with transfer pricing issues, we consider that those statutory provisions do not provide an adequate legal basis for the IRD to deal with transfer pricing issues in all circumstances. For example, there is currently no provision in the IRO that provides a legal basis for the IRD to make an upward transfer pricing adjustment on the profits of a Hong Kong taxpayer if the sole or dominant purpose of the transaction/arrangement involved is not to obtain a tax benefit.

Furthermore, unlike situations for related party cross-border transactions that are governed by a tax treaty, the IRO does not currently provide any mechanism for a corresponding adjustment in the case a primary adjustment is made to the transfer pricing of a domestic-to-domestic transaction between two Hong Kong group companies. This possibly results in double taxation of the adjusted amount and causes undue hardship to taxpayers.

Although the IRD has issued DIPN 46 stating its practices and views on TP related issues, the DIPN is not law and is not legally binding on any parties.

Finally, there is no mandatory TP documentation requirement under the current IRO. With the new three-tiered TP documentation (including the country-by-country reporting) requirement recommended by the OECD under BEPS Action 13 which many countries have adopted or planned to adopt, and the possible increase in cross-border TP disputes and potential TP adjustments initiated by overseas tax administrations in the future, we believe that the Government should consider introducing a TP documentation requirement in Hong Kong. Notwithstanding, we understand that many taxpayers find that compliance with BEPS Action 13, in particular for the preparation of the Master File and Country-by-Country Reporting, to be extremely burdensome. Therefore, in considering the extent to which Hong Kong should adopt the OECD's recommended documentation requirement, the Government should take into account the situation in Hong Kong (in particular, the territorial concept of taxation) and be mindful of not creating an undue compliance burden on taxpayers.

(iii) Taxation of digital economy / e-commerce

Action 1 of the BEPS Action Plan deals with the tax challenges of the digital economy. Although the OECD's final report on BEPS Action 1 has recommended resolving the BEPS issues in relation to digital economy by the indirect taxes option and through modifying the definition of permanent establishment, the TP rules and the controlled foreign corporation ("CFC") rules, etc. and most of these recommended measures appear to be not relevant to Hong Kong (as Hong Kong does not impose any VAT/GST or have any CFC rules, etc.), we are of the view that a review of the current profits tax treatment of digital economy / e-commerce should be performed by taking into consideration the principle that profits from digital / e-commerce businesses should be taxed in the place(s) where the business activities generating the profits are performed and also the need to facilitate companies in setting up an online trading platform in Hong Kong. More updated guidance on determining the source of profits in the context of digital/ e-commerce businesses should also be provided as the current Departmental Interpretation & Practice Note ("DIPN") on the profits tax treatment of electronic commerce (i.e. DIPN 39) was issued by the IRD back in 2001.

Our proposal:

Working with businesses and professional bodies to carry out a comprehensive review of the current tax law of Hong Kong to make it more compatible with modern business environment and international tax rules, including (i) conducting a comprehensive review of the existing interest expense deduction rules to make it more in line with international tax practice, (ii) incorporating specific and comprehensive TP legislation into the IRO and considering introducing a TP documentation requirement in Hong Kong and (iii) reviewing the current profits tax treatment of digital economy / e-commerce and updating the guidance on determining the source of profits in the context of digital/ e-commerce businesses.

D Tax incentives for individuals

The majority of salaried income earners in Hong Kong belong to the middle-income group. Amidst the general inflationary environment of Hong Kong, these people suffered particularly from the high housing costs of Hong Kong in the past year. In order to relieve the burden of these hard working people who contribute much to the revenue of the government, we recommend the following tax incentives for individuals.

D1 Expanding the tax bands for salaries tax assessment

Tax reduction should be offered to these hard working salaried income earners. Nevertheless, we do not recommend reducing the number of taxpayers in the tax base. A narrow tax base will jeopardise the government revenue in bad times of the economy. We therefore recommend reducing the tax burden of the middle-income salary earners by increasing the tax bands in salaries tax assessment.

Our proposal:

To expand each of the tax bands from $40,000 to $50,000 without altering the current level of personal allowance. By doing so, the tax burden of the majority of taxpayers will be relieved without narrowing our tax base.

D2 Increasing the dependent parent / grandparent allowances and removing the requirement of "ordinarily reside" in Hong Kong

The Government has allocated a lot of resources to take care of the aged group by subsidizing residential care services in recent years. However, to preserve our core value of filial piety in society, it would be even better for the aged to be looked after by their children. To promote the development of this core value in society, we recommend the dependent parent/grandparent allowance be slightly increased from $80,000 to $84,000 for taxpayers living together with their parents/grandparents who are aged 60 to 79 (the corresponding allowance be reduced by half in respect of parents/grandparents who are aged 55 to 59). In addition, we further recommend increasing the allowance in respect of parents/grandparents who are aged 80 or above from $40,000 to $50,000 (for taxpayers not living together with parents/grandparents); and from $80,000 to $100,000 (for taxpayers living together with parents/grandparents) in order to show our heartfelt concern and respect to those who have previously contributed a lot to our society.

Another point we would like to mention is the requirement for the eligibility of the dependent parent and grandparent allowances. Currently the dependent parent and grandparent allowances could be granted only if the dependent parent and grandparents are ordinarily residing in Hong Kong. The contributions made by Hong Kong taxpayers to their parents and grandparents residing outside Hong Kong, such as in Guangdong province, should be equally recognised on a fairly basis.

Our proposal:

To increase the dependent parent/grandparent allowances by the amounts as suggested above to taxpayers who take care of their parents/grandparents and to allow the claim of dependent parent/grandparent allowances in respect of dependent parent/grandparents who are not ordinarily residing in Hong Kong.

D3 Allowing an individual to elect for personal assessment on his or her own

At present, a married person must elect for personal assessment jointly with the consent of his/her spouse in order to get tax relief. Given that for tax purposes, an individual is a separate taxing person, we consider that there is a case that tax relief under personal assessment should also be granted on an individual basis. Furthermore, the current joint election of personal assessment also means that personal income information of one spouse will be known to the other. This is against the trend of financial independence and privy of financial information between spouses. We therefore recommend allowing couples to elect for personal assessment separately without the other party's consent.

Our proposal:

To allow married couples to elect for personal assessment separately so as to reflect the fact that an individual is a separate taxing person and in line with the trend of financial independence and privy of financial information between spouses.

D4 Deduction of medical insurance premium

The Government has been working on implementing the voluntary health insurance scheme ("VHIS") in Hong Kong. To encourage more people to join the VHIS or opt for private healthcare services in Hong Kong, we suggest that the insurance premiums paid for VHIS and other private medical insurance schemes should qualify for tax deduction, subject to a cap of say, $30,000 of qualifying premiums paid a year. Deduction of the medical insurance premiums will not cause a significant loss in revenue to the Government because the premium received by the insurance companies will be assessed to profits tax. The proposal will help direct more patients to the private medical sector and hence reduce the cost of the medical services which will otherwise be borne by the Government.

Our proposal:

To allow tax deduction for insurance premiums paid for VHIS and other private medical insurance schemes of up to $30,000 a year.

D5 Tax deduction for voluntary contributions to the MPF scheme

Currently, tax deduction is available to employees only for their mandatory part of contributions to the MPF scheme. Since we are still far from reaching a consensus on the introduction of a comprehensive retirement protection system, in the interim and in order to encourage people to better prepare for their retirement, we propose that the Government allow tax deduction for employees' voluntary contributions to the MPF scheme of up to $50,000 a year, subject to a clawback of the tax deductions previously allowed if there is an early withdrawal of the accrued benefit from the voluntary contributions.

Our proposal:

To allow tax deduction for employees' voluntary contributions to the MPF scheme of up to $50,000 a year.

E Broadening our tax base

A narrow tax base has long been a notable defect of Hong Kong's current tax system. In the consultation document for 2016 Policy Address and 2016-17 Budget published in October 2015, the Government has pointed out that Hong Kong's tax base is narrow and government revenue is sensitive to economic fluctuations depending on broader economic changes beyond its control. The consultation document further stated that the volatility of government revenue poses challenges to the management of public finances.

The problem of fiscal volatility is of particular concern given the aging population of Hong Kong. The consultation document has pointed that according to the Working Group on Long-Term Fiscal Planning, with an aging population and slower economic growth, a structural deficit would be inevitable if government expenditure keeps growing and outpacing economic and revenue growth. The consultation document on retirement protection issued by the Government in December 2015 also raises the issue that with a rapidly aging population, the society has to consider the appropriate means to finance a strengthened but yet sustainable and affordable retirement protection system in Hong Kong, and one of the possible means being to raise taxes or introduce new taxes.

Besides the above, the public funding required for implementing the 15-year free education in Hong Kong and the future implementation of the voluntary health insurance scheme will all mean an increase in government expenditure in the coming years.

In order to uphold the fiscal discipline enshrined in the Basic Law and maintain a healthy and sustainable fiscal system, the Institute believes that the Government should, at the same time of containing the growth of government expenditure and promoting the growth of the economy, continue to study and explore ways of broadening Hong Kong's tax base and reducing our fiscal volatility.

Given the international trend of lowering the direct (income) tax rate and increasing the reliance on indirect taxes as a means of raising stable government revenue, the Institute believes that the Government should explore the option of introducing some new type(s) of indirect taxes or levies in Hong Kong. The study should not be limited to sales tax, turnover tax, GST or similar taxes but should be extended to other more novel and efficient forms of taxes and levies (e.g. social security and healthcare levies) imposed in other parts of the developed economies. By doing so, the Government will have more room and flexibility in allocating the government resources on public expenditure.

Our proposal:

The Government should continue to carry out studies and explore ways to broaden Hong Kong's tax base and reduce our fiscal volatility in order to uphold the fiscal discipline and maintain a healthy and sustainable fiscal system. A broadened tax base with new stable sources of income will assist the Government to tackle the fiscal pressure brought about by the aging population and allow the Government more room and flexibility in allocating the government resources on public expenditure.

Yours sincerely,

For and on behalf of
The Taxation Institute of Hong Kong

Karmen Yeung
President