香港稅務學會
THE TAXATION INSTITUTE OF HONG KONG

CTA
註冊稅務師
Certified Tax Adviser

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PRIVATE AND CONFIDENTIAL
The Honourabl, Mr Paul Chan Mo-po, GBS, MH, JP
Financial Secretary
25/F, Central Government Office
2 Tim Mei Avenue
Tamar, Hong Kong

BY HAND

Dear Mr. Chan,

2017-2018 BUDGET PROPOSALS

The Hong Kong economy picked up slightly in the third quarter of 2016 over a year earlier, thanks to the strengthening of domestic demand and improvement in exports of goods and services. It is expected that the real GDP for 2016 as a whole will grow at 1.5%, the mid-point of the Government's range forecast of 1% to 2% announced in August 2016[1].

Amid the volatility of the global capital market brought about by the US interest rate rise and the uncertainties in the global trade and economic environment stemming from Brexit and new trade policies that may be adopted by the newly elected US President, Hong Kong will need to continue to explore ways to improve its competitiveness as an international business and financial centre.

As many economies within the Asian region transform rapidly from the traditional labour intensive model to one heavily relying on innovation and technology, the Institute believes that more can be done by the Government in enhancing Hong Kong's economic structure e.g. by promoting research and development ("R&D") activities and entrepreneurship in Hong Kong.

As the Organisation for Economic Co-operation and Development ("OECD")'s Base Erosion and Profit Shifting ("BEPS") project enters into the implementation stage, the taxation system in Hong Kong is also undergoing a period of change in order to align with the latest international standard and be BEPS-compliant.

[1] *Source: The economic situation in the third quarter of 2016 and latest GDP and price forecasts for 2016 released by the Government on 11 November 2016.*

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, funding support for public housing and the future implementation of the voluntary health insurance scheme ("VHIS") will all put increased pressure on the public finance.

The Institute believes that all of the above point to the need for the Government to perform a comprehensive review of the current tax policies and tax law in Hong Kong with an aim of modernising the current tax system such that it (1) becomes more competitive within the region and more conducive to doing business in Hong Kong, (2) can help dealing with the long-term fiscal challenges of Hong Kong, and (3) keeps pace of the latest international tax practice. In particular, the Institute believes that a comprehensive review of the Inland Revenue Ordinance ("IRO") should be carried out, tax incentives should be provided to core and strategically important industries/sectors that will enhance Hong Kong's economic structure and present opportunities for further economic growth of Hong Kong, options for broadening the existing tax/revenue base in Hong Kong should be explored as soon as possible, 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 2017-2018 cover the following areas:

A Boosting the development of targeted industries to enhance Hong Kong's economic structure

B Enhancing the tax system by promoting greater fairness and certainty

C Responding to the OECD's BEPS project

D Improving people's livelihood

E Broadening the tax base of Hong Kong

A Boosting the development of targeted industries to enhance Hong Kong's economic structure

As the economies in the Asian region continue to experience structural changes and technologies and innovation have now become one of the key driving forces for economic growth, we are of the view that Hong Kong will need to accelerate the pace of diversifying its industrial segments and encourage more businesses to engage in innovation and technology. The Institute believes that attracting these high value added industries/business activities to Hong Kong will not only give fresh impetus to the economic regeneration of Hong Kong but also help increase the Government's revenue when such businesses generate Hong Kong sourced profits commensurate with their value generating activities performed in Hong Kong. Accordingly, our proposals in this section focus on tax measures for (1) providing incentives for business enterprises to engage in R&D activities, (2) promoting Hong Kong as an intellectual property

("IP") hub and (3) boosting the growth of innovation and technology and other strategically important industries in Hong Kong.

A1 Tax incentives for research and development activities

The Government has indicated that it is determined to develop Hong Kong into a knowledge-based economy and an innovation hub for technology and its application in the region. The set-up of the Innovation and Technology Bureau ("ITB") clearly demonstrates Hong Kong's commitment to create an ecosystem for innovation and technology development.

However, statistics show that only 0.7% of our GDP is currently spent on ("R&D") in Hong Kong, which is far below the 2.7% in Singapore and 4.1% in our neighbour city, Shenzhen. Many studies have highlighted that R&D expenditure is very effective for driving long-term economic growth.

To encourage more Hong Kong business enterprises to spend more on R&D, the Institute considers that the Government should consider introducing tax incentives to attract more investment and commitment on R&D activities by Hong Kong business enterprises. For example, the Government should consider granting a super tax deduction, say, a deduction at 300% and 200%, on expenditure spent on R&D activities by Hong Kong taxpayers inside and outside Hong Kong respectively.

Furthermore, with the Inland Revenue Department ("IRD")'s narrow interpretation of the legislation, 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 notwithstanding 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 a 300% and 200% super tax deduction for R&D costs incurred by Hong Kong taxpayers inside and outside Hong Kong respectively. Furthermore, the IRD should interpret section 16B(1)(b) in a way such that sub-contracted out R&D expenditure also qualifies for a tax deduction provided that other general conditions for deductions are also met.

A2 Tax relief for moulds used outside Hong Kong where the design of the moulds is undertaken by taxpayers in Hong Kong

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 (or other countries) under import processing arrangements, by invoking section 39E of the IRO.

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

Under such an arrangement, the provision of moulds by the Hong Kong taxpayers to their sub-contractors is often necessary so that the sub-contractors can manufacture the goods to the specifications required by the Hong Kong taxpayers.

Typically, the design of the moulds (e.g. moulds of high-tech equipment or electronic components) would be undertaken by the Hong Kong taxpayers who then own the proprietary property rights in the design of the moulds. The actual construction of the moulds would however be normally subcontracted out by the Hong Kong taxpayers to third party sub-contractors, with the Hong Kong taxpayers bearing the capital expenditure on the constructions of the moulds.

We consider that, given the above circumstances, invoking section 39E to deny tax depreciation allowances in respect of the moulds used outside Hong Kong is particularly unfair and would jeopardize Hong Kong's role as a trading hub for goods manufactured in mainland China.

If it is considered not desirable to amend section 39E, we propose that a compensatory tax relief in lieu of the tax depreciation allowances in respect of the moulds could be granted to the Hong Kong taxpayers in the above circumstances with justification.

Such a compensatory tax relief could take the form of a one-off tax write-off of the capital expenditure incurred by the Hong Kong taxpayers on the construction of the moulds, where the Hong Kong taxpayers themselves undertake the design of the moulds in Hong Kong.

The justification for the compensatory tax relief is that it is an additional IP-related tax measure to incentivize taxpayers who undertake the design of the moulds in Hong Kong, in Hong Kong's pursuit as a centre of innovation, design and IP hub.

Our proposal:

To grant a compensatory tax relief in lieu of tax depreciation allowances in respect of capital expenditure incurred on the construction of moulds used outside Hong Kong under import processing arrangements as an additional IP-related tax incentive where the Hong Kong taxpayers concerned undertake the design of the moulds in Hong Kong.

A3 Tax relief for capital expenditure incurred on the acquisition of non-IP intangible property rights including franchises, licences and indefeasible rights of use etc.

We welcome the proposal contained in the last Budget to expand the scope of tax deduction for capital expenditure incurred for the purchase of intellectual property rights ("IPRs") from the existing five categories to eight, the proposed additions being layout-design of integrated circuits, plant varieties and rights in performance.

The proposed expansion is one of the measures recommended by the Working Group on IP Trading in March 2015 to promote Hong Kong as a regional IP trading hub.

While it is commendable for the Government to encourage enterprises to engage in the development of IP-related business in Hong Kong, we consider that capital expenditure incurred on the acquisition of certain other non-IP intangible property rights should also be eligible for tax deduction.

Just like capital expenditure incurred on plant and machinery in the manufacturing sector, capital expenditure on the acquisition of many non-IP intangible property rights, including franchises, licences and indefeasible rights of use (in respect of telecommunication cables), is often incurred by the service, creative and telecommunication industries as part of their costs of doing business in Hong Kong, in our ever increasingly technology-, knowledge- and innovation-based economy.

In this regard, we appreciate it has long been the Government's taxation policy and principle that capital receipts should not be taxed, and therefore deduction of capital expenditure should not be allowed.

We however consider that this policy and principle should not generally apply to assets and rights, the value of which is expected to be realized through a taxpayer's own business use rather than sale.

Moreover, since an exception of the aforesaid policy and principle has already been made for certain IPRs and plant and machinery, the case for according a similar tax treatment for the non-IP intangible property rights would also be justified. This is the case for the sake of fairness to taxpayers and also given the important role played by the service, creative and telecommunication industries in developing a diversified economic structure that Hong Kong aims to achieve.

Our proposal:

To grant tax deductions for capital expenditure incurred on the acquisition of certain non-IP intangible property rights, including franchises, licences and indefeasible rights of use, which is often incurred by our service, creative and telecommunication industries as part of their costs of doing business in Hong Kong.

A4 Tax measures to promote Hong Kong as an international intellectual property hub

As a means of promoting Hong Kong as an international IP hub, we propose that Hong Kong should consider introducing a preferential tax regime for income derived from patents and certain other related IPs that are compliant with the OECD's recommended nexus approach under BEPS Action 5.

For example, under such a regime, qualifying profits generated from the use of the patents and other IPs including royalties and profits from the sale of products, services and processes with the embedded patents and IPs would qualify for a 50% concessionary tax rate, subject to certain conditions as specified in the OECD's nexus approach for IP regimes. Such initiative would be in line with the Government's vision of leveraging on re-industrialization as a potential area of economic growth for Hong Kong, whereby attracting high value-added production to Hong Kong.

Many overseas jurisdictions including Belgium, the Netherlands and the UK already have this kind of preferential tax regime for patents and certain related IPs in order to promote innovation and attract investment in R&D activities

Our proposal:

Hong Kong should consider introducing a preferential tax regime for patents and other related IPs under which qualifying profits generated from the exploitation of the patents and the IPs concerned would enjoy say a 50% concessionary tax rate in Hong Kong.

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

We consider that granting unilateral tax credit in Hong Kong for overseas withholding tax suffered on royalty income would further promote Hong Kong as an international IP hub.

Hong Kong taxpayers who grant the use of IPRs to persons outside Hong Kong will normally suffer overseas withholding taxes in the foreign jurisdictions concerned in respect of the royalty income.

However, such royalty income of 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* [2] case. This has the effect that the royalty income earned by the Hong Kong taxpayers will be double taxed.

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 in Hong Kong 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 fully exploit 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.

This proposal is also in line with the Institute's submission on the Government's BEPS consultation paper, where we suggest that the Government should consider introducing a unilateral tax credit system in Hong Kong.

[2] *CIR v HK-TVB International Ltd. [1992]*

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 locate their IP holding company in Hong Kong.

A6 Conducive tax regime for the aircraft leasing industry

In the 2016-17 Budget, the Financial Secretary mentioned that the use of tax concession will be examined to boost aircraft financing business in Hong Kong and explore business opportunities in aerospace financing.

The current tax rules in Hong Kong are not conducive to the development of the aircraft leasing/financing business due to denial of depreciation allowances on aircrafts leased to non-Hong Kong based aircraft operators even though the related aircraft leasing income may be fully subject to tax in Hong Kong. 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.

A7 Tax incentives for other core and strategically important industries in Hong Kong

Most of the existing tax incentives in Hong Kong are related to the financial services industry. In order to enhance the economic structure of Hong Kong and attract different types of businesses to Hong Kong, we suggest that tax incentives be provided to other core and strategically important industries/business segments as well.

(i) Regional headquarters

One such business segment is the headquarters economy. The Secretary for Financial Services and the Treasury indicated in one of his previous speeches that attracting more companies to set up their Corporate Treasury Centres ("CTCs") in Hong Kong would contribute to the development of headquarters economy in Hong Kong. We strongly agree to this view as it is common for multinational corporations to house their regional headquarters and CTCs in the same location. As such, we consider that tax incentives should be provided to regional headquarters in Hong Kong in addition to those recently introduced for CTCs in Hong Kong so as to encourage more multinational corporations to set up their regional headquarters together with 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.

(ii) Innovation and technology industry

As mentioned above, the innovation and technology industry is another industry that is regarded as being strategically important to Hong Kong. The ITB has identified a few technological areas with development potential, such as communication technologies, integrated circuit design, biotechnology and Chinese medicines. In addition to the tax measures proposed above for encouraging R&D and IP-related business activities in Hong Kong, the Government should also consider providing tax incentives for promoting the development of these industries/sectors.

(iii) Green industry

In the 2016 Policy Address, the Chief Executive reaffirmed the Government's commitment to building Hong Kong as a smart city. One component of smart city development is "Smart Environment", which involves, among others, effective management and optimisation of building, community and urban resources to achieve energy conservation and emission reduction. Towards this theme, we consider that tax incentives should also be introduced to support the development of the green industry.

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 regional headquarters and selected non-financial services industries/sectors that are of strategic importance to Hong Kong, such as innovation and technology industry and green industry, so that the taxation of such regional headquarters industries/sectors remains competitive as compared to the other countries within the region. Concessionary tax rate (e.g. 8.25% or 10%) on profits derived from such regional headquarters and industries/sectors can be considered as one of the possible incentives.

In addition, 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 green energy and resource recovery activities.)

B Enhancing the tax system by promoting greater fairness and certainty

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 international business and financial centre.

B1 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 improving the livelihood of Hong Kong people, we believe the Government should lend more support to the SMEs to help easing their financial burden and maintaining their competitiveness.

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.

B2 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 used 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.

B3 According a "statement of loss" the same legal status as an "assessment"

The Court's decision in the *Common Empire*[3] 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 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.

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[3] *CIR v Common Empire Ltd. [2006]*

B4 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 Responding to the OECD's BEPS project

The OECD's BEPS project has brought significant changes to the international taxation landscape. As a responsible member of the international community, we acknowledge that Hong Kong will need to respond to the BEPS measures recommended by the OECD under the BEPS Action Plan. We welcome the Government's move in issuing the BEPS consultation paper in October this year to solicit views from various stakeholders and its commitment to maintaining Hong Kong's simple and low tax regime to help Hong Kong maintain its competitive and attractive investment environment while implementing the BEPS package in Hong Kong. The Institute made a detailed submission on the BEPS consultation paper in December last year, which urged the Government to strike a balance between enabling Hong Kong to meet the BEPS minimum standards specified by the OECD and minimising the administrative burden of as well as providing reasonable certainty to taxpayers in Hong Kong. The more important comments in our submission are summarised below:

- Interaction between the source rules and the transfer pricing (“TP”) rules – Upon codification of the TP rules in the IRO, it should be made clear in the IRO that the TP rules will not override the source rules.

- The existence of proper TP documentation should serve as a reasonable excuse and no penalty (including commercial restitution) should be imposed on taxpayers where (i) reasonable TP documentation has been prepared in good faith and (ii) the arm’s length pricing indicated in the TP report has been followed in the related party transactions, even if there is a TP adjustment.

- To reduce the compliance burden and costs of doing business in Hong Kong, the proposed exemption for TP documentation should be revised taking into consideration of (1) raising the proposed exemption threshold for small private companies; (2) introducing an exemption criterion based on the amounts of related party transactions; (3) introducing safe harbour rules to exempt or simplify TP documentation requirement for certain types of low risk transactions, etc.

- Penal provisions for incorrect tax returns and failure to keep proper TP documentation should not be imposed on domestic related party transactions that are tax neutral and related party transactions that are not subject to tax in Hong Kong.

- Interaction between the domestic objection/appeal mechanism and the Mutual Agreement Procedure (MAP) should be further clarified and the OECD’s recommendations on the interaction of the two should be taken into account in coming up with the statutory MAP regime.

- Consideration should be given to introducing a unilateral tax credit system in Hong Kong to minimise double taxation in the absence of a tax treaty.

- Hong Kong should spare no effort in persuading its treaty partners to adopt the “Principal Purposes Test (“PPT”) only” option during treaty negotiations and take into consideration the impacts of the Limitation on Benefits (“LOB”) rule on specific industries such as the funds and asset management industries before committing to such rule.

D Improving people’s livelihood

D1 Waiver of stamp duty for first home buyers

Given the soaring property price in Hong Kong, the general public (in particular the younger generation) in Hong Kong are still experiencing difficulties in buying their first home although anti-speculation measures such as increase in ad valorem stamp duty, special stamp duty and buyer’s stamp duty have been introduced by the Government in recent years. To provide relief for these people, we propose that the Government waives the ad valorem stamp duty for first home buyers, subject to fulfilment of certain criteria.

Our proposal:

We propose that ad valorem stamp duty on transfer of residential property be waived for first home buyers when the following conditions are met:

- The market value of the first home purchased does not exceed HK$6,000,000;
- The buyer(s) must be a natural person and at the age of 18 or over;
- The buyer(s) must be a Hong Kong permanent resident;
- Either the buyer(s) or his/her spouse has not previously owned any residential property in Hong Kong; and
- The buyer(s) must live in the residential property purchased for a continuous period of 3 years. If the buyer(s) resells the property within 3 years, there will be a claw back of the stamp duty amount waived, together with the special stamp duty on the property resold within 3 years of acquisition.

D2 Nurturing career development and entrepreneurship of the youth

One of the keys for developing the innovative and technology-based industry in Hong Kong is to nurture and attract young talents to the R&D and advanced technology sector.

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

To provide greater support to the career development of the youth, we believe that the Government should also consider providing tax incentives to encourage the employment of the youth and to nurture entrepreneurship among young talents.

As over 98%[4] 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 to encourage SMEs to provide more job opportunities at entry level to the youth when certain specified conditions are met. Such arrangement will not only help to improve the upward mobility of the youth by facilitating them to enter into the job market, develop and grow themselves through working experience but will also help SMEs to fulfil their corporate social responsibility and improve their corporate image.

Our proposal:

We suggest that the Government grants a 150% tax deduction to employing organizations for up to a maximum of 12 months of the monthly remunerations paid to youth newly hired by them where the following conditions are met: (i) the youth are aged between 18 to 25 (inclusive) and (ii) the deduction of each monthly remuneration of each qualified newly

[4] *Source: Website of the Support and Consultation Centre for SMEs (updated as of 14 November 2016): https://www.success.tid.gov.hk/english/sme_men_pro/sme_men_pro.html*

hired employee shall not exceed $12,000.

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.

D3 Expanding the tax bands for salaries tax assessment

With the increasing living costs brought about by soaring rents and inflation, tax reduction should be offered to the class of 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 without altering the current level of personal allowances 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.

D4 Removing the requirement of "ordinarily reside" in Hong Kong

Currently, the dependent parent and grandparent allowances could only be granted if the dependent parents and grandparents are ordinarily residing in Hong Kong. However, some of the elderly may choose to live outside Hong Kong (e.g. in the Guangdong province) due to the high living costs in Hong Kong or some other reasons (e.g. the relatives or family members who can take care of them are residing outside Hong Kong). We consider that 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 extend the dependent parent/grandparent allowances claims in respect of dependent parent/grandparents who are not ordinarily residing in Hong Kong. Such concession shall only be applied to those parents/grandparents who are Hong Kong permanent residents.

D5 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.

D6 Deduction of medical insurance premium

Although the Government is working on implementing a government-regulated voluntary health insurance scheme (VHIS) to encourage people to opt for private healthcare services in Hong Kong, we believe that the public will still need incentive to join the VHIS and other private medical insurance schemes which may provide a better/enhanced protection than the VHIS.

We suggest that the insurance premium paid for VHIS and other private medical insurance schemes should qualify for tax deduction, subject to a maximum of, say, $30,000 of qualifying premium paid each year. Deduction of the medical insurance premium 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 premium paid for VHIS and other private medical insurance schemes of up to $30,000 a year.

D7 Tax deduction for voluntary contributions to the MPF scheme

Currently, tax deduction is available to employees only for their mandatory 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 claw back 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 the tax base of Hong Kong

A narrow tax base has long been a notable defect of Hong Kong's current tax system. In the consultation document for 2017 Policy Address and 2017-18 Budget published in October 2016, 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 raised 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.

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.

The international trend has been lowering the direct (income) tax rate and increasing the reliance on indirect taxes as a means of raising stable government revenue. Countries such as Japan, Malaysia and the UK are either planning to lower the corporate income tax rate or introducing concessionary tax rates for SMEs or other taxpayers. Moreover, according to the "Consumption Tax Trends 2016" published by the OECD in November 2016, VAT revenues are at an all-time high in OECD countries at 6.8% of GDP and 20.1% of total tax revenue on average. In addition, countries are increasingly looking at base broadening measures to raise additional revenue from VAT.

Given the above, the Institute believes that the Government should explore the option of introducing some new type(s) of indirect taxes or levies in Hong Kong as soon as possible. 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

21/F., Kam Sang Building, 255-257 Des Voeux Road Central, Hong Kong
Tel: (852) 2810 0438 Fax: (852) 2523 1263 Web Site: www.tihk.org.hk E-Mail: tihkadm@tihk.org.hk