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THE TAXATION INSTITUTE OF HONG KONG

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BY HAND
PRIVATE AND CONFIDENTIAL

The Honorable Paul Chan
Financial Secretary
25/F, Central Government Office
2 Tim Mei Avenue
Tamar, Hong Kong

19 January 2018

Dear Honorable Paul Chan,

2018-2019 BUDGET PROPOSALS

Thanks to the improving global economic conditions and solid growth in domestic demand, the Hong Kong economy expanded notably in the third quarter of 2017 over a year earlier. It is expected that the real GDP for 2017 as a whole will grow at 3.7%, higher than the mid-point of the HKSAR Government's range forecast of 3% to 4% announced in August 2017[1].

As various countries around the world are revisiting their tax policies and/or introducing BEPS-compliant tax incentives to attract more businesses and investment (e.g. the US tax reform, the UK's plan to lower its corporate income tax rate to 17% by 2020 and the new BEPS-compliant patent box regimes in Ireland, Italy and the UK), Hong Kong also needs to review its tax policies/measures from time to time to enhance its tax competitiveness.

While the Institute welcomes the numerous tax initiatives taken by the current-term administration such as the Tax Policy Unit, the "Summit on the New Directions for Taxation", the two-tier profits tax system and the super tax deduction for research and development ("R&D") expenditure, the Institute hopes that is only the beginning and more tax incentives would also be offered to industries/sectors that are strategically important for Hong Kong and that would help diversify Hong Kong's economic structure (e.g. headquarters economy, intellectual property ("IP") hub and innovation and technology ("I&T") start-ups etc.).

Externally, in order for Hong Kong to fully capitalise on the opportunities arising from the Mainland Government's Guangdong-Hong Kong-Macao Bay Area ("Bay Area") initiative, the

[1] *Source: The economic situation in the third quarter of 2017 and latest GDP and price forecasts for 2017 released by the HKSAR Government on 10 November 2017.*

Institute recommends that the HKSAR Government lobbies with the Mainland Government on a number of tax and business measures that would facilitate Hong Kong companies doing business and Hong Kong individuals working in the Bay Area.

Domestically, the persistent issues of narrow tax base and volatile government revenue have yet to be resolved. Going forward, the aging population and the government spending needed to provide better support for public housing, education, health and social welfare will all put increased pressure on the public finance. In this regard, the Institute recommends that options for broadening the existing tax/revenue base in Hong Kong be explored as a longer-term task of the HKSAR Government.

The Institute believes that all of the above point to the need for the HKSAR Government to perform a comprehensive review of the current tax system and tax policies (including a comprehensive review of the Inland Revenue Ordinance ("IRO")) in Hong Kong such that they (i) become 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) keep pace of the latest international tax standards.

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 HKSAR Government.

Our proposals for 2018-2019 cover the following areas:

A Fostering the development of targeted industries to diversify Hong Kong's economic structure and trade facilitation

B Enhancing the competitiveness of the tax system by promoting greater fairness and certainty

C Collaborating with the Mainland and international tax measures

D Improving people's livelihood

E Broadening the tax base of Hong Kong

A Fostering the development of targeted industries to diversify Hong Kong's economic structure

A1 Tax incentive for regional headquarters

We consider that tax incentive should be introduced to attract more multinational companies ("MNCs") to locate their headquarters operations in Hong Kong. As mentioned in the Arrangement between the National Development and Reform Commission (NDRC) and HKSAR Government on advancing Hong Kong's full participation in and contribution to Belt and Road Initiative signed on 14 December 2017, Hong Kong should encourage Mainland enterprises to establish their regional headquarters (RHQs) in Hong Kong and use Hong Kong as a front-end platform to access related countries and regions for establishing operations under the framework of the Belt and Road Initiative; and support enterprises from related countries and regions to set up their RHQs in Hong Kong for tapping the Mainland market.

Developing the headquarters economy in Hong Kong will also help building up a critical mass of key management personnel in Hong Kong and driving the growth of the related professional service sectors (e.g. banking, corporate finance, legal and accounting services) in Hong Kong. More importantly, encouraging MNCs to set up their regional headquarters in Hong Kong can lead to relocation of other key corporate functions (e.g. corporate treasury, human resources, R&D and IP ownership) to Hong Kong given that some corporations prefer to house these key corporate functions in the same location as their regional headquarters. Some other neighbouring countries of Hong Kong, such as Malaysia and Singapore, have already offered a tax incentive for regional headquarters. *In the Mainland, some local governments also provide rental subsidies for office premises and executive quarters as well as personal income tax subsidies.*

Our proposal:

To provide tax incentive and/or other subsidies for regional headquarters operating in Hong Kong (e.g. a reduced tax rate, say a 50% concessionary rate, for the qualifying profits derived by such regional headquarters).

A2 Tax incentive for trading/procurement/processing management hubs

ASEAN has been Hong Kong's second largest trading partner in merchandise trade and the fourth largest in services trade. Hong Kong and the ASEAN signed a Free Trade Agreement (FTA) on 12 November 2017, and it is expected that more trading and procurement activities will take place with the ten members of ASEAN. Moreover, as facilitated by the FTA, more processing trade and toll manufacturing may take place in ASEAN or other Belt and Road countries by Hong Kong companies who will play important role in processing management for the operations extended to overseas jurisdictions.

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, especially trading income. Limited or auxiliary business activities in Hong Kong can cause the IRD to take the view that the entire trading profits are with a Hong Kong source, as no apportionment is allowed for trading profits. Inconsistent application of the source rules (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 encouraging real economic activities in Hong Kong and keeping Hong Kong's economy growing.

In order to mitigate the adverse impacts of uncertain and costly offshore claims on taxpayers and encourage companies to locate their trading or procurement hubs in Hong Kong, we suggest that a concessionary tax regime be introduced for trading and procurement hubs in Hong Kong. Such tax incentive will not only encourage more core trading and procurement operations to take place in Hong Kong but also support the growth of other related sectors such as the transportation and logistics industry.

Our proposal:

To introduce a concessionary tax regime for trading and procurement hubs in Hong Kong (e.g. a reduced tax rate, say a 50% concessionary rate, for the qualifying profits derived by such trading and procurement hubs); and to take a more flexible approach in granting the concessionary 50:50 apportionment of profits derived by Hong Kong companies from their processing/production operations in the Mainland and overseas jurisdictions.

A3 Tax incentive to further promote the fund industry

Currently, offshore investment funds can enjoy profits tax exemption provided that the specified conditions for the exemption are met. In addition, a bill on extending the offshore funds tax exemption to onshore privately offered open-ended fund companies ("OFCs") is currently under the scrutiny of the Legislative Council. To further encourage more investment funds to domicile in Hong Kong and to eliminate the ring-fencing feature in the existing offshore funds tax exemption regime, we suggest that the current profits tax exemption for investment funds be further relaxed as suggested below.

Our proposal:

To extend the current profits tax exemption for investment funds to (i) cover all onshore funds and not just privately offered OFCs; (ii) cover funds investing in Hong Kong private companies or non-Hong Kong private companies with substantial business operations in Hong Kong (except Hong Kong and overseas private companies with substantial holding in Hong Kong real estate); (iii) remove the existing tainting provision such that a qualifying fund with a non-qualifying investment may only be subject to profits tax in respect of the non-qualifying investment and (iv) provide a concessionary tax treatment of deeming the gains derived by a qualifying fund from disposal of a non-qualifying investment as capital in nature if such investment has been held for three years or more.

A4 Tax incentive for investing into local I&T start-ups

As mentioned in the 2017 Policy Address delivered by the Chief Executive in October 2017, the development of I&T can lead to new industries and create wealth, provide more employment for young people and improve people's daily lives.

Although tax incentives alone may not drive I&T investment significantly, it can serve as a complementary measure to create a more conducive environment for nurturing I&T in Hong Kong as a whole. As such, we consider that tax incentives (other than the super R&D tax deduction already proposed by the HKSAR Government) should be introduced in Hong Kong to encourage more investment in local I&T start-ups in Hong Kong.

Taking China and Singapore as examples, both countries have offered tax incentives for investing into local qualifying start-ups. In China, 70% of the qualifying investment amount in local small to medium sized hi-tech start-ups can be used to offset the taxable income of the investors (which can be a corporation, a limited partnership or an individual). In Singapore, under the Angel Investors Tax Deduction Scheme, 50% of the qualifying investment costs of an individual investor in a local high potential start-up can be used to offset the individual's taxable income, with a deduction cap of S$250,000.

Our proposal:

To consider introducing the following tax incentives for investing into qualifying local I&T start-ups in Hong Kong: (i) to offer income exemption or tax credit in respect of the investment costs in local start-ups engaged in I&T, subject to certain conditions (e.g. the start-ups must hire certain percentage of local I&T talents); (ii) to extend the current profits tax exemption for offshore funds to cover investments in all qualifying local I&T start-ups in Hong Kong (instead of just those under the Innovation and Technology Venture Fund Scheme) and (iii) to provide profits tax exemption for onshore funds investing in qualifying local I&T start-ups in Hong Kong.

A5 Super tax deduction for promoting the I&T industry and cultural & creative industry

(1) Super tax deduction for R&D expenditures incurred by the I&T industry

The HKSAR Government has proposed that effective from 1 April 2018, the first HK$2 million of qualified R&D expenditure be eligible for a 300% tax deduction and the remainder at 200% with no cap on the amount of enhanced deduction.

In this regard, we understand that only R&D activities undertaken in Hong Kong (i) by an enterprise itself or (ii) sub-contracted out to a designated local research institution would qualify for the proposed super tax deduction. Presumably, the policy objective behind this requirement is to encourage more R&D activities to be undertaken in Hong Kong. However, given that Hong Kong may lack sufficient people with the necessary skills and expertise to conduct certain types of R&D activities, enterprises may find it necessary to undertake part or all of their R&D activities outside Hong Kong, especially in the Bay Area, where there is a much larger pool of talent, skills and research institutions, and Hong Kong's fuller integration with which is a stated government policy.

In fact, based on the Inland Revenue Department ("IRD")'s current narrow interpretation of section 16B(1)(b) of the IRO, where R&D activities are not undertaken by an enterprise itself but sub-contracted out to be performed by a related or unrelated service provider (other than an approved research institute), expenditures incurred for such sub-contracted out R&D activities would not even qualify for a normal tax deduction under section 16B(1)(b), regardless of whether such sub-contracted out R&D activities are performed by the service provider in or outside Hong Kong. This is the case notwithstanding that the enterprises concerned would own the proprietary interest of any outcome of such sub-contracted R&D activities and can, therefore, commercially exploit the same to produce their profits which are chargeable to tax in Hong Kong.

Furthermore, by only granting super tax deduction for qualified R&D expenditures without any cash-conversion feature of the claimed deduction, the proposal would mainly benefit those enterprises which are profit-making and are required to pay taxes in current year. For those enterprises which have not yet made any taxable profits, any super tax deduction claimed can only be carried forward and be used to reduce their future taxable profits (and hence future tax liabilities or cash flow), if any.

Our proposal:

While welcoming the HKSAR Government's proposal, we consider that the proposal would be more effective in spurring more R&D activities to be undertaken by Hong Kong enterprises if the proposal could also include the following features: (i) expenditures incurred for sub-contracted R&D activities undertaken by any service provider (i.e. not restricted to an approved research institute under the current law or a designated local research institution under the proposal) engaged by a taxpayer in or outside Hong Kong would qualify for a normal tax deduction under section 16B(1)(b) of the IRO and (ii) instead of denying the proposed super tax deduction in full, the Government may consider granting a lower rate of super tax deduction for expenditures incurred for R&D activities undertaken outside Hong Kong including the Bay Area (whether by taxpayers themselves or by their service providers). This would also be in line with the policy objective of encouraging more R&D activities to be undertaken in Hong Kong to the extent possible taking into account the possible capacity constraint of Hong Kong in this regard.

In addition, to ease the cash flow of enterprises engaged in R&D, particularly start-ups and small and medium sized enterprises ("SMEs"), the Government should consider allowing these enterprises the option of converting their super tax deduction for a year into cash or a refundable tax credit subject to certain conditions. This proposed cash-conversion feature is quite common in the super tax deduction regimes for R&D expenditures of many overseas jurisdictions (such as Australia, Canada, Singapore and the UK) and would also be supplementary to our existing R&D Cash Rebate Scheme.

(2) Super tax deduction for the cultural & creative industry

The Chief Executive has indicated in her election manifesto that as a means of promoting the cultural and creative industry, she would consider also granting super tax deduction for certain expenditures incurred by the industry.

We urge the HKSAR Government to extensively consult different stakeholders of the industry in order to identify the types of expenditures that should be eligible for the super tax deduction under this government's initiative.

Two of the promising sectors of the industry that may deserve for the HKSAR Government's support are the film industry and APPS design industry. The HKSAR Government has already set up a Film Development Fund to support the production of films by Hong Kong film producers.

In parallel with the operation of the Fund, the HKSAR Government may consider granting a super tax deduction of say, 200% for expenditures incurred, and not subsidized by the Fund, on the production of films based on certain criteria and subject to a certain limit. For example, one such criterion could be for costs incurred for making film shots in Hong Kong. This criterion for granting a super tax deduction could be justified on the grounds that such expenditures would (i) create employment in Hong Kong and (ii) promote not just the film industry but also the tourism industry in Hong Kong. The effects of the films "Lord of the Rings" and "Harry Potter" on the tourism industry of New Zealand and the UK respectively are testimony to this proposition. Films should include mobile-based brief films.

Our proposal:

The HKSAR *Government should extensively consult different stakeholders of the cultural and creative industry to identify the types of expenditures that should be eligible for a super tax deduction under its initiative of promoting the industry, including the possible granting of a super tax deduction, say 200%, for expenditures incurred on film shots made in Hong Kong.*

A6 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 to 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.

A7 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 recent proposal 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 HKSAR 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 HKSAR 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.

A8 Tax measures to promote Hong Kong as an international IP 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 HKSAR 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.

A9 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* case[2]. 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 HKSAR Government’s BEPS consultation paper, where we suggest that the HKSAR Government should consider introducing a unilateral tax credit system in Hong Kong.

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.

[2] *CIR v HK TVBI International Ltd. [1992]*

A10 Tax measures for enterprises leasing plant and machinery for use outside Hong Kong

Under the Mainland Government's Belt and Road initiative, many construction and infrastructure projects are being undertaken in the countries along the Belt and Road route. A possible business opportunity for Hong Kong enterprises under the Belt and Road initiative is the financing and leasing of heavy equipment and machinery needed for the Belt and Road projects.

However, where the arrangement involves an operating lease of the equipment and machinery by the Hong Kong enterprise to a user outside Hong Kong , the Hong Kong enterprise as owner of the equipment and machinery leased would be denied tax depreciation allowances under section 39E of the IRO, even though the relevant leasing income could be chargeable to tax in Hong Kong under section 14 of the IRO by way of the IRD applying an "operations test" for determining the source of the leasing income.

The operation of section 39E in this manner would hinder Hong Kong enterprises in exploiting the business opportunity arising from the Belt and Road initiative by way of investing and leasing plant and machinery needed for the Belt and Road projects.

Our proposal:

We propose that as a means of overcoming the denial of tax depreciation allowances under section 39E so as to enable Hong Kong enterprises to fully exploit the business opportunity arising from the Belt and Road initiative, the HKSAR Government can, similar to the legislation for encouraging leasing of aircraft by Hong Kong enterprises, grant a deemed notional deduction in lieu of tax depreciation allowances for plant and machinery leased outside Hong Kong, where the relevant leasing income is chargeable to tax in Hong Kong.

A11 Tax incentives for the green industry

In the 2017 Policy Address, the Chief Executive announced that the HKSAR Government will take the lead in arranging the issuance of a green bond in the next financial year to demonstrate its support for sustainable development and determination to combat climate change. While green finance is one of the key elements of the green industry, the industry encompasses various other types of business activities such as waste recycling and resource recovery. We consider that tax incentives should also be introduced to support the development of these businesses in the green industry.

Our proposal:

We suggest that the HKSAR Government grants (i) a super tax deduction of 150% to taxpayers who acquire qualifying environmental protection facilities / plant or machinery and (ii) subsides or tax holidays to taxpayers in the green industry (e.g. taxpayers engaged in waste recycling 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 maintain the competitiveness of its tax system.

B1 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 HKSAR 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.

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

The Court's decision in the *Common Empire case*[3] 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[4] 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.

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

[4] *Aviation Fuel Supply Company v CIR [2014]*

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 Collaborating with the Mainland and international tax measures

C1 Collaborating with the Mainland on the Bay Area initiative

The Bay Area initiative signifies the Mainland Government's support for (i) a closer collaboration between the nine cities of the Guangdong province, Hong Kong and Macau and (ii) facilitating the free flow of people, goods and capital between Hong Kong and the other cities in the Bay Area. The initiative would create synergy and generate new impetus for future economic development for the city cluster in the Bay Area.

In order for Hong Kong to fully capitalise on the opportunities arising from the Bay Area initiative, we recommend that the HKSAR Government lobbies or initiates discussions with the relevant Chinese authorities for them to consider implementing the following tax/business measures in the Bay Area:

(1) China tax exemption for dividends paid out from the Bay Area

Currently, if a Hong Kong company invests in a Chinese company in the Bay Area, the profits of the Chinese company will be subject to China Corporate Income Tax at effectively 10% to 25% (depending on whether it qualifies for a reduced tax rate offered to certain companies or industries). In addition, the after-tax profits distributed by the Chinese company to the Hong Kong company will be subject to a withholding tax

("WHT") of 10% (the domestic rate) or 5% (the reduced rate under the China-Hong Kong double tax arrangement). Lowering the China tax burden of investing in the Chinese companies in the Bay Area can encourage more capital in Hong Kong to invest in the area.

Our Proposal:

In order to encourage more capital from Hong Kong to invest in the Bay Area, we suggest that the HKSAR Government lobbies with the Chinese Government on exempting Hong Kong resident companies from the Chinese WHT on dividends paid by the Chinese companies in the Bay Area, or deferral of the payment of the Chinese WHT if the after-tax distributable profits have been re-invested in an affiliated company in the Bay Area carrying on an encouraged, allowable or restricted project until the ownership of the affiliated company is sold completely to a third party.

(2) Allowing Hong Kong companies to set up branches in the Bay Area

Currently, only foreign banks and insurance companies are allowed to set up branches in China. If Hong Kong companies engaged in other selected industries (e.g. software and apps development, pharmaceuticals/biotechnology and I&T) are allowed to set up branches in China, they can enjoy more flexibilities in terms of working capital flow and a reduced China tax burden (as profits repatriated from the Chinese branch to its Hong Kong headquarters will not be subject to WHT in China).

Our Proposal:

In order to offer more flexibilities in terms of flow of working capital and reduce the China tax burden of Hong Kong resident companies investing in certain industries (e.g. software and apps development, pharmaceuticals/biotechnology and I&T) in the Bay Area, we suggest that the Government lobbies with the Chinese Government on allowing Hong Kong resident companies engaged in those industries to set up branches in China.

(3) Lowering the labor costs for Hong Kong individuals working in China

Currently, where a Hong Kong individual employed by a Hong Kong company is seconded to work for a related company in China, the individual and the Chinese company are required to make social welfare contributions in China. At the same time, the individual and the Hong Kong company are required to make contributions to the Mandatory Provident Fund ("MPF") Scheme in Hong Kong. At present, Chinese citizens who make contributions to the pension funds in China are already exempt from making MPF contributions in Hong Kong.

Our Proposal:

To attract more Hong Kong talent and young people to work in the Bay Area and to lower the labor costs of businesses for sending Hong Kong people to work in China, we suggest *that China and Hong Kong enter into a social security agreement such that Hong Kong individuals who are required to make MPF contributions in Hong Kong will be exempt from social welfare contributions in China.*

C2 Expanding Hong Kong's tax treaty network, in particular with the Belt and Road countries

In the 2017 Policy Address, the Chief Executive mentioned that the HKSAR Government aims to increase the total number of double tax agreements signed by Hong Kong to 50 in the next few years. We welcome this goal set by the HKSAR Government and recommend that it continues to lobby with the few major developed countries that have not yet signed a tax treaty with Hong Kong (e.g. Australia, Singapore and the US).

In addition, to allow Hong Kong companies to fully participate in and capitalise on the opportunities brought by the Belt and Road initiative, we also recommend that the Government expedite the expansion of Hong Kong's tax treaty network with the Belt and Road counties such as Bangladesh, Israel and Turkey, etc. and the remaining five member countries of ASEAN (e.g. Cambodia, Philippines, Singapore).

Our Proposal:

In order to provide double taxation relief and reduce the overseas tax costs for Hong Kong companies investing abroad and in particular, the Belt and Road countries, we recommend that the HKSR Government continues lobbying with Australia, Singapore and the US on signing a tax treaty and expedite the treaty negotiations with the Belt and Road countries.

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 HKSAR 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 I&T-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 HKSAR Government should also consider providing tax incentives to encourage the employment of the youth and to nurture entrepreneurship among young talents.

As over 98%[5] 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 HKSAR 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 hired employee shall not exceed $12,000.

We further suggest that the HKSAR 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 HKSAR Government.

D3 Lowering the top marginal tax rate to 15% for salaries tax

[5] *Source: Website of the Support and Consultation Centre for SMEs (updated as of 28 April 2017): https://www.success.tid.gov.hk/english/sme_men_pro/sme_men_pro.html*

As a two-tier profits tax system will soon be introduced to lower the tax burden of corporations and unincorporated businesses (in particular SMEs) in Hong Kong, we consider that the salaries tax burden of individual employees in the middle class should be reduced as well.

Our proposal:

To lower the top marginal tax rate for salaries tax from 17% to 15%.

D4 Increasing and Allowing apportionment of dependent parent/grandparent allowances and elderly residential care expenses

At present, if a parent/grandparent is maintained by more than one child/grandchild, only one of the children/grandchildren can be granted the dependent parent/grandparent allowances or a deduction of the elderly residential care expenses. For the sake of fairness and to encourage more individuals to support the costs of living of their parents/grandparents together with their siblings (if any), we consider that the amounts of dependent parent/grandparent allowances and the deduction ceiling of the elderly residential care expenses can be increased and allowances/deduction should be allowed to be apportioned/shared among contributing siblings.

Our proposal:

To (i) increase the amounts of dependent parent/grandparent allowances, additional allowances and deduction ceiling of the elderly residential care expenses for each qualified dependent parent/grandparent from $23,000/$46,000/$92,000 to $30,000/$60,000/$120,00 (see table below) and at the same time raise the amount that an individual has to contribute towards maintaining a parent/grandparent in order to qualify for the allowances/deduction from $12,000 to $18,000 per year and (ii) allow an apportionment of the dependent parent/grandparent allowances or deduction of the elderly residential care expenses among individuals who contribute to the maintenance of their parents/grandparents together with their siblings.

Please refer to the table below for a summary of the proposed amounts for the allowances and deduction.

	2017/18	Proposed
Dependent Parent / Grandparent Allowance		
(a) For each qualified parent / grandparent aged 55 or above but below 60	$23,000	$30,000
(b) For each qualified parent / grandparent aged 60 or above	$46,000	$60,000
Additional Dependent Parent / Grandparent Allowance		
(a) For each qualified parent / grandparent aged 55 or above but below 60	$23,000	$30,000

(b) For each qualified parent / grandparent aged 60 or above	$46,000	$60,000
Deduction ceiling of Elderly Residential Care Expenses	$92,000	$120,000

D5 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.

D6 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.

D7 Tax deduction for individuals' voluntary contributions for retirement protection and first home acquisition

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 HKSAR Government allows 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. In addition, a separate account within the MPF scheme or a separate scheme may be set up for receiving and managing voluntary contributions made by individuals as savings for acquiring their first home in the future (e.g. the First Home Super Saver Scheme in Australia). A similar tax deduction of up to $50,000 a year can be granted as a tax incentive for individuals to make such voluntary contributions.

Our proposal:

To allow tax deduction of up to $50,000 a year for each of the (i) employees' voluntary contributions to the MPF scheme for retirement protection purpose and (ii) individuals' voluntary contributions to a separate account within the MPF scheme or a separate scheme for first home acquisition purpose.

D8 Tax deduction of medical insurance premiums

We understand from the 2017 Policy Address that the HKSAR Government is going to implement the Voluntary Health Insurance Scheme ("VHIS") in 2018 and tax deduction will be offered as an incentive for members of the public to procure the health insurance products under the scheme. We consider that to encourage more people to opt for private healthcare services in Hong Kong so as to ease the burden of the public health sector, tax deduction should also be offered for the insurance premiums paid for other private medical insurance schemes.

Deduction of the medical insurance premiums will not cause a significant loss in revenue to the Government because the premiums 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 of up to $30,000 a year for insurance premiums paid under private medical insurance schemes other than the VHIS.

E Broadening the tax base of Hong Kong

A narrow tax base has long been a notable feature of Hong Kong's current tax system. The narrow tax base, together with the fact that the government revenue is sensitive to economic fluctuations depending on broader economic changes beyond its control, has resulted in the volatility of government revenue. The problem of fiscal volatility is of particular concern given the aging population of Hong Kong and the increasing demand in recurrent government funding on public housing, education, health, and social welfare, etc.

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 HKSAR Government should, at the same time of promoting economic growth to increase government revenue, continue to explore ways of broadening Hong Kong's tax base and reducing our fiscal volatility. In this regard, a study on introducing new types(s) of indirect taxes or levies in Hong Kong in appropriate time should be carried out. 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.

While we understand that a comprehensive review of the current tax system and structure in Hong Kong is not the priority of the current-term administration, we are of the view that such an exercise, including a comprehensive review of the IRO to modernise it and make it more effective in attracting our targeted businesses, should be a longer term task of HKSAR Government.

Our proposal:

The HKSAR Government should, in the longer term, (i) conduct a comprehensive review of the tax system and structure in Hong Kong (including a comprehensive review of the IRO) and (ii) carry out studies and explore possible options to broaden Hong Kong's tax base, such as introduction of new types(s) of indirect taxes or levies in Hong Kong in appropriate time.

Yours sincerely,

For and on behalf of
The Taxation Institute of Hong Kong

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