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## 2019-2020 BUDGET PROPOSALS

The Hong Kong economy grew solidly in the first three quarters of 2018, with a 3.7% real GDP growth in the first three quarters of 2018 over a year earlier. Taking into account the various increasing downside risks in the external environment, the HKSAR Government forecasts that the real GDP for 2018 as a whole will grow at 3.2%, which is within the range forecast of 3% to 4% announced by it in August 2018[1].

Looking ahead, the various external factors, such as the China-US trade dispute, the rise of global trade protectionism, the possible further interest rate hikes in the US and the future development on Brexit, will likely affect Hong Kong's economy and give rise to heightened uncertainties.

Given the above external market situation and to achieve a long-term sustainable economic growth in Hong Kong, the Institute fully agrees to the HKSAR Government's policy objectives of driving economic diversification and taking up the roles as a "facilitator" and "promoter" to foster further economic growth in Hong Kong, as stated in the Chief Executive's Policy Address in October last year.

Following the HKSAR Government's direction of diversifying Hong Kong's economy and developing new industries to drive economic growth, we include in our 2019/20 budget submission a number of proposals that aim at achieving the above mentioned government policy objectives. We also include in the budget submission our proposed measures on (1) consolidating the pillar industries; (2) enhancing the competitiveness of the Hong Kong tax system; (3) enhancing closer economic collaboration with the Mainland; (4) improving people's livelihood and (5) comprehensive review of the Hong Kong tax system, including the tax structure and tax law.

Our proposals for 2019-2020 are grouped under the following areas:

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

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

C Collaborating with the Mainland for closer economic integration

D Improving people's livelihood

E Comprehensive review of the tax system

[1] *Source: The economic situation in the third quarter of 2018 and latest GDP and price forecasts for 2018 released by the HKSAR Government on 16 November 2018.*

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

### A1 Tax incentive for regional headquarters

We have advocated the introduction of a tax incentive for regional headquarters ("RHQs") set up in Hong Kong in our previous budget submissions.

We urge the HKSAR Government to consider the introduction of such incentive so as to attract more multinational companies ("MNCs") and China-based enterprises to locate their headquarters operations in Hong Kong. Such incentive can facilitate Hong Kong's participation in the Mainland Government's Belt and Road initiative as Hong Kong can act as a RHQ hub/platform for (1) Mainland enterprises investing or operating in the Belt and Road countries and (2) enterprises in the Belt and Road countries that would like to tap into the Mainland market.

In addition, to make the RHQ tax incentive more attractive, we suggest that the scope of RHQ activities qualifying for the tax incentive be broad enough to cover the key functions that are commonly performed by a RHQ (e.g. corporate planning, research and development ("R&D"), finance, marketing, human resources, information technology).

**Our proposal:**

*To introduce tax incentive (e.g. a reduced tax rate of 8.25% for the qualifying profits) for RHQs operating in Hong Kong and ensure the scope of qualifying RHQ activities cover the key functions that are commonly performed by a RHQ.*

### A2 Tax incentive for processing management/trading/procurement hubs

There are investors from the Mainland and Belt & Road countries who would like to set up a production-related hub in Hong Kong for cross-border processing/production activities in order to benefit from the production resources in the ASEAN, in particular the free trade agreement concluded between the ASEAN and Hong Kong. These investors treasure Hong Kong's unique and solid cross-border processing/production management experience with the Mainland.

Since the names and arrangements of cross-border processing/production operations may vary across different countries, the concessionary 50:50 apportionment claim should not be limited to "contract processing" but should be extended to any cross-border processing/production related operations managed via Hong Kong provided that Hong Kong companies take up vital functions or create indispensable value to the operations in both Hong Kong and other 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 50:50 apportionment claims/offshore claims on taxpayers and encourage companies to locate their processing management/trading/procurement hubs in Hong Kong, we suggest that a concessionary tax regime be introduced for processing management/trading/procurement hubs in Hong Kong. For example, a concessionary tax rate can be granted to trading hubs in Hong Kong that satisfy certain criteria in terms of annual turnover, annual local business spending and number of qualified employees, etc.

Such tax incentive will not only encourage more core processing management/trading/procurement operations to take place in Hong Kong but also support the growth of other related sectors such as logistics, financial and professional services industries.

**Our proposal:**

*To introduce a concessionary tax regime for processing management, 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 hubs.*

### A3 Attracting investment holding activities from zero/nominal tax jurisdictions to Hong Kong

In November 2018, the OECD Inclusive Framework on BEPS issued a paper under BEPS Action 5 entitled "Resumption of Application of Substantial Activities Factor to No or Only Nominal Tax Jurisdictions" ("the OECD Paper"), which requires zero or nominal tax jurisdictions (i.e. tax havens) to introduce laws demanding companies to have adequate economic substance (e.g. in terms of adequate number of qualified full-time employees and an adequate amount of operating expenses) for certain business activities in order to enjoy the zero or nominal tax rate.

The OECD Paper may have an impact of driving MNCs away from tax havens as it may be difficult to find full-time qualified employees there and the running cost of maintaining entities will likely increase. Hong Kong should consider positioning itself to attract these MNCs to move their business activities to Hong Kong.

In the past several years, Hong Kong has introduced various OECD-compliant tax incentives to attract treasury, captive insurance and fund vehicles to be based in Hong Kong. Another area that Hong Kong could win businesses from tax havens is investment holding.

One reason for MNCs to set up investment holding companies in tax havens such as the BVI and the Cayman Islands is that the share transfer of such companies is not subject to stamp duty. Hong Kong may consider revising the stamp duty law such that Hong Kong stamp duty would be waived for transfer of shares in Hong Kong investment holding companies that hold wholly and exclusively offshore/non-Hong Kong assets. There will not be any loss of revenue for Hong Kong because MNCs would have set up an investment holding company in a tax haven otherwise. If MNCs are forced to spend more in the tax havens going forward, with a favourable stamp duty regime in Hong Kong, they may be willing to move their investment holding companies to Hong Kong for higher efficiency and superior commercial infrastructure.

**Our proposal:**

*To waive stamp duty for transfer of shares in Hong Kong investment holding companies that hold wholly and exclusively offshore/non-Hong Kong assets.*

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

The HKSAR Government has been focusing on developing the Innovation and technology sector ("I&T") in Hong Kong in the past few years.

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 implemented) should be introduced in Hong Kong to encourage more investment in local I&T start-ups in Hong Kong.

Other countries such as China and Singapore 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 offering 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).*

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

***(1) Enhanced tax deductions for R&D expenditures incurred by the I&T industry***

Under the recently amended section 16B of the Inland Revenue Ordinance ("IRO"), effective from 1 April 2018, the first HK$2 million of qualifying R&D expenditure incurred on qualifying R&D activities will be eligible for a 300% enhanced tax deduction and the remainder at 200% with no cap on the amount of the enhanced tax deductions that can be claimed.

However, to qualify as qualifying R&D activities, the relevant R&D activities must be either (i) wholly undertaken in Hong Kong by an enterprise itself or (ii) sub-contracted out to a designated local research institution. Understandably, 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 their R&D activities outside Hong Kong, especially in the Greater Bay Area ("GBA"). This would particularly be the case given that Hong Kong's fuller integration with the GBA is a stated policy of the HKSAR Government and that the GBA offers a much larger pool of talent, skills and research institutions.

In fact, under the current interpretation of the Inland Revenue Department ("IRD") of section 16B 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 by an R&D institution as defined), expenditures incurred for such sub-contracted out R&D activities would not even qualify for the 100% normal tax deduction. This would be the case regardless of whether such sub-contracted out R&D activities are performed by the service provider in or outside Hong Kong.

Such an IRD's interpretation of section 16B would render Hong Kong enterprises participating in a cost sharing arrangement ("CSA") for pooled R&D activities to be undertaken by a separate entity of a group not being able to obtain any tax deduction in Hong Kong for their share of the costs incurred under a CSA.This would be the case notwithstanding that the enterprises concerned would own a pro-rata share of the proprietary interest of any outcome of such pooled R&D activities and can, therefore, commercially exploit the same to produce their profits which are chargeable to tax in Hong Kong.

It would therefore be unfair to deny Hong Kong enterprises any tax deduction in Hong Kong in the aforesaid circumstances given the importance of CSAs for R&D activities. Nor would such a denial be conducive to fostering a wider ecosystem necessary for developing Hong Kong as an R&D hub in the region.

Separately, by only granting enhanced tax deductions for qualifying R&D expenditures without any cash-conversion feature of the claimed deductions, the amended section 16B would mainly benefit those enterprises which are profit-making and are required to pay taxes in a current year. For those enterprises which have not yet made any taxable profits, any enhanced tax deductions 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 latest initiative to grant enhanced tax deductions for qualifying R&D activities, we consider that the recently amended section 16B of the IRO should be further enhanced.*

*To be more effective in spurring more R&D activities to be undertaken by Hong Kong enterprises, including R&D activities under CSAs which may, by necessity, be undertaken outside Hong Kong, we propose the enhancement on section 16B should include the following features:*

*(i)* *expenditures incurred for sub-contracted R&D activities undertaken by any service provider (i.e. not restricted to an R&D institution as defined) engaged by a taxpayer in or outside Hong Kong would qualify for the 100% normal tax deduction;*

*(ii)* *instead of denying the enhanced tax deductions in full, the HKSAR Government may consider granting a lower rate of enhanced tax deduction, say at 150%, for expenditures incurred for R&D activities undertaken outside Hong Kong including the GBA (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 considering the possible capacity constraint of Hong Kong in this regard; and*

*(iii)* *to ease the cash flow of enterprises engaged in R&D activities, particularly start-ups and small and medium sized enterprises ("SMEs"), the HKSAR Government should also consider allowing such enterprises the option of converting their enhanced tax deductions for a year into cash or a refundable tax credit subject to certain conditions. This proposed cash-conversion feature is quite common in the enhanced tax deduction regimes for R&D expenditures of many overseas jurisdictions (such as Australia, Canada 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 capital expenditures incurred on the acquisition of certain non-IP intangible property rights including indefeasible rights of use, operating licenses and franchises etc.**

We welcome the recent legislation 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 new additions being layout-design of integrated circuits, plant varieties and rights in performance.

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 expenditures incurred on the acquisition of certain non-IP intangible property rights should also be eligible for tax deduction.

Just like capital expenditures incurred on plant or machinery in the manufacturing sector, capital expenditures on the acquisition of many non-IP intangible property rights, including indefeasible rights of use (in respect of telecommunication cables), operating licenses and franchises are often incurred by the telecommunication, creative and service industries as part of their normal costs of doing business in Hong Kong, Support for these industries is important to Hong Kong's development of a more diversified technology-, knowledge- and innovation-based economy.

In this regard, we appreciate it has long been the taxation policy and principle of the HKSAR Government that since capital receipts from the sale of a capital asset are not taxable, capital expenditure on the purchase of a capital asset should not be allowed for a tax deduction in Hong Kong.

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 by a taxpayer through self-use rather than sale.

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

**Our proposal:**

*To grant tax deductions for capital expenditures incurred on the acquisition of certain non- IP intangible property rights, including indefeasible rights of use, operating licenses and franchises as a means of supporting the development of the telecommunication, creative and service industries as part of a more diversified economic structure of Hong Kong.*

## A7 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 patents and other related 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 an 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.*

## A8 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 would have the effect that the royalty income earned by the Hong Kong taxpayers will suffer double taxation, i.e. both in Hong Kong and overseas.

There will currently be 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.

Where no relevant tax treaties apply, Hong Kong taxpayers can only claim a tax deduction in Hong Kong for their overseas withholding taxes paid on royalties under section 16(1) of the IRO.

However, 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]*

**A9 Tax measures for enterprises leasing equipment or 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 or machinery needed for the Belt and Road projects.

However, where the arrangement involves an operating lease of the equipment or machinery by a Hong Kong enterprise to a user outside Hong Kong , the Hong Kong enterprise as owner of the equipment or machinery leased would be denied tax depreciation allowances under section 39E of the IRO. This would be the case 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 the "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 equipment or machinery needed for the Belt and Road projects.

**Our proposal:**

*We propose that, similar to the legislation for encouraging leasing of aircraft by Hong Kong enterprises, the HKSAR Government can consider granting a deemed notional deduction in lieu of tax depreciation allowances for equipment or machinery leased outside Hong Kong, where the relevant leasing income is chargeable to tax in Hong Kong.*

**A10 Tax relief for plant or machinery used outside Hong Kong particularly 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 plant or machinery, moulds in particular 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.

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

In response to the concerns raised by the industry, the Secretary for Financial Services and Treasury ("SFST") has indicated that he is re-examining the section 39E issue and will study and explore feasible options that comply with the principles of tax symmetry and transfer pricing involved[3].

In our previous 2016-17 budget submission, we took the view that a suitable amendment to section 39E such that tax depreciation allowances can be granted to taxpayers would not render Hong Kong breaching the tax symmetry and transfer pricing principles involved. Nor would Hong Kong be accused by other tax jurisdictions of engaging in harmful tax practice in this regard. We maintain the same view as before.

Specifically, we would like to draw your attention to Singapore where taxpayers would generally be granted the normal tax depreciation allowances as well as the Integrated Investment Allowances in respect of plant or machinery placed by them overseas with their outsourced contract manufacturers.

We hope the SFST can complete his current review and announce the results of the review as soon as possible.

**Our proposal:**

*We urge the HKSAR Government to complete its current review of the section 39E issue (i.e. denying tax depreciation allowances for plant and machinery used outside Hong Kong under a leasing arrangement) and launch a consultation with the stakeholders on its proposal of addressing the issue as soon as possible.*

## A11 Tax incentive for ship leasing and management business

The Chief Executive announced in the 2018 Policy Address that the HKSAR Government will implement tax measures to foster ship leasing business in Hong Kong with a view to enhancing Hong Kong's position as a ship leasing centre in the Asia-Pacific region.

We support the Chief Executive's vision to develop high-value added maritime services in Hong Kong.

[3] *The response of the government is contained in the Legislative Council paper which is accessible from https://www.legco.gov.hk/yr17-18/english/bc/bc06/reports/bc0620180620cb1-1090-e.pdf*

As far as ship owners who lease out their ships on a bare-boat basis are concerned, if their leasing or charter-hire income in respect of international voyages is chargeable to tax under section 14 of the IRO (i.e. not exempt under section 23B of the IRO), the applicable corporate tax rate would be 16.5%. This rate of tax is higher than that applicable to many qualifying ship lessors in Singapore.

Furthermore, because of the operation of section 39E of the IRO, such owners would not normally be entitled to tax depreciation allowances in respect of their costs incurred on the acquisition of a ship.

The above tax disincentives need to be removed if Hong Kong is to strive to become a leading maritime centre in the region.

In addition, to further develop or enhance Hong Kong's competitiveness as a leading maritime centre in the region, we consider that the proposed tax incentive should be wide enough to attract a diversified cluster of shipping companies, including ship management, brokerage and financing etc.

**Our proposal:**

*We suggest that, similar to the legislation for qualifying aircraft lessors, the HKSAR Government grant (i) a notional tax deduction to qualifying ship owners in Hong Kong who lease out their ships to compensate for their non-entitlement to tax depreciation allowance in cases such owners are chargeable tax in Hong Kong under section 14 of the IRO; and (ii) a concessionary tax rate of 8.25% on qualifying profits derived by qualifying ship lessors, ship leasing managers and other shipping-related support service providers such as ship financiers and brokers.*

## A12 Tax incentives for the green industry

In line with the government objectives of reducing waste and drawing up long-term decarbonisation strategy as mentioned in the 2018 Policy Address, we consider that tax incentives should be introduced to support the development of businesses in the green industry, such as waste recycling and resource recovery.

**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 competitiveness of the tax system by promoting greater fairness and certainty

### B1 Tax loss relief for business

Under the current provisions of the IRO, a company can generally carry forward the tax losses it sustains in a year of assessment indefinitely to offset against its assessable profits in subsequently years of assessment. 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 sustains 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 had 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 sustained 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 of Appeal's decision in the *Common Empire case*[4] 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 of

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

assessment 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 in dealing with a statement of loss 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[5] decided by the Court of Final Appeal has, however, cast doubt on the above approach of dealing with a statement of loss. 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 case law development, it is an appropriate time to review the legal status of a "statement of loss".

**Our proposal:**

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

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

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

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

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

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. 0.25% for TRC purchased on or after 5 November 2018) and request the group company with tax adjustment to pay the tax in dispute together with interest at the judgment debt rate (i.e. around 8%). The unfairness to taxpayers resulting from the huge disparity between the TRC interest rate and the judgment debt interest rate was highlighted by the Court of First Instance in the recent *Dairyfarm case*[6].

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.*

### B4 Reviewing the current tax allowances for industrial buildings

To expedite the speed of revitalisation of the old industrial buildings in Hong Kong and encourage more companies to invest in these revitalisation projects, we suggest that the initial allowance for industrial buildings be increased from 20% to 25% and the annual allowance be increased from 4% to 5%.

In addition, under the current regime, tax relief is only available on the original costs of construction (but not the purchase costs) of a building over a period of 25 years. As a result, no tax relief is available for a taxpayer who purchased an industrial building that has been used for over 25 years. We therefore suggest that a tax relief be granted for capital expenditure incurred (excluding the land costs) by taxpayers on purchasing an existing industrial building as well.

**Our proposal:**

To increase the rate of initial allowance and annual allowance for the costs of construction of an industrial building to 25% and 5% respectively, and grant a tax relief for capital expenditure incurred (excluding the land costs) by taxpayers on purchasing an existing industrial building.

[6] *Dairyfarm Establishment and The Dairy Farm Company, Limited v CIR [2018]*

## C Collaborating with the Mainland and international tax measures

### C1 Collaborating with the Mainland on the Greater Bay Area initiative

The Guangdong-Hong Kong-Macau Greater Bay Area ("GBA") 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 GBA. The initiative would create synergy and generate new impetus for future economic development for the city cluster in the GBA.

In order for Hong Kong to fully capitalise on the opportunities arising from the GBA 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 GBA:

***(1) China tax exemption for dividends paid out from the GBA***

Currently, if a Hong Kong company invests in a Chinese company in the GBA, 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 GBA 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 GBA, 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 GBA, 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 GBA carrying on an encouraged, allowable or restricted project until the ownership of the affiliated company is sold completely to a third party.*

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

As a result of the amendments to the Individual Income Tax ("IIT") Law and related regulations in China, expatriate employees working in China will no longer be allowed to treat specific employment fringe benefits (e.g. housing and children education) as tax-exempt items after 31 December 2021. While the revised IIT Law and regulations specify that resident employees can instead take tax deduction on such expenses (though the deductible thresholds may be much lower than the tax-exempt amounts), it is not clear whether the tax deduction is available to non-resident individuals as well. In addition, for

those expenses that are reimbursed by an employer, it is not sure whether the expenses can be ranked for tax deduction again while the benefits become fully taxable. The above may significant increase the costs of Hong Kong people working in China. To encourage more Hong Kong individuals to work in China, we suggest that the HKSAR Government shares the above uncertainties with the Chinese Government to see if there can be any concessionary treatments for Hong Kong resident individuals, especially for those working in the GBA.

For Hong Kong individuals who work in the GBA but live in Hong Kong, we suggest that the HKSAR Government lobbies with the State Administration of Taxation of China ("SAT") on accepting expenses incurred in Hong Kong by these individuals as qualified tax deductible expenses for China IIT purpose.

In addition, 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. On the other hand, Chinese citizens who make contributions to the pension funds in China are already exempt from making MPF contributions in Hong Kong. If Hong Kong individuals who are required to make MPF contributions in Hong Kong can be exempt from social welfare contributions in China, the costs for them to work in China can be reduced.

**Our Proposal:**

*To attract more Hong Kong talent and young people to work in the GBA and to lower the labor costs of businesses for sending Hong Kong people to work in China, we suggest that: (1) the HKSAR Government lobbies with the Mainland Government on granting a concessionary treatment for Hong Kong individuals working in China on claiming a tax deduction of expenses incurred by such individuals for China IIT purpose and (2) 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 2018 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 HKSAR Government expedites 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%[7] 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

As a two-tier profits tax system has been implemented from year of assessment 2018/19 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%.*

[7] *Source: Website of the Support and Consultation Centre for SMEs (updated as of 31 May 2018): https://www.success.tid.gov.hk/english/sme_men_pro/sme_men_pro.html*

## D4 Increasing various personal allowances and allowing apportionment of dependent parent/grandparent allowances and elderly residential care expenses

(1) Increasing basic allowance, married person's allowance and single parent allowance

As the basic allowance, married person's allowance and single parent allowance have not be increased since year of assessment 2016/17, we suggest that the amounts of these allowances be increased for year of assessment 2019/20.
In addition, in order to provide further tax relief for taxpayers who need to maintain a new born child, we suggest that the additional child allowance (currently available in the year of birth) be extended for one year such that taxpayers can claim the allowance in the year of birth as well as the year subsequent to the year of birth.

Finally, 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 basic allowance and single parent allowance from $132,000 to $145,000; (ii) increase the amount of married person's allowance from $264,000 to $290,000; (iii) extend the additional child allowance of $120,000 for one year so that it is also available in the year subsequent to the year of birth and (iv) 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 $25,000/$50,000/$100,000 to $30,000/$60,000/$120,000 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 from $12,000 to $18,000 per year and (v) 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.*

| | **2018/19** | **Proposed** |
|---|---|---|
| **Basic allowance** | 132,000 | 145,000 |
| **Married person's allowance** | 264,000 | 290,000 |
| **Single parent allowance** | 132,000 | 145,000 |
| **Dependent Parent / Grandparent Allowance** | | |
| (a) For each qualified parent / grandparent aged 55 or above but below 60 | $25,000 | $30,000 |
| (b) For each qualified parent / grandparent aged 60 or above | $50,000 | $60,000 |
| | | |
| **Additional Dependent Parent / Grandparent Allowance** | | |
| (a) For each qualified parent / grandparent aged 55 or above but below 60 | $25,000 | $30,000 |
| (b) For each qualified parent / grandparent aged 60 or above | $50,000 | $60,000 |
| | | |
| **Deduction ceiling of Elderly Residential Care Expenses** | $100,000 | $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 Tax deduction of medical insurance premiums**

The HKSAR Government has implemented the Voluntary Health Insurance Scheme ("VHIS") in 2018 and effective from year of assessment 2019/20, a salaries tax deduction of $8,000 (maximum) for the qualifying premiums paid for each insured person for each year of assessment 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 a tax deduction that is similar to one for insurance premiums paid under the VHIS for insurance premiums paid under other private medical insurance schemes.*

## E Comprehensive review of the tax system

Hong Kong's tax legislation (i.e. the IRO) has not undergone a comprehensive review since 1976. With the rapidly changing modes of doing business and the rise of digital economy, a comprehensive review of the IRO is necessary to ensure the provisions therein are compatible with the modern business environment and up-to-date to provide the necessary clarity and certainty to attract foreign businesses to Hong Kong.

On the other hand, 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.

As mentioned by the Institute in its previous budget submissions, 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 e.g. by considering the possibility of introducing new types(s) of indirect taxes or levies in Hong Kong in appropriate time

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) 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.*

**12 February 2019**
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