Tax policy and budget proposals

2018 - 19

Being Smart, Staying Ahead and Staying Healthy

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

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"*Being Smart, Staying Ahead and Staying Healthy* "

<u>Summary</u>

The Hong Kong Institute of Certified Public Accountants ("Institute")'s 2018-19 budget proposals, under the heading *Being Smart, Staying Ahead and Staying Healthy*, developed by the Institute's Taxation Faculty, focus primarily on tax policies and measures on the revenue side of the budget.

A summary of the proposals is as follows:

A. Business and sustainable development

1. <u>To strengthen Hong Kong's position as a financial centre</u>:

   a. Review the offshore fund exemption with a view to extending the scope to certain resident funds and making the conditions more flexible.

   b. Explore the potential regulatory and tax regime for digital currencies.

2. <u>To promote Hong Kong as a research and development ("R&D") centre and intellectual property ("IP") hub</u>:

   a. As start-up companies may not be generating profits in their early years, and so not benefit from any (super) deductions for expenditure on R&D, consideration should be given to granting them tax credits to incentivise such investment.

   b. Expand the scope of eligible R&D deductions to include, for example, technology for distributed ledger.

   c. Allow R&D activities, which may be sub-contracted, or partially subcontracted, for a fee, to entities outside Hong Kong, to be entitled to the deductions under section 16B of the Inland Revenue Ordinance, where the control and risk-taking activities take place in Hong Kong.

   d. Consider tax incentives for venture funds and angel investors to invest in start ups. This could supplement the efforts of the new Innovation and Technology Venture Fund Scheme, which is a time-limited initiative.

   e. Expand the range of IP rights eligible for capital expenditure deductions to encourage the creation and commercialisation of IP, and generally make tax policies on the exploitation of IP rights more flexible to attract increased investment from multi-national enterprises.

   f. Grant a unilateral tax credit for foreign withholding taxes paid on royalties, where the income is subject to tax in Hong Kong, in particular where there is no Comprehensive Avoidance of Double Taxation Agreement in place.

3. A more business-friendly environment:

   a. Introduce group loss relief.

   b. Introduce loss carry back.

   c. Introduce more comprehensive arrangements for electronic filing of tax returns.

4. Comprehensive avoidance of double taxation on income agreements:

   a. Prioritise markets more relevant and important to Hong Kong, including Australia, Taiwan, the United States of America, and also Belt-Road countries, including Singapore, the Philippines and Egypt.

   b. Explore the inclusion of provisions on the taxation of visiting academics and researchers, as part of a range of policy measures to encourage R&D and the development of centres of excellence.

5. Longer-term, sustainable development:

   a. To address concerns about pollution and global warming, the government should consider measures such as increasing the level of the cap on the exemption of first registration tax ("FRT") on electric private cars. The maximum FRT waiver could be reserved for persons who trade in a petrol-engine car for an electric car (or who are buying the family's first car).

   b. Explore possible incentives for commercial car parks to add more charging stations for electric vehicles.

   c. Revisit the issue of introducing electronic road pricing in congested areas at peak times.

   d. Consider additional incentives for R&D in renewable energy and "green" industries.

   e. In support of strategies and initiatives in the government's "Smart City Blueprint", tax incentives can be considered to promote retro-commissioning and building-based smart/IT technologies. Additional deductions could also be considered for businesses to undertake cybersecurity audits.

   f. Leverage on the Mainland's experience to facilitate and promote the development of green finance.

6. Resources for tax system development:

   a. Increase suitable resources available to the Inland Revenue Department and the Tax Policy Unit to help expedite some initiatives and address outstanding issues. Expand the current remit of the Tax Policy Unit to cover a broader range of tax policy issues and enlarge its composition to include private sector tax and industry experts, academics and government officials (including those on the investment promotion side).

B. Community measures

7. Housing affordability:

   a. Provide a deduction for rental payments for taxpayers whose primary residence is rented accommodation, subject to an annual limit of HK$100,000.

8. Encouraging young people to adopt a healthy lifestyle and increasing healthcare options:

   a. Promote a healthier lifestyle among children by giving their parents a deduction for expenditure incurred for participation in sports training classes or activities, at an annual cap of HK$12,000 per child.

   b. Provide a deduction for the cost of private health insurance premiums, with an annual cap of HK$12,000 per taxpayer and each dependant, to increase people's choice and encourage a better use of resources within Hong Kong's healthcare system.

9. Upgrading workforce skill sets:

   a. Allow the deduction for self-education expenditure to be used not only by the taxpayer but also by the taxpayer's dependants, if they are not eligible for the allowance in their own right.

   b. Consider additional incentives for employers to send employees on courses to upgrade their skills, particularly in the innovation and technology field.

10. Salaries tax allowances:

   a. Review and rationalise the levels of the personal allowances and salaries allowances for children, dependent parents or grandparents, dependent siblings, single parents and disabled dependants.

11. Ageing population:

   a. Encourage people to save more and earlier for retirement, by allowing taxpayers an additional deduction for voluntary contributions to their mandatory provident fund accounts, of up to HK$60,000 annually.

C. Tax base and public funds

12. Long-term stability of the tax base:

   a. Continue to consider options for broadening and stabilising the tax base given, e.g., the ageing of the population and the associated pressures on the tax system. This should be done as part of a broader and deeper review of Hong Kong's tax system.

Introduction

Hong Kong's tax system remains an important part of the city's attractiveness to investors. In the World Bank's latest report on the ease of doing business, Hong Kong ranks an impressive fifth out of 190 economies, albeit dropping one place due to perceived gaps in the local insolvency laws. The survey covers 10 areas. In relation to *paying taxes*, Hong Kong remains third, ahead of the four countries above it in the overall rankings (namely, New Zealand, Singapore, Denmark and South Korea).[1]

Hong Kong has few taxes, generally low tax rates and relatively straightforward tax legislation, in the Inland Revenue Ordinance (Cap. 112, "IRO"). However, tax rates, particularly corporate tax rates, are dropping in various major jurisdictions and competitor markets around the world. The major tax reforms recently passed by Congress in the United States ("US") will, among other things, reduce the corporate tax rate to 21% from 35%. The average top corporate rates in Asia and Europe in 2017 are 20% or lower[2] and some jurisdictions, such as the Republic of Ireland, have a much lower rate. Against this background, Hong Kong's corporate profits tax rate of 16.5% may not be the magnet for investment that it once was. Meanwhile, there are also both external and internal pressures tending to add complexity to Hong Kong's simple tax regime. One such development is the impact on Hong Kong of the Organisation for Economic Co-operation and Development ("OECD")'s base erosion and profit shifting ("BEPS") initiative and action plans. A commitment by the Hong Kong SAR Government ("the government") to comply with the BEPS minimum standards, including "Country-by- Country Reporting", requires more substantive transfer pricing rules to be put in place and a major bill has recently been introduced in the legislature. Hong Kong has also been under some pressure to adopt, and has adopted, the "Common Reporting Standard", which implements the international standard on the automatic exchange financial account information.

Internal pressures leading to greater complexity arise in part from the introduction of tax concessions and incentives to keep Hong Kong's economy competitive. The perceived need, at the same time, to close all possible loopholes and opportunities for abuse by incorporating specific, often convoluted, anti-avoidance measures alongside the incentives creates an impression that the government is giving with one hand and taking away with the other. Other jurisdictions do not see the need to introduce specific anti-avoidance measures with each new incentive and are either less concerned about closing every possible loophole than they are to allow the benefits to the economy to accrue, and/or are prepared to rely on general anti-avoidance provisions to take action if abuses do occur. The IRO already contains quite effective general anti-avoidance provisions and the government should be able to rely on these to discourage abuses without having to dilute the benefits of new tax incentives.

As indicated above, developments in international tax are having an increasing impact on Hong Kong's tax system. However, our responses to such developments

[1] *Doing Business 2018,* World Bank Group: http://www.doingbusiness.org/~/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB2018-Full-Report.pdf

[2] *Corporate Income Tax Rates Around the World 2017*, Tax Foundation https://files.taxfoundation.org/20170907092820/Tax-Foundation-FF559.pdf

often appear to be rushed and to suggest that Hong Kong does not have sufficient, expert resources in place to anticipate and prepare for the necessary changes. We would also suggest that there is a lack of suitable forums and mechanisms for the development of policy positions and responses that take account of Hong Kong's particular circumstances.

The upshot is that many changes have been made to our tax legislation and administration in recent years, which have added length and complexity to the IRO and, to some extent, increased uncertainty in the system. Meanwhile, other important areas of the tax system, such as the further development of electronic filing, have had to take a back seat and Hong Kong finds itself lagging behind most major markets in modernising its tax administration.

There are also pressures on the system from other sources, including budgetary constraints, the inherent limitations of a territorial tax system in a globalised world, the narrow tax base, the ageing population, as well as difficulties in achieving consensus on changes that may need to be made.

However, we note and welcome the action that has recently been taken in relation to several important measures, which are measures that the Institute has been advocating for some time. These include the setting up of a tax policy unit ("TPU"), which was announced in the 2017-18 budget in February, and a concessionary profits tax rate for small and medium-size enterprises ("SMEs"), as well as super deductions for spending on research and development ("R&D"), which were announced in the chief executive's policy address in October.

While the immediate focus of the TPU is on incentives for R&D and the two-tier profits tax regime, we continue to believe that Hong Kong needs to take a more holistic view of its tax regime and establish a consensus within the community on the direction of travel in the longer term. For example, many jurisdictions have moved towards increased reliance on indirect taxation. Some jurisdictions are looking closely at the effectiveness of their incentive arrangements (e.g., Canada), and others have done away with specific incentives altogether (e.g., Ireland). The United Kingdom ("UK") will no doubt have consider carefully whether its tax system remains fit for purpose as it leaves the European Union ("EU") and seeks to attract more investment to the UK, which in future is unlikely to come with automatic access to the EU.

Turning to the economic situation, Hong Kong's economy is currently faring well. Growth in the first three quarters was 3.9% and over the full year it is now forecast to achieve 3.7%, which is higher than the mid-point of the range forecast of 3-4%, announced at the time of the second quarter figures. The labour market remains in a state of full employment, with the seasonally adjusted unemployment rate falling to 2.9% in the period October to December 2017, which is the lowest in nearly 20 years. Underlying inflation for the fourth quarter remained moderate at 1.6%[3]. As result of a fiscal surplus for 2016-17 which exceeded the original forecast by HK$100 billion ($111 billion instead of the forecast $11 billion), the fiscal reserves stood at over $954 billion at the end of March 2017 and over one trillion dollars as November 2017[4].

[3] Census and Statistics Department, Hong Kong SAR Government. (Statistics for October- December 2017).
[4] Budget Consultation Information Pack, Hong Kong SAR Government (January 2018): https://www.budget.gov.hk/2018/consultation18/eng/pdf/Information_Pack.pdf

In a generally positive analysis of the current state of Hong Kong's economy, the International Monetary Fund recently stated:

"The Hong Kong SAR economy has gathered momentum since the second half of 2016 and over the course of 2017, in line with the global economic recovery. The macroeconomic outlook has improved significantly and a robust recovery is expected to continue. Nevertheless, the outlook faces multiple challenges, both external and domestic. Hong Kong SAR is well placed to navigate through these challenges given the strong buffers and robust policy frameworks in place, including ample fiscal reserves, strong financial regulatory and supervisory frameworks, and the Linked Exchange Rate System, which serves as an anchor of stability. Policies should aim to further build buffers and use them effectively, if needed, to secure sustainable growth over the medium term."

Mainland China's economy continues to show a solid performance, with the latest figures indicating year-on-year GDP growth of 6.9% for 2017 as a whole. The economies in Europe and the US have been picking up and securities markets around the world, including Hong Kong, have been achieving record highs on the back of what commentators are calling a synchronised and broadly based recovery.

<u>Proposals</u>

1. The growth and progress that we have experienced over the past few decades has put Hong Kong on the map, originally as a manufacturing centre and more recently as service centre, in particular an international financial centre and commercial hub. Hong Kong has built an enviable reputation as a good place to do business. At its core, the financial system, the legal framework and independent judiciary, and the talent pool, which have been critical in Hong Kong's successful development so far, will continue to provide the bedrock in a world that is being challenged to innovate and to question conventional approaches to operating businesses, and nurturing talent, while also facing demanding community and social needs.

2. A digital economy and a global market give businesses and people the ability to transcend traditional boundaries. In order to keep pace with the changes, at the international level, policy makers are moving to update their regulatory frameworks and best practices. Governments are also reviewing their laws to see how they should accommodate current business models and technological change; taxation is no exception.

3. Amid these challenging times, greater transparency is called for, especially in taxation, as jurisdictions compete to preserve their tax bases. This presents Hong Kong with opportunities not only to align itself with international standards and practices, but also to strategise and determine its best positioning in the global marketplace, and to consider adopting new policies that will help secure continuing success in the longer term. Other jurisdictions are working hard to enhance their tax regimes and make them more competitive. In this environment, Hong Kong must not be complacent or stand still, otherwise it risks losing its edge.

4. Recent initiatives by the government in the tax arena, including convening a high-level tax summit, are encouraging. The TPU, announced in last year's budget, and the proposals, referred to above, to lend support to SMEs and R&D,

are welcome responses to calls for change that have long been voiced by businesses and professionals. These are steps in the right direction. Yet, given the pace of change, it would seem that regular and timely evaluation of tax policies and measures is needed. Building on the momentum of these recent initiatives, the Institute suggests a number of proposals to enhance the tax regime, to facilitate business and improve the community's well-being.

A. Business and sustainable development

Financial services

5. The financial services industry, one of Hong Kong's pillar industries, faces keen competition. In addition, technological changes have intensified competition which is no longer limited to traditional competitors. While efforts have been made over the years to keep pace with developments, the tax-related changes have, at times, fallen short of the industry's expectations. As explained above, the effectiveness of some new laws rolled out together with specific anti-avoidance provisions is doubtful. It is also unclear how beneficial several of the recent concessions, such as those on captive insurance and Islamic finance, have been to the economy. Against this background, we propose that the following additional measures be considered:

   a. The offshore fund exemption should be extended to certain Hong Kong-resident funds, which would put offshore and onshore funds on a more equal footing. In addition, the conditions within the offshore fund exemption are viewed as being too restrictive when compared with regimes elsewhere (e.g., in relation to the exclusion of investment into Hong Kong companies and Hong Kong real estate).

   b. Bitcoin and other "cryptocurrencies" are a reflection of the rapid development and "disruptive" possibilities of the digital economy and modern information technology, which have leaped ahead of the ability of governments to respond to such changes in their regulatory and tax regimes. Hong Kong should not let itself be caught out. In recent times Bitcoin appears to be metamorphosing from an alternative means to purchase goods and services into an asset class itself. There are echoes of the global financial crisis in the general lack of understanding of the nature of the products and the risks they carry. Governments in some jurisdictions have started to act. Hong Kong should take action now to evaluate the situation and decide whether more regulation and investor protection are needed and what tax treatment should be applied to trading with and in digital currencies. Guidance should be given to investors and taxpayers to help them understand the risks and also the possible tax considerations when dealing with transactions involving digital currencies.

Research and development

6. R&D and intellectual property ("IP") are integral parts of a world where technology is ubiquitous and is increasingly customised to the specific needs of businesses. For R&D activities to flourish in Hong Kong, a more extensive set of policies may be necessary, including taxation-related and non-taxation-related support. Apart from the R&D super deductions recently announced, other aspects of the tax regime as it relates to R&D and IP are in need of review.

7. Start-up companies may not be able to enjoy R&D deductions as they will often not be generating profits in their early years; hence consideration should be given to allowing them to enjoy tax credits, which may be a more pragmatic way of incentivising investment into R&D for such companies.

8. Given the rapid changes in new technology, we suggest expanding the scope of eligible R&D deductions to include, for example, technology for distributed ledger.

9. The scope of the existing deduction under section 16B, IRO is quite restrictive, in that the R&D activities must take place in Hong Kong. We suggest that, instead of this, the test adopted should be where the "control", i.e., the so-called DEMPE (development, exploitation, maintenance, protection and enhancement) activities take place. This would also be consistent with the BEPS action plans and would enable R&D activities to be sub-contracted for a fee to entities outside Hong Kong, while the control and risk-taking activities remained in Hong Kong.

10. Consideration should also be given to offering venture funds and angel investors tax incentives to invest in start ups, which would accord with the strategies and initiatives in the government's Smart City Blueprint[5]. A 2017 EU study indicates that taxation can play a useful role in supporting this type of investment, suggesting that, for example, loss relief on a more favourable basis than the baseline would be one way to support the de-risking of such investments[6]. The new Innovation and Technology Venture Fund Scheme is a step in the right direction, but this is a time-limited scheme. Continuing incentives should be considered.

11. To encourage the creation and commercialisation of IP, at present, certain types of capital expenditure on prescribed IP rights are deductible under sections 16(1)(g), 16E and 16EA of the IRO. There are however, various other types of capital expenditure that would not fall under any of the IP rights, which may be necessary for different industries, e.g., the telecommunications industry, where significant expenditure may be incurred for certain rights to operate in Hong Kong; and such expenditure cannot be amortised as deductions. We propose, therefore, that the range of tax deductible IP rights be reviewed, and the policy towards the creation and commercialisation of IP should be made more flexible, generally, in order to attract more investment from multi-national enterprises to Hong Kong.

12. In addition, a unilateral tax credit should be granted for foreign withholding taxes paid on royalties, where the same income is subject to tax in Hong Kong. This is particularly important where there is no Comprehensive Avoidance of Double Taxation Agreement ("CDTA") in place. Hong Kong does not have CDTAs with some of its major trading partners, including the US and Australia.

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[5] *Hong Kong Smart City Blueprint*: *Smart People - Innovation and entrepreneurial culture*.
[6] *Effectiveness of tax incentives for venture capital and business angels to foster the investment of SMEs and start-ups,* European Union 2017: https://ec.europa.eu/taxation_customs/sites/taxation/files/final_report_2017_taxud_venture-capital_business-angels.pdf.

A more business-friendly environment

13. For a number of years, the Institute has been advocating measures that recognise how groups of companies actually operate, such as group loss relief and loss carry back. These are facilities commonly available in other jurisdictions. In addition, in relation to tax compliance, we propose that more comprehensive arrangements should be put in place sooner rather than later to enable all taxpayers to file tax returns electronically.

14. Group loss relief would provide a simple and very welcome measure of relief for corporate groups. For legitimate commercial reasons, e.g., to diversify the risk of different types of activities or for operating in different locations and environments, many business enterprises operate in the form of a group of companies. Some companies within the group may record allowable losses, whilst others have taxable profits. Groups that are in effect operating under one overall management should be permitted to offset losses incurred by one group company against profits made by another, subject to meeting suitable criteria. Anti-avoidance provisions could be introduced, such as specifying an appropriate definition of a group (for example, the relevant companies having to be wholly, or at least 90%, owned by the same parent company) and stipulating that losses may be transferred only to offset current profits, without any carry back of losses to past years' profits of other companies within the group. The Financial Services Development Council[7] is also recommending that group tax loss relief be made available in Hong Kong and has outlined criteria that should minimise the changes required to introduce this measure and also reduce any scope for abuse.

15. Loss carry back is another measure to encourage new investment ventures and business expansion. This could help relieve businesses of the financial burden arising from new investments, should they end up sustaining losses while gauging the viability of the investments. This facility would also improve business viability, as it could reduce the impact of fluctuations in a company's results, which could otherwise lead to cashflow difficulties, particularly during economic downturns.

16. The degree of connectivity available today means that many taxpayers are accustomed to making returns of different kinds online, and many may prefer filing their tax returns electronically. The existing limited framework for electronic filing needs to be extended to all taxpayers and accommodate common practices (e.g., filing by tax representatives). The move towards the introduction of comprehensive arrangements for electronic filing of tax returns should be more rapid, as little progress has been seen since the introduction of electronic filing for simple tax returns some years ago. This is particularly important for overseas investors. The current situation also affects the perception of Hong Kong as an advanced economy and world city.

Comprehensive avoidance of double taxation on income agreements

17. The government has been commendably proactive in recent years in its efforts to expand the network of CDTAs. Looking ahead, we recommend that priority be given to markets that are potentially more relevant and important given Hong

[7] FSDC Paper No. 33, September 2017.

Kong's role and positioning, which would include Australia, Taiwan, the US, and also countries within the Belt-Road initiative, including Singapore, the Philippines and Egypt.

18. The CDTAs of some jurisdictions contain provisions on the taxation of visiting academics and researchers, as part of a range of policy measures to encourage R&D and the development of centres of excellence in those jurisdictions. Hong Kong should explore whether including similar provisions in its CDTAs in future could help to bring about benefits here.

Longer-term, sustainable development

19. While the development of physical infrastructure continues to be necessary to promote greater economic development in Hong Kong, we should not lose sight of the longer-term impact on the environment and the quality of life of the population. To balance growth and sustainability, we recommend that attention also be given to the promotion of "green measures", including measures to address air borne pollution and traffic congestion. Pollution, which is often the other side of the coin of economic development and increasing affluence, has a negative impact on the long-term health of the community. This has been one of the downsides of the very rapid economic development of the Mainland and, acknowledging this, the Mainland Government has more recently been incentivising green industries. It has also become one of the world's largest issuers of green bonds. In Hong Kong, the government should also take this cue to address concerns about pollution and global warming.

20. Measures to be considered should include increasing the level of the cap on the exemption of first registration tax ("FRT") on electric vehicles. Since the relatively low cap was imposed in the previous budget, the number of private electric vehicle registered has dropped substantially. If the concern is that electric cars are not replacing petrol- and diesel-engine cars, but only adding to the overall number of private vehicles on the road, then the maximum FRT waiver (which was previously a full waiver, without a cap) could be reserved for persons who trade in an old petrol car for an electric car (or who are buying the family's first car).

21. We understand that, while the number of electric cars increased by several times while the full FRT waiver was in place, the increase in the number of electric charging stations increased much more slowly. If Hong Kong is to encourage the replacement of petrol-engine vehicles by electric vehicles, and it is worth noting that several European countries have now set target dates for phasing out petrol and diesel vehicles altogether, there must an appropriate infrastructure in place. This has to include ready access to charging a stations (and, potentially, penalties for people who park non-electric vehicles in those spaces). We recommend, therefore, exploring tax incentives for commercial car parks to add more charging stations for electric vehicles.

22. We propose that the issue of introducing electronic road pricing in congested areas, at peak times, be revisited. Various other cities around the world have introduced forms of electronic road pricing, and these have been found to be successful in reducing traffic congestion at peak times.

23. More generally, additional incentives should also be considered for R&D in

renewable energy and green industries. This may include incentives for constructing more energy-efficient buildings, supporting investment and R&D in renewable energy and environmental/ green industries, and promoting recycling. Referring again to the government's Smart City Blueprint, tax incentives can be considered to promote retro-commissioning and building-based smart/IT technologies[8]. Additional deductions could also be considered for businesses to undertake cybersecurity audits, particularly in industries which store and make use of large quantities of sensitive personal data.

24. As regards green finance, speaking at the Institute's Best Corporate Governance Awards presentation ceremony on 30th November, 2017, Secretary for Financial Services and the Treasury, Mr. James Lau, noted that "Mainland China was the largest green bond market in the world in 2016, with the total issuance amount reaching US$23 billion, over one quarter of the total global issuances. As of the end of September this year, China's year-to-date green bond issuance totalled US$21 billion, representing an increase of 11 per cent compared to the first nine months of 2016." He went to say: "As an international financial centre and the global RMB business hub, Hong Kong is well equipped to become the premier financing platform for Hong Kong and Mainland enterprises that seek to raise funds through green bonds. Our Chief Executive, Mrs. Carrie Lam, announced in the Policy Address in October that the Government will take the lead to issue a green bond in 2018-19 to promote the development of green finance and to demonstrate the Government's commitment to promote sustainable economic development." Hong Kong can make reference to the Mainland's experience, therefore, to facilitate and promote the development of green finance. Appropriate tax measures should be considered if this would help develop the market.

Resources for tax system development

25. The resources allocated to tax development and administration need to reflect the importance to Hong Kong's economic wellbeing of the tax regime and the increasing demands that are being placed on it. The Institute is of the view that sufficient, suitable resources for the IRD and the new TPU could help to expedite some initiatives and address outstanding issues. For example:

    a. There has been a quick succession of bills over the past few years relating to the implementation of international tax initiatives, in particular, the BEPS action plans and automatic exchange of financial account information. The government is perceived as being largely reactive to these developments but, with additional resources and expertise in place, developments such as these can be anticipated, allowing more time for discussion and debate within Hong Kong and for Hong Kong to formulate its own positions and determine how best to implement any necessary measures.

    b. Electronic filing of simple tax returns was introduced some years ago. The framework for e-filing needs to be further developed and to be able to accommodate existing practices (e.g., filing by tax representatives), so that e-filing of tax returns can be encouraged, as it is in other developed jurisdictions.

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[8] *See Smart City Blueprint* : *Smart Environment - Green and intelligent buildings, and energy efficiency*.

c. Concerns have been raised for some time by the Institute and others about whether key elements of our tax regime are becoming less certain and predictable, including offshore claims and the source of profits; the difficulties in finalising tax affairs, particularly where losses are involved; and the increasing reliance on non-statutory/ administrative practices to determine tax treatment (e.g., the tax treatment of unrealised gains after the Court of Final Appeal's decision in the case of *Nice Cheer Investment Ltd. v. CIR*[9] and the tax treatment of court-free amalgamations under the new Companies Ordinance). Uncertainties such as these can act as a brake on investment, as, all things being equal, businesses naturally prefer to invest where they can gauge their tax liabilities. We believe that there is scope for more codification (e.g., rules on the source of profits) and that legislation should be introduced where necessary to improve clarity and certainty. In the current environment, IRD Departmental Interpretation and Practice Notes ("DIPNs") have become a more important tool of interpretation. In addition, therefore, there should be a more clearly defined mechanism for consulting on new and revised DIPNs.

d. As far as the TPU is concerned, while we welcome its establishment, its current remit and staff resources appear to be quite limited. It has been focusing, initially, on certain specific incentives, namely R&D and the two-tier profits tax arrangements. While these are important initiatives, we hope that it will be in position to broaden its remit, and its composition and range of expertise to be able to research into the long-term needs and competiveness of Hong Kong's tax system, including issues such as the long-term sustainability of the source principle; broadening the tax base; reviewing the effectiveness of existing incentives and modernising the legislation. In relation to its composition, the Institute has previously suggested a more diverse membership for the TPU, including private sector tax and industry experts and academics, as well as government officials (including those on the investment promotion side of the government).

26. The above initiatives require resources and we believe that the fundamental importance of the tax system to Hong Kong's economy and the need to ensure that we have system that will be fit for decades to come warrant a reasonably substantial investment of resources. We note in passing that, as there is no requirement for charities to register in Hong Kong, IRD retains a responsibility for assessing whether applicants objects meet the criteria to be eligible for the tax exemptions available to charitable and community organisations. This does not seem to be the best use of IRD's resources. We note also that the Law Reform Commission has recommended more extensive regulation of charities[10]. This could be further explored as it could, potentially, free up valuable IRD resources for the pressing demands of developing Hong Kong's tax system and administration.

27. Generally, we consider that the government should be more willing to look at

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[9] FACV 23/2012.

[10] *Law Reform Commission Report on Charities,* press release, 6 December 2013: http://www.hkreform.gov.hk/en/publications/rcharities.htm

engaging outside expertise in the tax and commercial fields, which is something that is done in other jurisdictions. While we are aware that the government commissions consultancies from time to time, on a project basis, there should be a clearer and more transparent process. In addition, the idea of two-way placements could be considered, to bring private sector practitioners and specialists into the IRD and/or Financial Services and the Treasury Bureau (Treasury Branch) and to offer government officials secondments in the private sector. Safeguards can be put in place to ensure that no conflicts of interest arise.

B. Community measures

Housing support

28. Purchasing homes, at the current prices, is beyond the reach of many taxpayers. For taxpayers who are renting their primary residence, we propose that they be offered an allowance to be used in relation to rental payments. This should be subject to an annual limit of HK$100,000, equivalent to the home loan interest deduction. Employees who are already claiming a housing allowance from their employers, and taxpayers who have previously claimed their full entitlement of the home loan interest deduction, should not be eligible for this benefit.

Encouraging young people to adopt a healthy lifestyle and increasing healthcare options

29. Adopting an active, healthy lifestyle from a young age can increase health benefits in later life and also can help reduce healthcare costs in the long term. To encourage greater interest and participation in sport activities, we recommend that a deduction be allowed to cover expenditure incurred by parents for their children to take part in approved extra-curricular sports training classes or activities, at an annual cap of HK$12,000 per child.

30. To provide additional, and potentially better, healthcare options for the community, we recommend allowing a deduction for the cost of private health insurance premiums, with an annual cap of HK$12,000 per taxpayer. In addition, taxpayers should also be allowed to claim deductions for premiums paid on behalf of a dependent spouse and children, subject to a similar cap per dependant. This measure can provide greater choice to taxpayers and help to encourage a better use of resources in Hong Kong's healthcare system, reducing some of the pressure on the public health system.

Upgrading workforce skill sets

31. To support the upgrading of skills in order to improve opportunities for and the competitiveness of the workforce, the Institute recommends reviewing the scope of the deduction for self-education expenses currently capped at HK$100,000, and making it more flexible. We recommend that any amount not taken up by the taxpayer should be available for use by the taxpayer's dependants. It would therefore be available to the taxpayer's spouse, for, e.g., training to join or re-join the workforce, or the taxpayer's children between 18 to 25 years old, who are not in full-time education and not taxpayers themselves, or not earning enough to be able to claim the deduction in their own right. In the light of recent economic and technological trends, the deduction should be able to be used for

courses offered by reputable providers on innovation and technology, or starting a business and entrepreneurship, which may not fit squarely into the IRO criteria, of being undertaken "for the purpose of gaining or maintaining qualifications for use in any employment."

32. Specific tax incentives could also be considered for employers to send employees on qualifying courses to upgrade their skills, particularly in the innovation and technology field. Such training should also not be treated as a taxable perquisite in the hands of employees.

Salaries tax allowances

33. In recent years, the allowances for children and other dependants have been revised at different times and with different level of increases. For example, child allowances have doubled since 2008-09, while allowances and additional allowances for dependent parents and grandparents have increased by 53.3% and those for dependent siblings and disabled dependants by only 25%. The basis for these adjustments should be made more transparent. The level of the existing allowances for single and married persons, children, dependent parents or grandparents, dependent siblings, single parents and disabled dependants should be reviewed and rationalised. Thereafter, any adjustments should be made on a more transparent basis and aligned with each other, where appropriate. Where there are sound policy, or other, reasons for differential adjustments, these should also be made clear. Pending a review, we propose that these allowances should all be increased broadly in line with inflation.

Ageing population

34. The government projects that compared with 1981, when 10.3 members of the working population (aged 15-64) supported one person over 65, by 2041, there will be only 1.8 members of the working population supporting one elderly person. In the face of a rapidly ageing population, it is highly desirable for members of the community to start saving more and earlier for their retirement. We propose, therefore, that taxpayers be allowed an additional deduction of up to HK$60,000 annually for voluntary contributions to their mandatory provident fund accounts. To ensure that these tax-exempt contributions would be used only for their intended purposes, they could be made taxable if withdrawn for non-approved purposes before retirement.

Disabled access to commercial buildings

35. Hong Kong continues to lack facilities for wheelchair/ disabled access to commercial buildings, particularly older buildings, and on public transport, albeit the MTR is adding more lifts into new stations. With the ageing population, this problem is likely to be exacerbated. We propose, therefore, a 100% deduction for qualifying expenditure to retro-fit commercial buildings for disabled access.

C. Tax base and public funds

Long-term stability of the tax base

36. It is a given that the government is not currently short of money. In the 2016-17 budget, the Financial Secretary forecast a surplus of $11 billion in the

consolidated account for 2016-17. In the event, the surplus turned out to be $111 billion, $100 billion more than the original forecast. As at the end of March 2017, the fiscal reserves stood at $954 billion (and currently exceed one trillion dollars) and another very large surplus is expected in 2017-18. However, as indicated above, the demands on the fiscal system will increase substantially over time, particularly as the size of the taxpaying workforce rapidly diminishes relative to the size of the retired population. Therefore, options for broadening and stabilising the tax base should continue to be considered. In addition to the "greying" of the population and the attendant rise in health care costs, other factors, such as the increasing volatility and unpredictability of key sources of revenue, including land premiums (bearing in mind that the government is committed to increasing the land supply by holding on a regular auctions, etc.), mean that the existing system is likely to come under increasing strain. While proposals for a goods and services tax ("GST") have received very limited support in the past, this issue has not been revisited for over a decade and, moreover, a goods and services tax is not the only option for broadening the tax base. Examples of jurisdictions that have successfully introduced a GST can be studied (e.g., New Zealand and Singapore). Options other than a GST should also be researched. This should be done as part of a broader and deeper review of Hong Kong's tax system, as mentioned above.

Appendix 1: Proposed changes for salaries tax allowances and deductions

Allowances and deductions	Existing (HK$)	Proposed (HK$)
Allowances[11]:		
- Basic	132,000	134,640
- Married person	264,000	269,280
- Child (annual, each dependant)	100,000	102,000
- Child (initial, each dependant)	100,000	102,000
- Dependent brother or sister (each dependant)	37,500	38,250
- Dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the government's disability allowance scheme	46,000	46,920
- aged 55 or above but below 60	23,000	23,460
- Additional dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the government's disability allowance scheme	46,000	46,920
- aged 55 or above but below 60	23,000	23,460
- Single parent	132,000	134,640
- Disabled dependant (each dependant)	75,000	76,500
Deductions, maximum limit:		
- Self-education expenses	100,000 limited to claims by taxpayer	100,000 extended to claims by the taxpayer's spouse, or children (aged 18 to 25 studying part-time, or not earning enough to claim directly themselves)
- Voluntary MPF contributions	-	60,000
- Private healthcare insurance premiums		
- taxpayer	-	12,000
- additional dependent spouse/ children (each dependant)	-	12,000
- Rental payment for taxpayer's primary residence	-	100,000

[11] For illustration purposes, the proposed allowances are increased on the assumption that the benchmark is set at current levels and the inflation rate is 2%.

Appendix 2: Proposed changes in salaries tax allowances and deductions - impact on a typical individual

Example: Single person

This example illustrates the impact of[12]:

- an increase of basic allowance to HK$134,640
- a deduction for voluntary MPF contributions of HK$15,000[13] (annual limit of HK$60,000)
- a deduction for private healthcare insurance premiums with annual limit of HK$12,000
- a deduction of rental payment with annual limit of HK$100,000

	Existing		Proposed		Savings	
	(HK$)		(HK$)		(HK$)	(%)
Income		300,000		300,000		
Allowances/ deductions:						
Basic allowance	132,000		134,640			
Mandatory MPF contribution	15,000		15,000			
Voluntary MPF contribution	-		15,000			
Private healthcare insurance	-		12,000			
Rental payment	-		100,000			
Total allowances/ deductions		147,000		276,640		
Net chargeable income		153,000		23,360		
Tax payable		12,510		467	12,043	96%

[12] Assumptions are as for Appendix 1.
[13] Assuming an additional voluntary contribution of the same amount as the person's statutory contribution.

Appendix 3: Proposed changes in salaries tax allowances and deductions - impact on a typical family

Example: Married person with spouse separately assessed, two children who are not newborns, and living with two dependent parents over 60 years of age throughout the whole year

This example illustrates the impact of[14]:

- an increase of basic allowance to HK$134,640
- an increase in child allowance to HK$102,000
- an increase in dependent parents allowance and additional allowance to HK$46,920
- a deduction for voluntary MPF contributions of HK$18,000[15] (annual limit of HK$60,000)
- a deduction for private healthcare insurance premiums with annual limit of HK$12,000

	Existing (HK$)			Proposed (HK$)			Savings (HK$)	Savings (%)
Income			650,000			650,000		
Allowances/ deductions:								
Basic allowance		132,000			134,640			
Child allowance	2 children 100,000 each	200,000		2 children 102,000 each	204,000			
Dependent parent allowance and additional allowance	2 parents 92,000 each	184,000		2 parents 93,840 each	187,680			
Mandatory MPF contribution		18,000			18,000			
Voluntary MPF contribution		-			18,000			
Private healthcare insurance		-		1 taxpayer and 2 children 12,000 each	36,000			
Total allowances/ deductions			534,000			598,320		
Net chargeable income			116,000			51,680		
Tax payable			7,170			1,368	5,802	81%

[14] Assumptions are as for Appendix 1.
[15] See footnote 13.