Tax policy and budget proposals

2016 - 17

A modern tax system, a stronger economy and a closer community

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

Taxation Faculty Executive Committee 2015

Chair:	Florence Chan
Deputy Chair:	Anthony Tam So Kwok Kay
Members:	Sarah Chan William Chan Patricia Gooi Gary James Nelson Lam Edward Lean May Leung Curtis Ng Percy Wong Kitty Yip
Secretaries:	Peter Tisman Elena Chai

Budget Proposals 2016-17 Sub-committee

Convenor:	Curtis Ng
Members:	William Chan Sarah Chan Edward Lean May Leung So Kwok Kay
Secretaries:	Peter Tisman Elena Chai

Table of Contents

Tax policy and budget proposals 2016-17

A modern tax system, a stronger economy and a closer community

Key proposals

The Hong Kong Institute of CPAs' 2016-17 budget proposals, under the heading *A modern tax system, a stronger economy and a closer community*, developed by the Institute's Taxation Faculty, focus on tax policies and measures on the revenue side of the budget.

With a focus on enhancing the coherence and effectiveness of the tax regime, to benefit the economy and the community, it is recommended that a tax policy unit be established to complement the work of different government agencies. Comprising taxation and industry experts, economists, academics, and government representatives, it should study how taxation could drive the economy with the aim to achieve a more holistic system that balances the revenue base, and the needs of the economy and the community. The key proposals are:

Tax policy

1. Set up a tax policy unit or group comprising tax and industry experts, and other stakeholders, to review the competitiveness of Hong Kong's tax system and improve and speed up the process of tax policy development.

2. Allocate adequate resources, in particular to the Inland Revenue Department and the Board of Review, to reflect the increasing demands on, and the importance of, the tax system and effective tax administration.

For the economy

3. Proactively plan tax incentives to keep pace with market developments, and conduct post-implementation reviews on their effectiveness in generating more economic activity.

4. Clarify interpretation of tax rules, by regular updates of the departmental interpretation and practice notes and fuller use of the advance ruling system.

5. Improve the predictability of tax affairs, by shortening the time-bar period and finalising the status of tax losses within a definite period.

6. Study options for broadening the tax base, having regard to the projected future demands on the tax system.

7. As support for the small and medium enterprises sector, reduce the corporate profits tax rate to 15% for companies whose gross income does not exceed HK$5 million.

8. Introduce loss carry-back provisions.

9. Introduce group loss relief provisions.

10. As the Mainland Government develops the "One Belt One Road", initiative, consider expanding the network of double tax agreements to the countries included within the initiative.

For the community

11. Allow a deduction for rental payments for a taxpayer's primary residence, with an annual cap of HK$100,000, to assist those who cannot afford their own homes.

12. Review and rationalise the level of the different salaries tax allowances. In the meanwhile, increase the allowances broadly in line with inflation.

13. Allow a deduction for private healthcare insurance premiums, with an annual cap of HK$12,000, and additional deductions for premiums paid to cover dependent spouses and children at a similar cap per dependant, to encourage more efficient use of the public and private health care services.

14. Allow deductions for individual taxpayers' voluntary contributions to their mandatory provident fund schemes, with an annual cap of HK$60,000, to help people plan better for their retirement.

15. To support the upgrading of skill sets, extend the application of the deduction for self-education expenses, so that any portions unused by a taxpayer can be used by the taxpayer's spouse or children, who are not in full-time education and not otherwise able to claim it for themselves.

Introduction

1. The Hong Kong Institute of CPAs' submission on the Policy Address and Budget focuses on tax policy and budgetary measures.

2. Over the past several decades, Hong Kong has developed from being a manufacturing-based economy to, primarily, a service-based economy and has become an important international financial centre. In the past 15 or so year, Hong Kong has served increasingly as a fund-raising centre for Mainland China's rapidly growing economy and industrial development. While Hong Kong remains a very popular destination for initial public offerings, and is likely to top the list again in 2015, after enjoying an extended period of high economic growth before the turn of the millennium, Hong Kong's trend growth rate has slowed down, averaging 3.4% per annum in the 16-year period since 1997[1].

3. Regionally, Hong Kong's industries face keen competition from neighbouring jurisdictions. In the shipping and logistics sector, for example, over the past decade, Hong Kong's ranking among the world's busiest container ports has slipped from first to fourth place[2]. Other locations are also beginning to challenge Hong Kong's position as the pre-eminent international financial centre in the region[3]. Meanwhile, at the global level, concerted action from some of Hong Kong's main trading partners, seeking to protect their own revenue bases, may also have an impact on Hong Kong's long-standing role and advantages as a low tax regime.

4. The pressure on Hong Kong's attraction as a low tax regime may stem from a number of sources. In today's mobile global economy, businesses may choose to establish themselves in other developed markets, rather than Hong Kong, as other countries are progressively lowering their corporate tax rates (for example, the United Kingdom ("UK") where the main rate of corporation tax is due to fall to 18% in 2020).

5. Pressure may also stem from coordinated action, spearheaded by international organisations, in particular the Base Erosion and Profit Shifting ("BEPS") initiative rolled out by the Organisation for Economic Co-operation and Development ("OECD"), which is expected to lead to the adoption of more uniform rules and regulations, including an increased flow and exchange of information and a wider use of transfer pricing rules. One of the main objectives is to align taxing rights more closely with what are considered to be the main centres of economic activity. This may have the effect of reducing Hong Kong's appeal as an intermediary

---

[1] Report of the Working Group on Long-Term Fiscal Planning (Phase One), p.37, para.2.10
[2] Research Office Legislative Council Secretariat, Research Brief, Issue No.3 2014-2015, Four Pillars and Six Industries in Hong Kong: review and outlook, February 2015, p.3, figure 3
[3] Ibid., pp.4-5, para.2.5

jurisdiction in international trade, commerce and investment, with the consequential loss of economic activity that this may entail.

6. Against the background of a maturing economy, an ageing population, as well as the potential limitations of the fiscal structure[4], the Working Group on Long-Term Fiscal Planning ("WGLTFP"), set up by the government, looked into Hong Kong's fiscal sustainability, based on projections on economic growth, government revenue and government expenditure[5]. The conclusion reached by the working group was that, if present trends continue and no remedial action is taken, a structural deficit is looming and the scale of the deficit could be serious[6].

7. Hong Kong has an established and strong foundation, which includes the rule of law and a respected judicial system, a skilled labour force and a well-developed financial system. These are some of the important building blocks for Hong Kong to develop a strategic vision for the future and to reposition itself, as appropriate. The four pillar industries (i.e., trading and logistics, financial services, professional and producer services, and tourism), which have been the main economic drivers, have seen their growth peak and, since 2007, have lost some momentum[7]. The six industries identified as having the potential to diversify the economy (i.e., cultural and creative, education services, medical services, environmental, innovation and technology, and testing and certification services), have seen only modest growth[8].

8. Achieving and maintaining the right balance in the allocation of resources between economic and community development, while ensuring long-term fiscal health, is a complex matter. A range of initiatives is needed, and the Institute recognises that there are various government actions that aim to help in achieving these objectives. In its report, the WGLTFP recommended enhancing the tax regime to ensure that the tax structure can meet the long-term needs of Hong Kong and address the fiscal pressures in the long run[9]. Before that, the report of the Bauhinia Foundation also made similar recommendations.

9. In terms of attracting investment to Hong Kong, a simple, low-rate tax system has historically served us well and has been one of the jewels in Hong Kong's crown. However, with a number of countries around the world reducing their corporate tax rates and moving further towards quasi-territorial systems of taxation (i.e., excluding foreign profits), in future, Hong Kong's headline tax rates may not stand out as being much lower than those in competing markets. Further, the revenue

---

[4] Report of the Working Group on Long-Term Fiscal Planning (Phase One), pp.9-10, para.1.5
[5] Ibid., p.iii, para.2
[6] Ibid., pp.xxviii-xxxi, para.40-43
[7] Research Office Legislative Council Secretariat, Research Brief, Issue No.3 2014-2015, Four Pillars and Six Industries in Hong Kong: review and outlook, February 2015, p.1, para.1.1
[8] Ibid, p.7, para.3.1
[9] Report of the Working Group on Long-Term Fiscal Planning (Phase One), p.168, para.7.31

legislation in Hong Kong has not been reviewed in depth for 40 years and it is badly in need of maintenance and updating. The Inland Revenue Ordinance (Cap. 112) ("IRO") was drafted for a different economic world and the greater mobility of people, goods, services, capital and information nowadays means it is being applied to situations that it was not designed to deal with. Hong Kong has tended to adopt the position reflected in the saying, "if it ain't broke don’t fix it", while making certain specific and piecemeal changes in response to pressure and lobbying from different interest groups. However, the premise that there is no problem with the current legislative framework is questionable and it has led to some incoherence in the tax system.

10. Tax is of course not the only issue, but now is a good time to take stock, and see what changes may need to be made to enhance the tax system, further develop the economy and foster a closer community. If we do not consider what continues to be good about the system and should be retained, and what needs to be changed, it will not be fit for purpose in the years ahead. There is already sufficient evidence of the need for updating our tax system. The onus cannot be on the Inland Revenue Department ("IRD") to do this. IRD's primary role is tax collection, revenue protection and administration of the law as it is and, as such, the department cannot be expected to play a pivotal role in driving tax policy.

Detailed proposals

A. Tax policy

11. The Institute advocates establishing a tax policy unit or group, which should include as members taxation and industry experts, economists, academics, as well as representatives from the Financial Services and the Treasury Bureau ("FSTB"), the IRD and investment promotion agencies. This is a recommendation that we have made before, and which others in the community have also called for, but we see it as being sufficiently important to continue to urge for its implementation. In developing tax policy proposals, the unit could interact with and complement the work of other bodies such as the Economic Development Commission.

12. We propose a permanent unit, housed within the administration, but, if deemed preferable, it could be set up initially as a project-orientated group, with its priority projects to include:

    - Studying and making recommendations on the overall competitiveness of Hong Kong's tax regime, including the setting of tax rates and desirability of industry/ market specific tax incentives.

    - Reviewing and making recommendations on the IRO, to accommodate today's business models and to provide clarity of treatment, where necessary.

13. Other jurisdictions adopt differing models for tax policy formulation and development and differing approaches to where the responsibilities lie. Two examples, the UK and Singapore, are discussed briefly below.

14. In Singapore, there are several key governmental statutory bodies that drive tax policy, namely: the Economic Development Board ("EDB"), which focuses on business and economic development generally, the Monetary Authority Singapore ("MAS"), which focuses on financial services policy, and the Maritime and Port Authority Singapore ("MPA"), which focuses on shipping. The EDB through its planning and policy unit, however, leads the development of tax policy and does so in the context of its mandate to drive and execute strategies necessary to attract foreign direct investment and spur economic growth.

15. The Inland Revenue Authority of Singapore ("IRAS") is the tax administrator in Singapore and maintains and administers, rather than develops, the tax policies and incentives. One of IRAS' main competencies is to administer and ensure the compliance of the statutory incentives (those that are broad-based and available to all taxpayers). Sometimes it does this in collaboration with the associated government agency. Discretionary tax incentives are administered by the

government statutory boards themselves including the EDB, MAS and MPA. Businesses seeking discretionary incentives apply directly to the relevant boards. IRAS and EDB have complementary functions – the EDB focuses on development of incentives and satisfaction of incentive conditions, whilst the IRAS administers the tax treatment and focuses on how tax incentives interact within the wider tax framework (e.g., treatment of expenses or transfer pricing issues).

16. In the UK, Her Majesty's Treasury ("HMT") is responsible for driving tax policy as the government's economic and finance ministry. It is responsible for strategic oversight of the UK tax system, including direct, indirect, business, property, personal tax and corporation tax. Its main priorities include making corporate taxes more competitive. Her Majesty's Revenue and Customs ("HMRC") is the tax administrator in the UK and administers taxes but has a limited role in policy making.

17. At present in Hong Kong, the FSTB drives the development of tax policy and is advised by the IRD. However, we note that the IRD's stated mission is that they are committed to:

- collecting revenue efficiently and cost-effectively
- providing courteous and effective service to the taxpaying public
- promoting compliance through rigorous enforcement of law, education and publicity programmes
- enabling staff to acquire the necessary knowledge, skills and attitude, so that they can contribute their best to the achievement of the department's vision.

18. Therefore, the advice and recommendations that are made by the IRD must be considered in the context of their mission, which is to act as effective revenue collectors, rather than to promote policies that drive economic growth. Hence, our recommendation for a separate, and ideally permanent, tax policy unit, with mandate to develop tax policies that are coherent with the scheme of taxation in Hong Kong with the aim of driving economic growth.

19. For this tax policy unit to be effective the IRD should be appropriately represented, as their officers are closest to the operational aspects of tax and have substantial knowledge on Hong Kong tax law. Their input will be vital to the development of coherent tax law. However, they should do so within the context of a policy unit with a remit that focuses primarily on economic growth rather than enforcement and collection of revenue under existing tax laws.

20. Having a separate tax policy unit as described above may help to address some of the other issues that appear to arise from current policy making. One such issue is that it is not clear that certain initiatives have been fully appraised in terms of their benefit to the economy versus the time and resources required to

implement them. For example, while it is still relatively new, the introduction of tax rules in respect of alternative bond schemes ("ABS"), which establishes the tax treatment for sukuk as "debt" and is aimed at facilitating a market in Hong Kong for Islamic bonds, has increased the length and complexity of the IRO and Stamp Duty Ordinance (Cap. 117) significantly, without, to date, leading to a significant number of transactions.

21. In the UK, as an example, all new tax legislation is accompanied by Tax Impact and Information Notes that set out, amongst other things, the anticipated impact on tax revenue over the coming five years (certified by the Office for Budget Responsibility), the economy, individuals and households and businesses, as well as any change in operational costs for HMRC. While we expect that some of this kind of analysis is being undertaken by the FSTB currently, a dedicated tax policy unit would ensure that this thorough assessment of tax policy changes takes place and is available to members of Legislative Council to aid their deliberation on new laws, and to the public and the IRD to assist in their interpretation of new laws.

22. In addition, to the above, in other jurisdictions, arrangements are in place to seek the input of business and other stakeholders into the development of tax policy. For example, the HMT has set up a Business Forum on Tax and Competitiveness (see:https://www.gov.uk/government/groups/business-forum-on-tax-and-competitiveness) which is chaired by the financial secretary to the treasury and includes finance directors, chief financial officers, chief executives or chairmen of some of the UK's leading companies, the director-general of the Confederation of British Industry, as well as the economist heading the Oxford University Centre for Business Taxation. The forum meets three or four times a year. Officials from HMT and HMRC attend meetings in order to test policy direction and possible proposals, share information on government views and listen to forum members' views

23. The role and scope of the forum is:

- To facilitate an open discussion of the issue of tax in the context of the UK's international competitiveness.

- To provide the UK Government with views from a range of different multinational businesses that can be used to inform the tax reform process and proposals.

- The focus of the forum is on long-term and strategic tax issues in the context of the UK's international competitiveness.

- It complements wider consultation as part of the UK Government's aim to have an open and transparent approach to tax policy.

24. Turning to the situation in Hong Kong, as regards evidence of the need for a review of the IRO and a study of Hong Kong's tax competiveness, the Institute would like to draw the government's attention to the following areas where we believe legislative changes or reviews are called for:

(Further information about some of these issues is also contained in other sections of this submission, as indicated.)

i. To take account of the tax impact of the new Companies Ordinance (see paragraph 28.iii, below).

ii. To provide for the introduction of comprehensive arrangements for electronic filing of tax returns. Most major jurisdictions already have this in place.

iii. To re-examine the time bar provisions to give finality to tax positions (see paragraph 29.i, below).

iv. To address uncertainties arising from court decisions and disputed interpretations of these (see paragraph 28.i and ii, below).

v. To review the effectiveness of tax incentives, including headline tax rates. Post-implementation, the group should review incentives to assess how useful they have been in generating more economic activity. This is currently one of the roles of the EDB in Singapore in determining which tax incentives to withdraw, replace, renew or develop in future. The findings of such studies could provide valuable information to help rationalise existing incentives and to inform discussion on future possible incentives. For example, as mentioned above, the tax legislation on ABS was announced in the 2009-10 budget and finally took shape in 2013. However, since its introduction, the market response seems to have been lukewarm, including two issuances by the government in 2014 and 2015[10]. Similarly, the impact of the legislation reducing the profits tax rate for captive insurance is also unclear.

vi. To consider whether the balance is right between offering incentives to facilitate business in Hong Kong and introducing extensive anti-avoidance measures? Many practitioners currently doubt whether it is. It is considered that anti-avoidance measures have made the IRO tax legislation much more complex and, perhaps, unnecessarily so, e.g., in relation to:

- Deductions for intellectual property rights ("IPR").
- Offshore fund exemptions.
- ABS

[10] Government of the Hong Kong SAR, Half-yearly Economic Report 2015, p.55, para.4.16

This may also be one reason why certain incentives do not appear to be very effective in generating economic activity post implementation.

vii. To consider and prepare for the possible impact of major international developments that will affect Hong Kong, such as the OECD's BEPS initiative and action plans (see paragraph 25.i, below). For example, Hong Kong needs to be prepared for issues such as the following:

- Transfer pricing is a big part of BEPS and Hong Kong has no formal transfer pricing rules. In contrast, Singapore has much more extensive guidelines and information available on transfer pricing.

- Demands internationally for more extensive and frequent exchanges of taxpayers' information and the resources that this may require.

- Hong Kong should also be more proactive in its response to actions that could damage its reputation, such as inclusion the European Union's tax black list and the recent placing of Hong Kong, as second, after Switzerland, on the Tax Justice Network Financial Secrecy Index.

<u>Adequacy of resources</u>

25. The resources allocated to tax development and administration need to reflect the importance to Hong Kong's wellbeing of the tax regime and the increasing demands that are being placed on it. The Institute is of the view that resources for the IRD and Board of Review (BOR) are a factor in how expeditiously some initiatives can progress. They include:

i. Responding to the BEPS initiative. As explained above, it is timely for Hong Kong to strengthen its transfer pricing regime by enacting a legislative framework, supported by additional interpretative guidance. For example, the IRO does not clearly allow the CIR to make transfer pricing adjustments outside of comprehensive double taxation agreements ("CDTAs"). There is also a need to clarify the interface between the "source" principle and transfer pricing rules and to define documentation requirements.

ii. 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 is possible, and even commonly used, as it is in other developed jurisdictions.

iii. The Institute's submission on the Inland Revenue (Amendment (No. 3) Bill recommended that a full-time panel of tax experts be established to hear the more complex tax cases before the BOR. This would equip the BOR with a high level of tax knowledge and experience whilst addressing the issue of potential conflicts of interest, given that the panel members would be employed full time on the BOR. The question of whether the BOR is equipped to handle complex cases, of which there is an increasing number, was raised by the Court of Final Appeal ("CFA") in the case of ING Baring Securities Ltd. v. Commissioner of Inland Revenue ("CIR")[11]. Acknowledging the advantages of the existing simple and inexpensive procedures, simple or non-complex cases could continue to be dealt with by a part-time general panel of members, comprising a number of deputy chairmen and members.

We suggest that the general panel should be smaller than the present pool of members to ensure that the general panel develops more expertise in taxation matters. When members of the proposed full-time, specialist panel are not engaged in complex cases, they could sit as chairmen to hear non-complex cases, which would ensure greater cohesion in the BOR's administration, and that the decisions of previous BORs, would be more likely to be followed or distinguished.

B. For business and the economy

26. A more competitive tax system and efficient administration should overall help to contribute to the sustainability of the economy. The Institute suggests introducing the specific measures below to develop local businesses and attract overseas businesses.

<u>Tax incentives</u>

27. When considering Hong Kong's business and tax competitiveness, tax incentives should take account of the changing business environment. For example:

    i. To entrench its position as an international financial centre, Hong Kong should consider timely tax measures that are in tune with industry trends. This may include:

    - Considering extending the offshore fund exemption to certain Hong Kong-resident funds, which would put offshore and onshore funds on a more equal footing. Singapore, for example, also provides an income tax exemption for on-shore funds that meet certain requirements.

---

[11] FACV19/2006

- Providing certainty of tax treatment for distributions on Additional Tier 1 instruments that form part of the regulatory capital requirements for Hong Kong banks, under Basel III. In this regard, we welcome the recent introduction of legislation into the Legislative Council aimed at addressing this issue.

ii. To promote Hong Kong's development as an intellectual property trading hub[12], consideration should be given to a range of possible tax measures, e.g.:

- For royalties, a unilateral tax credit should be granted for all foreign withholding tax paid that is subject to tax in Hong Kong, where there is no CDTA.

- For research and development ("R&D") conducted in Hong Kong, "super deductions" of 150% of the cost should be considered. Super deductions are offered in the Mainland, Australia, Singapore and the UK. In addition, deductions should be allowed for costs relating to R&D activities outsourced to external parties, and to IPR provided to third parties to produce goods outside Hong Kong. With the setting up of the new Innovation and Technology Bureau, this is an appropriate time consider additional support and incentives for innovation and R&D in Hong Kong. As indicated below, one significant sector in which innovation and technology should be supported and incentivised in future is "green industries".

iii. Energy conservation, renewable energy and "green" industries:

- With agreement reached on the Paris climate accord on 12 December, the world has committed to future of lower carbon intensity. As an advanced and progressive international city, a significant economy and major energy user, in terms of consumption per head, Hong Kong should increase its efforts to encourage energy conservation, including constructing more energy-efficient buildings, supporting investment and R&D in renewable energy and environmental/ green industries, and promoting recycling. There are already some tax incentives in place aimed at improving the environment, such the waiver of first registration tax ("FRT)" on electric vehicles and enhanced deductions for capital expenditure on environmental protection facilities, and others should be considered. We suggest that the government, in consultation with relevant stakeholders, draw up a coordinated set of policies on energy

---

[12] Budget speech 2014-15, para.99

conservation, reducing carbon intensity and environmental improvement, in which tax incentives and concessions can play a role.

<u>Clearer rules</u>

28. Clear interpretation of tax rules would give businesses greater confidence in their dealings on tax compliance matters. Important areas include addressing the uncertainty brought about by heavy reliance on court cases and interpretations of decisions on significant issues of tax treatment, and also concerns about the lack of finality in tax positions, referred to above. Measures that would to enhance the tax regime include:

    i. Addressing the decision of the CFA in the recent case of Nice Cheer Investment Ltd. v. CIR[13], in which Lord Millett, the same non-permanent judge of the CFA that delivered the judgment in the 2001 case of CIR v. Secan Ltd. and Another[14], pointed out that the government had misread his judgment in the 2001 case. This affects the important issue of whether unrealised gains (such as mark-to-market gains on securities) should be taxable. While we appreciate that an interim administrative measure has been put in place, and subsequently been rolled over, the judgment differs from the approach reflected in departmental interpretation and practice notes ("DIPN") No. 42.

    ii. The ING Barings case (see above) on source of profits and the case of CIR v Goepfert (1989) 1 HKRC on source of employment income. Some of the basic tests for determining source could be codified. This could be achieved by the introduction of appropriate amendments to the Inland Revenue Rules.

    iii. Early clarification of tax treatment arising from new legislation, such as assessing the impact of the new Companies Ordinance (Cap. 622), which includes provisions on court-free amalgamations of companies. This has remained uncertain since the commencement of the new ordinance in 2014.

    iv. Encouraging fuller use of the advance ruling system. The IRD should be prepared to accept applications and to publish advance rulings, wherever possible, even where there may be difficult or contentious points of law to consider.

    v. Producing regular updates of IRD DIPNs and inviting input from practitioners. In some cases, this could be an interim measure pending future legislative changes, given the time frames required for legislation to come to fruition.

---

[13] FACV 23/2012
[14] FACV 9/2000

Predictability of tax affairs

29. Predictability is important for business and time is often of the essence. The length of time for finalisation of tax affairs, particularly where there are past year loss cases, poses uncertainty for businesses. In this regard, the following measures should be considered:

   i. The statutory time limit for reopening an assessment should be shortened from the current six years to three years. Cases involving fraud should retain a ten-year limitation period. Shortening the time-bar period would mean taxpayers could promptly finalise their tax affairs, reducing the time and effort for queries relating to historical data. Numerous jurisdictions, including the UK, Australia, the United States and Singapore adopt a shorter time-bar period than Hong Kong.

   ii. Statements of loss should be issued within a definite period, and accorded the same status as notices of assessment. When statements of loss are not treated as assessments, it is unclear as to whether losses are available for setting off against future profits. It also means that the clock on the statutory time limit does not start when such statements are issued. Consequently, this can keep tax affairs open beyond six years, and require record-keeping beyond the statutory requirement of seven years. The uncertainty about the status of losses can also complicate discussions between taxpayers and their auditors, as it is unclear whether such losses can be booked as deferred tax assets.

Broadening the tax base

30. The WGLTFP also recommended avoiding excessive reliance on direct taxation[15]. In view of the projected long-term demands on Hong Kong's tax system, options for broadening and stabilising the tax base must continue to be on the table. The ageing of the population and the associated pressures on the tax system (e.g., rising health care costs), and 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), all mean that the existing system is likely to come under increasing strain. While proposals for a goods and services tax have received only limited support in the past, this issue has not been looked at for over eight years and also a goods and services tax is not the only option; other means of broadening the tax base should also be studied.

---

[15] Report of the Working Group on Long-Term Fiscal Planning (Phase One), p.168, para.7.31

Lower tax rate for small and medium enterprises

31. Given the importance of the small and medium enterprise ("SME") sector to Hong Kong, accounting for over 98% of the businesses and about 47% of private sector employment[16], there is substantial potential for major development within the sector. Consistent with the government's policy to support this sector, through financial (e.g., loan guarantee) and other programmes, we propose that the corporate profits tax rate should be reduced to 15% for companies whose gross income does not exceed HK$5 million.

Loss carry-back

32. We also propose the introduction of loss carry-back provisions that could improve the viability of businesses. Without loss carry-back provisions, the effects of fluctuations in a company's results can be exacerbated, particularly during economic downturns, and can cause cash flow difficulties. It would also encourage businesses to invest and test the water, before implementing more extensive expansion plans. Such provisions could relieve the financial burden arising from new investments should the business end up sustaining losses while gauging the viability of the expansion. While we note that the government considers that loss carry-forward should be able to assist enterprises to manage their losses[17], the effectiveness of loss carry-forward arrangements is dependent on a company becoming profitable and viable again, after experiencing losses.

Group loss relief

33. The Institute has for some time proposed that a form of group loss relief be introduced in Hong Kong. We note that the government considers that the measure may not benefit SMEs at large, which form the majority of business establishments[18]. However, although SMEs form the largest number of businesses, they contribute a smaller amount in aggregate to the revenue than large companies. Such relief would provide a simple, but much-needed, measure of relief to corporate groups. For legitimate commercial reasons, many businesses operate in the form of a group of companies, to diversify the risk of different activities or for operating in different locations. Some companies within the group may record losses, whilst others have profits. We also note the government's concern that the measure could be easily abused[19]. However, anti-avoidance provisions, such as sections 61A and 61B of the IRO, should already provide sufficient protection and further specific conditions could be introduced. These

---

[16] http://www.gov.hk/en/about/abouthk/factsheets/docs/trade&industry.pdf
[17] LCQ2: Enhancing Hong Kong enterprises' competitiveness, 16 Mar 2011, http://www.info.gov.hk/gia/general/201103/16/P201103160178.htm
[18] Ibid.
[19] Ibid.

could include an appropriate definition of a group (for example, the relevant companies having to be 90% owned by the same parent company) and a limit on the transfer of losses to offset current profits, and not against past years' profits of other companies within the group. The UK, United States, Australia and Singapore, for example, successfully operate group loss relief systems.

Expansion of CDTA network

34. The government has done a very effective job in expanding the network CDTAs from virtually none ten years ago to over thirty today. In terms of future CDTAs, as well as focusing on Hong Kong's traditional trading partners, we suggest that, as the Mainland Government develops its "One Belt One Road" initiative, the government should consider negotiating CDTAs with the countries included with the initiative. This should help support the initiative and serve as an additional incentive to further economic exchanges with the relevant countries.

C. For the community

35. Tax measures are also important in helping the livelihood of the community, given that many costs continue to rise and given, in particular, the problem of housing affordability. Furthermore, as the population ages, people need to be encouraged to prepare better for their retirement and their healthcare needs. An ageing population means a shrinking workforce, also bringing into question the need to consider education measures to help more people develop the appropriate skill sets to sustain the workforce. Against this background, the Institute recommends introducing the measures outlined below.

Home rental deduction

36. Many taxpayers cannot afford to buy their own homes now and may not be able to do so in the foreseeable future. Home purchase affordability (i.e. the ratio of mortgage payment for a 45-square metre flat to median income of households, excluding those living in public housing) stayed high, at around 62%, in the second quarter, exceeding the long-term average of 46% over the period 1995-2014[20]. Although speeding up the construction of flats by increasing land supply is the government's top policy priority, it takes time to increase supply[21]. Therefore, we propose that taxpayers be offered an allowance equivalent to the home loan interest deduction that can be claimed for rental payments in respect of the taxpayer's primary residence, subject to an annual limit of HK$100,000. Employees who are already claiming a housing allowance from their employers,

[20] Government of the Hong Kong SAR, Half-yearly Economic Report 2015, p.39, para.3.7
[21] Ibid, pp.37-38. paras.3.5-3.6

and taxpayers who have previously claimed their full entitlement of the home loan interest deduction, should not be eligible for this benefit.

Salaries tax allowances

37. In recent years, increases in the allowances for children and other dependants have not been revised in alignment with one another and have been given out at different times and with different proportionate increases. For example, child allowances have doubled since 2008-09, while allowances and additional allowances for dependent parents and grandparents have increased by 33.3% and those for dependent siblings and disabled dependants only by 10%. 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, adjustments should be made on a more transparent basis and aligned, where appropriate. Where there are good policy or other reasons for differential adjustments, this should also be made clear. Pending the above review, we propose that these allowances should all be increased broadly in line with inflation.

Private health care premiums

38. We noted that the government consulted on a voluntary health insurance scheme last year and we welcome such consultations, although it seems unlikely that specific measures will be implemented within the next few years. In order to encourage more efficient utilisation of both public and private health care services, given that more than half of the population does not have employer medical benefits or coverage by medical insurance[22], we propose that taxpayers be allowed a deduction for the cost of private health care insurance premiums, subject to an annual cap of HK$12,000 per taxpayer. In addition, the government should consider allowing taxpayers to claim deductions for premiums paid on behalf of dependent spouses and children, subject to a similar cap per dependant. If there are reservations about introducing this as a long-term measure while the government is still considering the merits of a voluntary health insurance scheme, we would propose that the deduction be offered in the coming year and that it may be introduced subject to an annual review.

---

[22] Census and Statistics Department, Hong Kong SAR, Thematic Household Survey Report No. 58, p.103, para.7.24, *"At the time of enumeration, some 3 510 600 persons or 51.3% of the total population covered in the survey were not entitled to any medical benefits provided by employers / companies and were not covered by medical insurance purchased by individuals…."*

Voluntary mandatory provident fund contributions

39. It is commonly accepted that the statutory mandatory provident fund contributions cannot at present provide an adequate nest egg for people's retirement. Debate is continuing on possible alternatives, such as a universal pension scheme, and the government has now launched a public engagement exercise on retirement protection. However, given the different views, it cannot be expected that agreement will be reached quickly as to the way forward and, in the meanwhile, taxpayers are not given any incentive to save more for their own retirement. If taxpayers, particularly from middle income groups can save more while they are working, this will put less pressure on the public coffers in the long run, at a time when the population is aging. Therefore, to encourage people to invest more for their retirement, we propose that taxpayers be allowed additional deductions for voluntary contributions to their mandatory provident funds, of up to HK$60,000 annually. As an anti-avoidance measure, the contributions could be made taxable again if withdrawn before retirement.

Self-education expenses

40. To encourage people to invest in their own education and training, to upgrade their skills and increase their employment opportunities, the Institute recommends making the application of the deduction for self-education expenses more flexible. Specifically, we propose that any amount of a taxpayer's maximum allowance that is not taken up by the taxpayer him or herself should be allowed to be used by the taxpayer's dependants. So, if the deduction limit of HK$80,000 is not fully utilised by the taxpayer, it should be permitted to be used for the self-education expenses of the taxpayer's spouse, for 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 who are not taxpayers, or do not earn enough to be able to claim the deduction in their own right. This may encourage more adults to undertake further training and study, especially given that the proportion of those currently expressing interest in doing so, relative to the population, is fairly low at 14%[23].

[23] Census and Statistics Department, Hong Kong SAR, Thematic Household Survey Report No. 56, p.118, para. 7.2, *"The survey results showed that some 848 200 persons aged 15 and over were interested in taking programmes / training courses to upgrade educational attainment or enhance vocational skills at the time of enumeration, constituting 14.0% of all persons aged 15 and over in Hong Kong.…"*

Appendix 1: Proposed changes for salaries tax allowances and deductions

Allowances and deductions	Existing (HK$)	Proposed (HK$)
Allowances[24]:		
• Basic	120,000	123,600
• Married person	240,000	247,200
• Child – annual (each dependant)	100,000	103,000
• Child – initial (each dependant)	100,000	103,000
• Dependent brother or sister (each dependant)	33,000	33,990
• Dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the government's disability allowance scheme	40,000	41,200
- aged 55 or above but below 60	20,000	20,600
• Additional dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the government's disability allowance scheme	40,000	41,200
- aged 55 or above but below 60	20,000	20,600
• Single parent	120,000	123,600
• Disabled dependant (each dependant)	66,000	67,980
Deductions, maximum limit:		
• Self-education expenses	80,000 limited to claims by taxpayer	80,000 extended to claims by taxpayer, spouse, or children between 18 to 25 studying part-time
• 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

24 Proposed allowances are increased under the assumption that the benchmark is set at current levels and an inflation rate of 3%.

Appendix 2: Impact of proposed changes in salaries tax allowances and deductions on a typical individual

Example: Single person

This example illustrates the impact of[25]:

- an increase of basic allowance to HK$123,600
- a deduction for voluntary MPF contributions of HK$15,000 (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 (HK$)		Proposed (HK$)		Savings (HK$)	Savings (%)
Income		300,000		300,000		
Allowances/ deductions:						
Basic allowance	120,000		123,600			
Mandatory MPF contribution	15,000		15,000			
Voluntary MPF contribution	-		15,000			
Private healthcare insurance	-		12,000			
Rental payment	-		100,000			
Total allowances/ deductions		135,000		265,600		
Net chargeable income		165,000		34,400		
Tax payable		16,050		688	15,362	96%

[25] Assumptions, as for Appendix 1.

Appendix 3: Impact of proposed changes in salaries tax allowances and deductions 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[26]:

- an increase of basic allowance to HK$123,600
- an increase in child allowance to HK$103,000
- an increase in dependant parents allowance and additional allowance to HK$41,200
- a deduction for voluntary MPF contributions of HK$18,000 (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			600,000			600,000		
Allowances/ deductions:								
Basic allowance		120,000			123,600			
Child allowance	2 children 100,000 each	200,000		2 children 103,000 each	206,000			
Dependent parent allowance and additional allowance	2 parents 80,000 each	160,000		2 parents 82,400 each	164,800			
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			498,000			566,400		
Net chargeable income			102,000			33,600		
Tax payable			6,240			672	5,568	89%

[26] Assumptions, as for Appendix 1.