MAZARS
2015/16 BUDGET PROPOSAL

Hong Kong, 16 January 2015

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INTRODUCTION

Hong Kong is an open and externally oriented economy which is greatly affected by the global economy in particular the Mainland and the US. The overall trade volume between Hong Kong and the Mainland accounted for more than half of Hong Kong's total trade value. Chinese companies also accounted for 57% of market capitalisation and 72% of annual equity turnover on the Hong Kong Stock Exchange at the end of 2013. The tourism industry has been an important part of the Hong Kong economy since it shifted to a service sector model in early 1990s. There has been a sharp increase of tourists from Mainland China, due to the introduction of the Individual Visit Scheme (IVS) in 2003. Despite Hong Kong's close connection with the Mainland, its monetary system is tied to the US.

Unfortunately, the Mainland is contending with its weakest expansion in almost 30 years. The slowdown of Mainland economic growth will inevitably hit the re-export trade, capital market activities, tourism etc. in Hong Kong. The US Federal Reserve forecasts for increasing interest rates in this year. If the US increases its interest rates, it will prompt Hong Kong to raise its borrowing costs as well.

Globally, the Euro Zone is in danger of its third recession since 2008. In Hong Kong, the Chief Executive has just proposed to increase the statutory minimum wage from HK$30 to HK$32.50 per hour. This can be translated into higher labour cost for enterprises in particular SME. The above negative factors have been echoed by the challenges posed by recent political unrest.

With all these threats and uncertainties, 2015 will be a challenging year for Hong Kong businesses. **Mazars Hong Kong believes that tax measures should be introduced to sustain Hong Kong's competitive advantage and to provide an optimal business environment, which in turn will help stimulating Hong Kong's economic growth**.

Hong Kong people are facing very high cost of living pressures. The government has already terminated its subsidies on electricity bills and rates demand notes since July 2014. Prices in every aspect of living have been rising. These coupled with the possible increase in mortgage loan interest added pressures to Hong Kong families on their high cost-of-living. **Mazars Hong Kong recommends that budgetary measures should also be introduced to relieve people's hardship and improve quality of life.**

"Population ageing" is a pervasive, profound and enduring tide sweeping across the world and Hong Kong is no exception. To encourage Hong Kong people to prepare for retirement and utilize private healthcare services, **Mazars Hong Kong recommends the government to introduce tax incentives.**

Our recommendations are focused on tax measures and can be classified into three headings:-

- Restoring Hong Kong's tax competitive advantage;
- Relieving people's hardship and pressures; and
- Preparing for the future.

1. RESTORING HONG KONG'S TAX COMPETITIVE ADVANTAGE

1.1 Reduction of corporate tax rate

For years, Hong Kong adopts a laissez faire policy. With its simple taxation system, low tax rate, and other favourable factors such as good infrastructures, proximity to the Mainland etc., Hong Kong has been very successful in attracting foreign investments.

However, since the financial crisis in 2008, many of our neighboring jurisdictions have been cutting their tax rates substantially and introducing various tax incentives to compete for foreign investments.[1] They are desperate for our economic achievement and very keen to catch up in every aspect. For examples, Singapore cut its corporate income tax rates from 20% in 2007 to 17% in 2010 and has introduced a lot of tax incentives to attract foreign investments in their target industries. Thailand and Taiwan also reduced their corporate income tax rates from 30% to 20% and 25% to 17% respectively.

[1] Corporate tax rates of our major neighboring jurisdictions are summarized in Table 1 on Page 9.

Hong Kong's corporate tax rate had been reduced from 17.5% to 16.5% in 2008/09 and has remained unchanged at 16.5% since then. Although Hong Kong still appears to have the lowest headline corporate tax rate amongst the neighboring jurisdictions in the region, its competitiveness in term of low tax rate is deteriorating and is close to zero for some jurisdictions, e.g. Singapore and Taiwan. While Hong Kong may still be considered one of the preferred investing locations in the Asia Pacific region for now, there is no room for complacency.

In order to restore our competitive advantage, **Mazars recommends considering the reduction of profits tax rate to 15% over a three-year period starting from 2015/2016.**

1.2 Modernization of current tax loss regime

The current tax loss regime in Hong Kong is relatively simple. Tax losses may be carried forward and set off against future profits of that business with no time limit. A corporation carrying on more than one trade may have losses in one trade offset against profits of another. However, losses may not be carried back and cannot be relieved against profits of parent, subsidiary or fellow subsidiary companies.

It is generally agreed that amongst others, principles of a good taxation system should include transparency, certainty, neutrality, fairness and cost efficiency. Taxpayers in similar situations conducting similar transactions should be subject to similar levels of taxation.

However, under our current tax loss regime, a loss-making company which has paid tax in the past could not obtain a tax refund even if it is in a loss position over its lifetime. Furthermore, a corporate group with profit-making subsidiaries and loss-making subsidiaries may need to pay tax even though the corporate group is loss-making. The current tax results do not appear to be fair or tax neutral.

Many developed jurisdictions allow tax losses carried back and offer some form of group relief mechanism. **Mazars recommends Hong Kong to modernize our tax loss regime to introduce tax loss carry back and group loss relief mechanism similar to other developed jurisdictions** so that corporate groups in Hong Kong can lower their tax burden and effective tax rates and reduce the needs to implement complex intra-group transactions. These will in turn encourage foreign investors in expanding or investing in Hong Kong.

1.3 Tax incentives for activities of regional headquarters

Hong Kong used to be one of the most preferred locations for setting up regional headquarters in the Asia Pacific region by multinational corporations leveraging on a number of factors including a low tax rates system, a robust legal and regulatory system in line with international standards, free flow of capital, etc.

We however note that these competitive advantages of Hong Kong have been fading away as our neighboring countries are keen to catch up in attracting foreign corporations setting up headquarters in their places. Shanghai, Singapore, Malaysia, the Philippines and Thailand all have different kinds of incentives for multinational corporations doing regional headquarters businesses in their countries. According to the Savills World Live-Work Index, which examines both housing and office costs reveals that Hong Kong has become the most expensive place to live and work in the world. Cost of living and working space per employee is 1.6 times more expensive than Singapore and 3.8 times more expensive than Shanghai.

It is evident that more and more multinational corporations have been moving their headquarters out of Hong Kong in recent years. Therefore, it is of paramount importance to address the issue and introduce measures to preserving Hong Kong's competitiveness in this area. In this regard, **Mazars Hong Kong recommends the Government to introduce a 50% concessionary tax rate for qualifying regional headquarters business in Hong Kong**.

The Financial Secretary in his 2014/15 Budget proposed to review the requirements under the Inland Revenue Ordinance for interest deduction for corporate treasury activities to encourage multinational enterprises to set up their global or regional treasury functions in Hong Kong. **Mazars Hong Kong urges the Government to commence the legislative process as soon as possible**.

1.4 200% tax deduction for R&D expenditure

In his 2014/15 Budget, the Financial Secretary has introduced new measures to encourage R&D investments and commercialization of R&D results. While we welcome the introduction of these measures in promoting R&D activities, we believe that the Government still can do more, particularly in the area of tax incentive measures, to further encourage businesses to invest into R&D activities.

Although Hong Kong provides accelerated depreciation allowance (i.e. 100% deduction in the year of expenditure) for qualifying R&D expenditure, it still lags behind from other neighboring countries which provide more favorable tax incentives in different forms (e.g. super tax deduction, tax credits and reduced tax rate for qualifying expenditure and activities etc.) in encouraging the R&D investments and activities. In this regard, **Mazars Hong Kong recommends the Government to introduce 200% super deduction for qualifying R&D expenditure.**

1.5 Two-tier profits tax system

Given the soaring rent and labor costs in Hong Kong, Hong Kong is getting more and more difficult for entrepreneurs to start up new businesses. The existing businesses particularly the SMEs who are also struggling for their survivals are facing a number of economic uncertainties ahead e.g. slackening in tourist spending, weak import demand from advanced economies, etc.

SMEs are the backbone of the Hong Kong economy accounting around half of the total employment. In the 2014/15 Budget, it is indicated that the Government appreciated the different challenges facing the SMEs and has rolled out an array of measures to support their development. In addition to the existing measures, **Mazars Hong Kong propose the Government to implement a two-tier profits tax system whereby a concessionary rate at 50% of the normal profits tax rate be applied to taxpayers whose annual taxable profits are below HK$2 million**. Two-tier corporate tax rate systems are also in place in some of our neighboring jurisdiction[2].

1.6 Tax deduction for capital expenditure on plant and machinery

In Hong Kong, it is a common business model to purchase plant and machinery (in particular moulds) and authorize manufacturers in the Mainland to use the same rent-free for the production of goods. The plant and machinery is solely used by the manufacturers for the production of goods for the Hong Kong company and the profits derived by that Hong Kong company from the sales of goods so produced are fully chargeable to Hong Kong profits tax.

Before 2006, it was the practice of the Hong Kong Inland Revenue Department ("IRD") to allow depreciation allowances for such normal commercial transactions. However, starting from 2006, the IRD has adopted a stringent practice denying depreciation allowances on capital expenditure incurred by the Hong Kong company for the purchase of any plant or machinery which is used by another person outside Hong Kong according to the plain meaning of section 39E of the Inland Revenue Ordinance.

The current stringent practice of the IRD, together with the rapid rising manufacturing costs in the Mainland in recent years, has created undue hardship for a number of businesses with manufacturing operations in the Mainland in particular the small and medium sized enterprises.

We are of the view that Section 39E is an anti-avoidance provision targeting sale-and-lease back and leveraged lease arrangements. The provision of plant and machinery to the mainland manufacturers as explained above is commercially driven and certainly not a tax avoidance scheme for the purpose of obtaining any tax benefits. The current stringent practice of the IRD denying depreciation allowances for normal commercial transactions is not in accordance to the original legislative intent. **Mazars Hong Kong urges the Government to revisit the issue and consider actions to resolve the protracted disputes between the IRD and taxpayers.**

1.7 Status of a statement of loss

There is a statutory time limit of six years in Hong Kong for the IRD to raise tax assessments. The statutory time limit however does not apply to companies which are in loss position. In practice, the IRD would issue Statements of Loss showing the amount of tax losses upon its review of the companies' position. Nonetheless, despite the issue of such Statement of Loss, the IRD, in some occasions, still

[2] Please refer to the notes to Table 1 on Page 9.

raises queries to challenge the quantum of tax losses which were incurred six years ago or even longer. In case that company is not able to produce the requested supporting documentation in defending its tax position, the IRD would simply disallow the tax losses regardless of the long lapse of time.

In view of the unfairness and unreasonableness in the current documentation retention requirements, **Mazars Hong Kong recommends the Statement of Loss as issued by the IRD should also be subject to the same statutory time limit** so as to provide certainty to taxpayers' tax position and dispense them from undue administrative burden of maintaining documentation for an infinite period of time.

1.8 A comprehensive review of our tax system

Hong Kong economy has been transformed from a manufacturing economy in 1970s to a services economy in 1990s and further to a knowledge-based economy in 2000s. In recent years, Hong Kong is able to expand its treaty network rapidly following the amendment to its tax legislation to allow the exchange of tax information with treaty parties. From a global prospective, the tax landscapes have also changed dramatically with its pace and complexity of change continues to increase (e.g. development of measures to counter harmful tax practices, implementation of automatic exchange of information, Foreign Account Tax Compliance Act, OECD's Base Erosion and Profits Shifting project etc.) Hong Kong's current taxation system is fallen too far behind.

Given the ever-changing economic and tax environment, **Mazars recommends the Government to conduct a comprehensive review of its tax system in order to cater the modern needs**.

1.9 A review of our tax law to align with the New Companies Ordinance

While a comprehensive review of our taxation system may take a longer time, there is a more immediate need to review certain provisions of the Inland Revenue Ordinance.

The New Companies Ordinance was effective on 3 March 2014. **Mazars Hong Kong urges the Government to conduct a review of the relevant provisions of the Inland Revenue Ordinance in light of changes brought by the new provisions in the New Companies Ordinance**, e.g. amalgamation of companies. The aim is to provide greater tax certainty to companies and thus helps to sustain a favourable business environment.

2. RELIEVING PEOPLE'S HARDSHIP AND PRESSURES

Hong Kong people are facing very high cost of living pressures. Prices in every aspect of living have been rising. These coupled with the possible increase in mortgage loan interest added pressures to Hong Kong families on their high cost-of-living.

To relieve people's hardship and cost of living pressures, **Mazars Hong Kong recommends the following measures be introduced**:

Tax measures

(a) removing the first tax band of 2%, i.e. the tax rate for the first tax band will be 7% (Mazars Hong Kong considers the inclusion of the tax band at the extremely low rate of 2% is not cost efficient at all. The elimination of this tax band can support the cost efficiency of our salaries tax system. This measure is suggested to be taken together with an increase of the same level in personal allowances so that the salaries taxpayers will not be affected); and increasing the basic allowance, married person and single parent allowance by a corresponding amount, i.e. HK$40,000;

(b) widening the income bands for the progressive tax rates under salaries tax from HK$40,000 to HK$50,000;

(c) waiving 75% of salaries tax and tax under personal assessment, subject to a ceiling of HK$15,000 for the year of assessment 2014/15;

(d) increasing the basic and additional child allowance from the current HK$70,000 to HK$75,000 for each child;

(e) increasing the Dependent Parent and Dependent Grandparent Allowance and the Additional Dependent Parent and Dependent Grandparent Allowance from the current HK$40,000 to HK$45,000;

(f) increasing the Dependent Parent and Grandparent Allowance and Additional Dependent Parent and Dependent Grandparent Allowance (for parent / grandparent aged 55 or above but below 60) from the current HK$20,000 to HK$22,500.

(g) increasing the deduction ceiling for elderly residential care expenses from the current HK$80,000 to HK$90,000 for taxpayers whose parents or grandparents are admitted to a residential care home;

(h) removing the time limit for claiming tax deduction for home loan interest; and

(i) introducing tax deduction of rental payment for the place of residence subject to a cap of HK$100,000 per annum.

Currently, taxpayers can claim deduction of the interest expenses incurred on their home loans. However, no tax measure is in place to help those house-renters despite that they suffer the most from the soaring property market. **Mazars Hong Kong believes the introduction of rental deduction does not only provide relief to those house-renters, but it can improve the fairness of our taxation system**.

Other subsidies

(a) waiving rates, subject to a ceiling of HK$2,000 per quarter for each rateable property; and

(b) granting each residential electricity account a subsidy of HK$2,400.

3. PREPARING FOR THE FUTURE

Like other advanced economies in the world, Hong Kong is facing an ageing population stemming from the city's long life expectancy and low birth rate. The elderly dependency ratio (i.e. the number of people aged 65 and over per 1,000 people aged 15 to 64) is expected to rise drastically to 49.7% in 2041 from the current one at 21.3% in accordance with the latest data released by the Census and Statistics Department.

The ageing population will pose sustained challenge to the public finance. In our previous Budget Proposals submitted, we repeatedly recommended the Government to introduce tax incentive measures to encourage people to better save and prepare for their retirement life by allowing tax deduction of voluntary contributions to MPF and other recognized retirement schemes as well as private medical insurance premiums.

The Government has recently launched the public consultation on the Voluntary Health Insurance Scheme. Mazars Hong Kong welcomes the exercise to take forward the scheme so as to provide an alternative to those who are able and willing to use private healthcare services through enhancing the quality of health insurance in the market. In addition to the introduction of the Voluntary Health Insurance Scheme, **Mazars Hong Kong also recommends the Government to introduce tax deduction of the premium paid for private medical insurance as a tax incentive**. This can further encourage people to utilize the private healthcare services so as to redress the balance of private and public healthcare usage and thereby relieving the burden of public finance in future.

In addition to the tax deduction of private medical insurance premiums, **Mazars Hong Kong also proposes the Government to extend the tax deduction of employee's contribution to voluntary contribution** to the MPF and other recognized retirement schemes. This can provide tax incentive for people to save and prepare for their retirement and thereby easing the public finance burden caused by the imminent ageing population.

The amount of tax deduction allowed for employees' contributions to the MPF and other recognized retirement schemes (including both mandatory and voluntary contributions) and the premiums of private medical insurance can be set at a maximum of 15% of the individual taxpayers' total taxable remunerations. This limit is in line with the tax deduction currently granted to employers in respect of their contributions made to the MPF and other recognized retirement schemes.

Table 1 – Corporate Tax Rates in Hong Kong and Neighboring Jurisdictions

	2007	2008	2009	2010	2011	2012	2013	2014
China (a)	33%	25%	25%	25%	25%	25%	25%	25%
Hong Kong	17.5%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%
Indonesia (b)	30%	30%	28%	25%	25%	25%	25%	25%
Japan (c)	40.7%	40.7%	40.7%	40.7%	40.7%	38%	38%	35.6%
Malaysia (d)	27%	26%	25%	25%	25%	25%	25%	25%
Philippines	35%	35%	30%	30%	30%	30%	30%	30%
Singapore (e)	20%	18%	18%	17%	17%	17%	17%	17%
South Korea (f)	27.5%	27.5%	24.2%	24.2%	24.2%	24.2%	24.2%	24.2%
Taiwan (g)	25%	25%	25%	17%	17%	17%	17%	17%
Thailand (h)	30%	30%	30%	30%	30%	23%	20%	20%
Vietnam (i)	28%	28%	25%	25%	25%	25%	25%	22%

(a) Businesses in certain Special Economic Zones are eligible for tax holiday for a few tax years and reduced tax rates thereafter. Special rates also apply to small-scale enterprises (20%) and enterprises with new high technology status (15%).

(b) Companies with gross turnover below IDR50 billion are eligible for 50% tax reduction of tax rate which is imposed proportionally on taxable income for gross revenue up to IDR 4.8 billion.

(c) The effective rate is illustrated for a company in Tokyo with paid-in capital of more than JPY100 million.

(d) For SMEs, a reduced tax rate of 20% is applied on the first MYR500,000 of chargeable income. Under a proposal, the main corporate tax rate will be reduced to 24% while the concessionary rate for SMEs will decrease to 19% on the first MYR500,000 of chargeable income.

(e) 75% of the first SGD10,000 of normal chargeable income is exempt from tax, and 50% of the next SGD290,000 is exempt from tax.

(f) Corporate income tax is charged at 10% on the first taxable income of KRW200 million, 20% on next taxable income in excess of KRW200 million up to KRW20 billion, and 22% on the remainder exceeding KRW20 billion. Local income surtax is also imposed at similar progressive rate in the range of 1% to 2.2% on the taxable income.

(g) The taxing threshold for taxable income is TWD120,000, and the total net income exceeding TWD120,000 is subject to corporate income at a rate of 17%.

(h) Progressive corporate income tax rates of 0%, 15% and 20% apply to locally incorporated companies with paid-up capital of not more than THB5 million and revenue of not more than THB30 million per year.

(i) For SMEs, a reduced tax rate of 20% applies if total revenue is less than VND 20 billion. The main corporate tax rate will be further reduced to 20% from 1 January 2016.

Table 2 – Neighbouring jurisdictions with group tax loss relief and tax loss carry-back relief

	Group tax loss relief	Tax loss carry-back relief
Japan	Yes	1 Year
Korea	Yes	1 Year
Malaysia	Yes	Not available
Singapore	Yes	1 Year
Taiwan	Yes	Not available

About Mazars

Mazars is an international, integrated and independent organisation, specialising in audit, accounting, tax and advisory services. We rely on the skills of more than 14,000 professionals in the 73 countries which make up our integrated partnership.

In China, Mazars has 600 highly-qualified professionals based in Beijing, Guangzhou, Hong Kong and Shanghai. They are fully committed to serving the growing and diversified needs of both Chinese companies and international firms.

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