MAZARS
2016/17 BUDGET PROPOSAL

Hong Kong, 29 December 2015

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INTRODUCTION

Traditionally, Hong Kong has been regarded an attractive place for foreign investments due to, among other things, its simple tax system and low tax rate. Questions however have been raised in recent years whether Hong Kong is still able to maintain its competitive edge amidst our neighbor jurisdictions' continuous improvement of their business environment, including favorable tax policies and measures, to compete with foreign investments.

Mazars Hong Kong has been submitting budget proposals to the Government for several years to share our views on the formulation of tax policies and budget measures, with particular emphasis on how to maintain Hong Kong's competitiveness edge in our tax system. In our last year's budget proposal, one of the recommendations was to provide tax incentive for setting up regional headquarters in Hong Kong. This aims to preserve Hong Kong's competitiveness in attracting MNC to set up headquarters for the Asia Pacific region.

While we welcome Mr. John Tsang's proposal in his Budget 2015/16 to provide tax incentives in order to promote Hong Kong to become a preferred choice of location for regional treasury centres, we consider the promotion of Hong Kong as regional headquarters is important and should be carried out in tandem with that for treasury centres.

In addition, in the last year's policy address, Mr. CY Leung indicated that the Government is studying the development of Hong Kong's aerospace financing business so as to strengthen Hong Kong's status as an international aviation and financial centre. In the subsequent Budget released, Mr. Tsang supplemented that the Government shall ride on the experience of other jurisdictions and explore possible measures that can promote aerospace financing business in Hong Kong.

Despite the Government's ambition to compete with our neighboring countries in the aerospace financing business, under our existing tax legislation, a Hong Kong lessor is not entitled to any depreciation allowance on the costs of an aircraft if it is leased to a non-Hong Kong person who will not use the aircraft in Hong Kong even though his rental income is fully chargeable to Hong Kong profits tax. The denial of depreciation allowance is due to the operation of Section 39E of the Inland Revenue Ordinance ("IRO") which was legislated as an anti-tax avoidance provision. Many tax practitioners, including Mazars Hong Kong, consider the scope of Section 39E is too broad bringing unintentional impact on those genuine aircraft leasing businesses in Hong Kong. In order to rectify this anomaly, we strongly recommend the Government to revise Section 39E of the IRO and propose amendment bill to address the issue sooner rather later.

Worse still, the impact of Section 39E is far reaching. Section 39E also denies depreciation allowance on the cost of moulds and machineries to those Hong Kong businesses which provide these moulds and machineries to their suppliers for manufacturing outside Hong Kong. Whilst the profits of these taxpayers are fully chargeable to Hong Kong profits tax, they are not entitled to any depreciation allowance on the costs of the moulds and machineries despite that such assets used for the production of their chargeable profits.

Over the past years, we have repeatedly urged the Government to review the anomaly created by the operation of Section 39E and address the unfairness in our tax system. We however truly regret that this has never been on the Government's agenda. One of the reasons for the Government's refusal to amend Section 39E is that it would be difficult for the Inland Revenue Department ("IRD") to verify (i) whether the moulds and machineries are used for the manufacturing of goods sold solely to the Hong Kong taxpayer; (ii) whether the assets have been sold; (iii) whether depreciation allowances of the same moulds and machineries have been claimed by other enterprises, etc. given that the relevant assets are located outside Hong Kong. We however consider that such practical difficulties in verifying taxpayers' deduction claim are not unique for moulds and machineries but exist for all business transactions involving non-Hong Kong companies. With the rapid development of our treaty network, the IRD can always obtain the necessary information through the exchange of information article in its Comprehensive Double Taxation Agreements with treaty partners.

We believe that while it is important for the Government to improve its tax regime to promote the development of new industry, e.g. aircraft leasing business, it is equally or even more important to address the problem facing by our existing businesses and fix the tax unfairness created by the operation of Section 39E. As such, we would still include this recommendation item in our proposal this year.

The global economic environment is complex. While the US has recently raised its interest rate for the first time in nearly a decade, a number of other countries are still implementing quantitative easing measures to spur their economies. As the Hong Kong dollar is pegged to the US dollar, the borrowing costs in Hong Kong are set to rise. Coupled with the weakest economic growth in the mainland China in almost two decades, we believe 2016 will be a challenging and uncertain year for Hong Kong people. According to a survey by CPA Australia released on 19 October 2015, 53% of the Hong Kong's professionals felt pessimistic about Hong Kong economy in 2016. In addition to maintaining Hong Kong's tax competitive advantage, we would also propose measures to relieve people's hardship and cost of living pressures.

Our budget proposal this year would cover the following three broad areas:-

- Maintain Hong Kong's tax competitive advantage;
- Better prepare for the future challenges; and
- Improve people's livelihood.

1. MAINTAINING HONG KONG'S COMPANY TAX ADVANTAGE

1.1 Tax deduction for capital expenditure on plant and machinery

Due to the rising land and labour costs in Hong Kong, most of the businesses have been moving their manufacturing operations to elsewhere, particularly the mainland China. It is a common commercial practice for these businesses to purchase plant and machinery (in particular moulds) and authorize manufacturers in the mainland China to use the same rent-free for the production of goods. The plant and machinery are 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.

The IRD considers the above rent-free provision of plant and machinery constitutes a lease arrangement and the plant and machinery are principally or wholly used outside of Hong Kong. As such, there would be no depreciation allowance on the costs of the plant and machinery available to the Hong Kong company under Section 39E of the IRO.

The IRD's strict interpretation and application of Section 39E is inequitable to Hong Kong taxpayers. Together with the rapid rising manufacturing costs in the Mainland in recent years, businesses with manufacturing operations in the mainland China, in particular the small and medium sized enterprises, are facing undue hardship and difficulties.

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 genuine commercial transactions is not in accordance to the original legislative intent. **Mazars**

Hong Kong urges the Government to revisit the issue and consider amending the IRO to rectify the situation.

1.2 Reduction of corporate tax rate

One of our competitive advantages is the simple tax system and low tax rate. Hong Kong's corporate tax rate stands at 16.5% since 2008/09. Although Hong Kong still appears to have the second lowest headline corporate tax rate following Macau amongst the neighboring jurisdictions in the region [1], its competitiveness in term of low tax rate is deteriorating and is close to zero for some jurisdictions.

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. For examples, Singapore cut its corporate income tax rates from 20% in 2007 to 17% in 2010 and has introduced various tax incentives to attract foreign investments into their target industries, e.g. regional headquarters, aircraft leasing finance and treasury centre etc. and targeted activities, e.g. mergers and acquisitions, R&D, new technologies etc. Thailand and Taiwan also drastically reduced their corporate income tax rates from 30% to 20% and 25% to 17% respectively.

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 2016/2017.**

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

1.3 Two-tier profits tax system

Given the rising operating costs in Hong Kong, it is getting more and more difficult for people to start up new businesses. For SMEs, while they barely survive the high operating costs, they are also 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. As of December 2014, there were about 321,000 SMEs in Hong Kong and accounted for around 47% of private sector employment. **Mazars Hong Kong proposes the Government introducing 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].

1.4 Modernization of current tax loss regime

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

[2] Please refer to the notes to Table 1.

transactions should be subject to similar levels of taxation.

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

Therefore, Mazars Hong Kong recommends the Government introducing 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 in difficult times and reduce the needs to implement complex intra-group transactions. These will in turn encourage foreign investors in expanding or investing in Hong Kong. A number of our neighbouring jurisdictions also allow tax losses carried back and offer some form of group relief mechanism[3].

1.5 Status of a statement of loss

Under the Hong Kong tax laws, the IRD is barred from raising tax assessment after six years of the relevant year of assessment. This statutory time limit however does not apply to companies which are in loss position. In practice, the IRD would issue Statements of Loss confirming 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 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.

1.6 200% tax deduction for R&D expenditure

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 neighbouring countries which provide more favourable 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.**

1.7 A comprehensive review of our tax system

Hong Kong economy has been transformed from a manufacturing economy in 1970s to a services

[3] Please refer to Table 2.

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 far behind.

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

2. BETTER PREPARE FOR THE FUTURE CHALLENGES

One of the major challenges facing Hong Kong in future is our 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 to 49.7% in 2041. The ageing population will pose sustained challenge to the public finance.

To address the problem from a tax policy perspective, we recommend the Government implementing tax incentive measures to encourage people to save and prepare for their retirement life. Mazars Hong Kong recommends **the Government to introduce tax deduction of the insurance premium paid for private medical insurance as a tax incentive**. This helps to encourage people to utilize the private healthcare services so as to balance the private and public healthcare usage, thereby relieving some burden of public finance in future. In addition to the tax deduction of private medical insurance premiums, Mazars Hong Kong also recommends **the Government to extend the tax deduction of employee's contribution to MPF scheme to voluntary contribution**. This can provide tax incentive for people to save more for their retirement so as to ease 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.

3. IMPROVING PEOPLE'S LIVELIHOOD

Considering the economic uncertainties ahead, Mazars Hong Kong recommends the following measures be introduced:

(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 improve 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 (i.e. HK$40,000) so that the salaries taxpayers will not be affected. In fact, all salaries taxpayers who are subject to progressive tax rates will be better off;

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

(c) 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;

(d) 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.

(e) 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**;**

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

(g) 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 subject to a limit of HK100,000 per year. However, no tax measure is in place to help those house-renters despite that they suffer the most from the elevated property prices. 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.

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

	2008	2009	2010	2011	2012	2013	2014	2015
China (a)	25%	25%	25%	25%	25%	25%	25%	25%
Hong Kong	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%	16.5%
Indonesia (b)	30%	28%	25%	25%	25%	25%	25%	25%
Japan (c)	40.7%	40.7%	40.7%	40.7%	38%	38%	35.6%	33.1%
Malaysia (d)	26%	25%	25%	25%	25%	25%	25%	25%
Philippines	35%	30%	30%	30%	30%	30%	30%	30%
Singapore (e)	18%	18%	17%	17%	17%	17%	17%	17%
South Korea (f)	27.5%	24.2%	24.2%	24.2%	24.2%	24.2%	24.2%	24.2%
Taiwan (g)	25%	25%	17%	17%	17%	17%	17%	17%
Thailand (h)	30%	30%	30%	30%	23%	20%	20%	20%
Vietnam (i)	28%	25%	25%	25%	25%	25%	22%	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 on the part of gross turnover 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. Effective from the 2016 year of assessment, 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 15,000 professionals in the 74 countries which make up our integrated partnership.

In China, Mazars has 700 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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