MAZARS
2017/18 BUDGET PROPOSAL

Hong Kong, 30 December 2016

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INTRODUCTION

Despite stabilization signs in our economy in the third quarter of 2016, we expect that Hong Kong, being an open and externally oriented economy, will still be facing an uncertain and challenging year ahead after a number of “Black Swan” events happened around the world during the year.

According to the Government’s data, thanks to the strengthening in domestic demand and a moderate improvement in the external environment, the Hong Kong economy grew modestly in the third quarter of 2016. In particular, the US economy, after a weak performance in the first half of the year, grew faster than expected in the third quarter.

The Mainland economy showed steady expansion in the third quarter, which is on its track to achieve the annual growth target. Overall, the external sector seemed to have shown stabilization signs despite the uncertainties arising from the US interest rate hike. Hong Kong’s exports continually grew in the third quarter and domestic demand also gained some momentum in the third quarter. The labour market remained in a state of full employment. In the third quarter of 2016, Hong Kong’s economy expanded 1.9% in annual terms, which was above the 1.7% increase recorded in the second quarter.

Over the past years, Mazars has been submitting budget proposals to the Financial Secretary with particular emphasis on measures in enhancing Hong Kong's tax competitiveness. In 2016, the Inland Revenue (Amendment) (No. 2) Ordinance 2016 has been enacted which allows, under specified conditions, the deduction of interest payable on money borrowed by a corporation carrying on in Hong Kong an intra-group financing business and also provides for a concessionary profits tax rate at 8.25 per cent for qualifying corporate treasury centres. We welcome the new legislation and believe that it provides a conducive environment for attracting multinational and Mainland corporations to centralise their treasury functions in Hong Kong, and thereby enhancing the competitiveness of our financial markets and contributing to the development of a headquarters economy.

Furthermore, we welcome the enactment of the Inland Revenue (Amendment) (No. 3) Ordinance which provides a legal framework in Hong Kong for implementing automatic exchange of financial account information in tax matters. The new legislation enables Hong Kong to deliver its pledge of support for the new international standard on automatic exchange of financial account information in tax matters as promulgated by the Organisation for Economic Cooperation and Development. This is important for Hong Kong to comply with the international standard and maintain our reputation as an international financial centre and a responsible member of the international community.

Being one of the major accounting firms in Hong Kong, we will keep contributing our thoughts to the Government on tax policy formulation with an aim to enhance Hong Kong tax competitiveness. In this budget proposal, our recommendations cover three areas that aim to:-

- enhancing Hong Kong's tax competitiveness;
- improving Hong Kong people's livelihood; and
- preparing for an ageing population.

1. ENHANCING HONG KONG'S TAX COMPETITIVENESS

1.1 Tax deduction for capital expenditure on plant and machinery

In the last year's budget, the Financial Secretary Mr John Tsang said that the Government would examine the use of tax concession to boost aircraft leasing business and explore business opportunities in aerospace financing. While we welcome the Government's intention to promote this industry, we have pointed out in our proposal that there was an anomaly in our tax legislation system that would severely hinder the development of the industry. Specifically, under our existing tax laws, 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 the lessor's 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.

We 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 moulds and machineries despite that such assets are solely used for the production of their chargeable profits.

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 Inland Revenue Department ("IRD") denying depreciation allowances for genuine commercial transactions is not in accordance to the original legislative intent.

Over the past years, we have repeatedly and strongly urged the Government to review the anomaly created by the operation of Section 39E and address the unfairness in our tax system. We however regret that this has never been on the Government's agenda. One of the alleged reasons for the Government's refusal to amend Section 39E is that it would be difficult for the IRD to verify whether the moulds and machineries are used for the manufacturing of goods sold solely to the Hong Kong taxpayer; whether the assets have been sold; 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 exist in all form of cross-border business transactions. The IRD can simply resort to the exchange of information article in the Comprehensive Double Taxation Agreement between Hong Kong and the mainland China to gather information about a taxpayer's manufacturing operations in the mainland China in ascertaining such depreciation allowance claim.

We believe that while it is important for the Government to revise 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 problems facing our existing industries and fix the tax unfairness created by the operation of Section 39E. **Mazars Hong Kong urges the Government to revisit the issue and consider amending the IRO to rectify the situation as soon as possible.**

1.2 200% Tax Deduction for R&D Expenditure

In our prior years' budget proposal, we recommended the Government to introduce 200% super deduction for qualifying R&D expenditure in promoting R&D activities. However, instead of introducing any tax incentive measures, the Government announced in the 2016-2017 Budget to increase the level of cash rebate from 30% to 40% under the Research and Development Cash Rebate Scheme ("the Scheme") in promoting R&D activities. The new increased rate has become effective on 24 February 2016.

The Scheme aims to reinforce the research culture among private companies and encourage them to establish stronger partnership with designated local public research institutions. The Scheme is administered by the Innovation and Technology Commission and provides a cash rebate equivalent to 40% of a company's expenditure in two types of applied R&D projects:-

i) R&D projects funded by Innovation and Technology Fund; and

ii) R&D projects funded entirely by companies and conducted in partnership with designated local public research institutions.

We appreciate the Government's recognition of the importance of technology and innovation in today's economy and welcome the increase of cash rebate to 40% under the Scheme. We however consider that these incentive measures should be codified into our tax legislation regime so as to demonstrate the Government's commitment to promote R&D activities in long term. As such, we would recommend again the Government to introduce 200% super deduction for qualifying R&Q expenditure. In fact, many of our laboring jurisdictions have similar tax incentive measures in place in promoting R&D activities.

1.3 Capital Deduction for Intellectual Property Expenditure

Mr Tsang proposed in his budget 2016-2017 that the Government would expand the scope of tax deduction for capital expenditure incurred for the purchase of Intellectual Property Rights ("IPR") from the existing five categories to eight. The additions are layout-design of integrated circuits, plant varieties and rights in performance. We welcome the proposed measure to promote the development of Hong Kong as an IP trading hub. However, we need to point out that under our existing tax legislations, a taxpayer will be denied a deduction where a person holds rights as a licensee of the IP rights that are used wholly or principally outside of Hong Kong by a person other than the taxpayer. Nevertheless, it is quite common for Hong Kong businesses to provide or license IP to third party contractors to produce goods outside Hong Kong due to cost considerations. We believe that a taxpayer should not be disadvantaged from making a commercially driven decision and it is not in the interest of the development of IP business in Hong Kong. **Mazars Hong Kong urges the Government to revisit the issue and consider amending the IRO to rectify the situation.**

1.4 Revamp of Our Profits Tax Regime

Simple tax system and low tax rate have all along been considered as ones of our competitive advantages. However, in the last decade, our neighboring jurisdictions have been keen in catching up by lowering their tax rate and introducing various tax incentive measures. Singapore, one of our major competitors, 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 of 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. Japan, Malaysia and Vietnam also lowered their corporate income tax rates recently in 2016. [1] In order to preserve our tax competitiveness, **Mazars recommends the Government to lower the profits tax rate from 16.5% to 15% over a three-year period starting from 2016/2017.**

In addition to lowering of our profits tax rate, the Government should introduce two-tier profits tax system to support our small and medium sized enterprises. Two-tier corporate tax rate systems are in place in most of our neighboring jurisdiction including Indonesia, Malaysia, Singapore, South Korea, Taiwan, Thailand and Vietnam. Mazars suggests **a concessionary rate at 50% of the normal profits tax rate be applied to taxpayers whose annual taxable profits are below HK$2 million.**

[1] *Please refer to the Appendix for a summary of corporate tax rates.*

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 Comprehensive Review of Our Taxation Regime

In the last decade, the global tax landscapes have 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.). 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**. The Government can also address the existing tax anomalies in our current tax legislation as mentioned and explore different ways to enhance our tax competitiveness in the course of the review exercise.

2. IMPROVING PEOPLE'S LIVELIHOOD

In our last year's budget proposal, we recommended the Government to increase the level of certain personal allowances and statutory deduction to easy people's financial burden amidst elevated living costs particularly in the area of housing. We welcome Mr Tsang's proposal in his 2016-2017 Budget to increase the followings:-

(i) the basic allowance and single parent allowance from HK$120,000 to HK$132,000 and the married person's allowance from HK$240,000 to HK$264,000;

(ii) the dependent parent or grandparent allowance (as well as the additional parent or grandparent allowance) aged between 55 and 59 from HK$20,000 to HK$23,000 and the dependent parent or grandparent (as well as the additional parent or grandparent allowance) aged

60 or above from HK$40,000 to HK$46,000; and

(iii) the deduction ceiling for elderly residential care expenses from HK$80,000 to HK$92,000.

In addition to the above, we would recommend the following tax measures to be introduced in the upcoming budget.

(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, the salaries taxpayers who are subject to progressive tax rate are better off;

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

(c) Removing the time limit for claiming tax deduction for home loan interest; and

(d) 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.

3. PREPARING FOR AN AGEING POPULATION

Mr Tsang forecasted in his last year's budget that recurrent expenditure on medical and health for 2016-17 would be HK$57 billion, accounting for 16.5 per cent of recurrent government expenditure. This represented an increase of more than 90 per cent when compared with a decade ago. It is a consensus that the ageing population in Hong Kong will pose sustained challenge to the public finance in future.

From a tax policy formulation perspective, we recommend the Government to introduce tax incentive measures to encourage people to save and prepare for their retirement life by allowing tax deduction of voluntary contributions to Mandatory Provident Fund schemes and other recognized retirement schemes as well as private medical insurance premiums.

Mazars Hong Kong 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.

In addition, **Mazars Hong Kong also recommends the Government to introduce tax deduction of the premiums 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.

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.

Appendix – Corporate Tax Rates in Hong Kong and Neighboring Jurisdictions

	2009	2010	2011	2012	2013	2014	2015	2016
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)	28%	25%	25%	25%	25%	25%	25%	25%
Japan (c)	40.7%	40.7%	40.7%	38%	38%	35.6%	33.1%	30.9%
Malaysia (d)	25%	25%	25%	25%	25%	25%	25%	24%
Philippines	30%	30%	30%	30%	30%	30%	30%	30%
Singapore (e)	18%	17%	17%	17%	17%	17%	17%	17%
South Korea (f)	24.2%	24.2%	24.2%	24.2%	24.2%	24.2%	24.2%	24.2%
Taiwan (g)	25%	17%	17%	17%	17%	17%	17%	17%
Thailand (h)	30%	30%	30%	23%	20%	20%	20%	20%
Vietnam	25%	25%	25%	25%	25%	22%	22%	20%

(a) Certain businesses in some free trade zones are eligible for reduced tax rates of 15%. 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. SMEs with revenues below IDR4.8 billion are taxed at 1% of revenue.

(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 19% is applied on the first MYR500,000 of chargeable profits.

(e) 75% of the first SGD10,000 of normal chargeable profit 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.

About Mazars

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Including the Hong Kong office, we operate 25 offices in China with around 2,800 staff. Through Mazars Group and our global Praxity Alliance, we can also draw upon a wide pool of resources, specialties and expertise such that we can truly claim to possess a personal touch backed by big experience.

CONTACTS

Mazars
42nd Floor, Central Plaza,
18 Harbour Road
Wanchai, Hong Kong
Tel.: (+ 852) 2909 5555

Michael To
Managing Partner
Tel: (+852) 2909 5680
Email: michael.to@mazars.hk

Anthony Tam
Tax Partner
Tel: (+852) 2909 5604
Email: anthony.tam@mazars.hk

Alexandra Hui
Tax Partner
Tel: (+852) 2909 5678
Email: alexandra.hui@mazars.hk