Tax policy and budget proposals
2020-21

Together for a Better
Hong Kong

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

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"Together for a Better Hong Kong"

<u>Summary</u>

The Hong Kong Institute of Certified Public Accountants the (Institute)'s 2020-21 budget proposals, under the heading, ***"Together for a Better Hong Kong"***, have been developed by the Institute's Taxation Faculty. The proposals encompass 13 proposed policies and other measures.

A summary of the proposals is as follows:

I. Holistic review of the Hong Kong tax system	**II. Supporting development of local startups**	**III. Community and business relief measures**	**IV. Environmental measures**
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Introduction

I. Macroeconomic developments

In the year since the last budget, the Hong Kong Special Administrative Region (Hong Kong)'s economic and political environment has deteriorated. While the territory's economy was growing at a solid rate of 2.9% year-on-year in Q3 2018, this year third quarter gross domestic product (GDP) recently released by the Census and Statistics Department[1] shows the territory has entered a technical recession (two quarters of negative real GDP growth). This is the first time since the global financial crisis that the territory has experienced a recession. This is forecast to continue through the fourth quarter and lead to a full-year contraction in GDP projected to be -1.3%[2].

Hong Kong faces not just a slowing domestic economy, but international headwinds. These include slowing growth in the Mainland, the long running saga of the trade dispute between the Mainland and the United States, and global tax changes.

GDP growth in the Mainland came in for the third quarter at 6% on an annual basis, still high by global standards, but its lowest level for 30 years.[3] This has led to slowing demand for Hong Kong property, with new leases to Mainland companies falling by almost 40 per cent in the first half of 2019 according to data from real estate consultancy Colliers.[4] The local residential and commercial markets have also been affected by the ongoing political disruption, with house prices falling by around 2.0% in October 2019 from the month before.[5]

Hong Kong has also found itself in the crosshairs of the Mainland-U.S. trade dispute. As a globally open re-export hub for Mainland-produced goods, Hong Kong's exports have been lower every month of the year to September than the previous year.[6] Although a limited "phase one" deal has apparently been agreed between the superpowers, and reports are that it will shortly be signed, in mid-January[7], the impetus that this will provide to Hong Kong's economy remains unclear.

Finally, the Organization for Economic Co-operation and Development (OECD) recently published its draft Base Erosion and Profit Shifting (BEPS) 2.0 (the BEPS 2.0 proposals) measures for public consultation.[8] These measures are designed to ensure cross-border businesses pay their fair share of tax across all the jurisdictions they operate in. The proposal involves two pillars. Pillar One allocates taxing rights for cross-border activities based on revised nexus and profit allocation rules. Pillar Two gives the parent and source jurisdictions a right to tax untaxed/undertaxed income where the income is taxed at an effective rate below a certain minimum rate. Together these could lead to significant impacts on the offshore regime, various concessionary tax regimes and the capital gains exemption in Hong Kong. The territory's tax policy may need to change, and Hong Kong should ensure it is prepared for the new regulations.

[1] https://www.censtatd.gov.hk/hkstat/sub/so250.jsp
[2] Office of the Government Economist, https://www.hkeconomy.gov.hk/en/situation/development/index.htm
[3] Slowing Chinese growth delivers blow to global economy, Financial Times, https://www.ft.com/content/396e67be-f0b5-11e9-ad1e-4367d8281195
[4] Hong Kong property market weakens on China slowdown, Financial Times, https://www.ft.com/content/d6cf4120-af49-11e9-8030-530adfa879c2
[5] http://www1.centadata.com/cci/cci_e.htm
[6] https://www.censtatd.gov.hk/hkstat/sub/sp230.jsp?tableID=055&ID=0&productType=8
[7] Trade war: China to travel to US on January 13 to sign phase one trade deal, SCMP, https://www.scmp.com/economy/china-economy/article/3044741/trade-war-chinese-put-back-visit-sign-truce-after-donald
[8] https://www.oecd.org/tax/oecd-leading-multilateral-efforts-to-address-tax-challenges-from-digitalisation-of-the-economy.htm

However, it is not all bad news. While Hong Kong currently faces political and economic difficulties, it still retains the top spot as the world's freest economy according to The Fraser Institute[9] and moved up to 3rd place in 2019, from 7th in 2018, in the World Economic Forum's *Global Competitiveness Report* [10] Financial market activity remains buoyant as well, and recently there have been two large initial public offerings, Budweiser Brewing Company APAC raising US$5 billion through its September listing; and ESR Cayman raising US$1.6 billion through its October listing. In addition, Alibaba is raised up to US$12.9 billion in its secondary listing in November, which would make it Hong Kong's third largest IPO since 1986.[11]

II. Policy areas

In order to maintain Hong Kong's strong position as a global financial hub, the Hong Kong Government (the government) should look to enact economic and tax policy reforms to further strengthen the economy and the ability of businesses to succeed from a strong local base. The Hong Kong Chief Executive's recent policy address proposed some stimulus and relief measures to improve the local working and living environment, which the Institute supports, but we would also like to see progress in other areas, including measures to improve the health and wellbeing of Hong Kong residents.

Business

Hong Kong ranks 25th in Startup Genome's *Global Startup Ecosystem Report 2019*,[12] below other Asian cities, including Beijing, Shanghai and Singapore. Improving the access to funding, support for research and development (R&D) to generate patents and other intellectual property, as well as other local support initiatives are vital to Hong Kong's long-term success in developing new businesses. A vibrant startup ecosystem also requires support from existing business leaders, so that young people can benefit from guidance from the development of innovative ideas through to the commercialization process. The government should consider further tax incentives alongside the recently-introduced super deductions for R&D expenditure to promote Hong Kong's startup environment. Furthermore, to encourage investors, the government should consider providing group tax loss relief to companies investing in startups and provide cash grants and equity financing to startups that meet certain qualifying conditions.

At the same time, the government needs to assess the potential impact of the proposed global minimum tax requirements under the OECD's BEPS 2.0 proposals.

Another issue that the Institute would like to highlight is the array of small- and medium-sized business (SME) and startup support schemes available now. There are currently more than 60 entities/ schemes providing funding which may leave businesses confused as to which scheme or schemes they should apply for. The government should review the number of schemes and rationalize and streamline them where possible.

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[9] Economic Freedom of the World: 2019 Annual Report, The Fraser Institute, https://www.fraserinstitute.org/studies/economic-freedom-of-the-world-2019-annual-report

[10] http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf

[11] Alibaba raises up to US$12.9 billion in landmark Hong Kong listing, Reuters https://www.reuters.com/article/us-alibaba-hongkong-pricing/alibaba-raises-up-to-12-9-billion-in-landmark-hong-kong-listing-idUSKBN1XT2W0

[12] Global Startup Ecosystem Report 2019, Startup Genome, https://startupgenome.com/reports

Living environment

Air pollution was named as the greatest environmental threat to health by the World Health Organization in 2019.[13] Traffic is a major contributor to air pollution, and while Hong Kong's air quality has improved markedly in recent years,[14] there is still a large number of older pollution-generating vehicles on the roads. Tax incentives should be offered to owners of private vehicles, taxis and other commercial vehicles, to encourage them to replace these older vehicles with new electric, or at least more efficient, vehicles. The Government should also continue its support for developing the public transport network, to provide alternative means of transportation, and so reduce the need for private vehicles. Together, these plans can help to further improve Hong Kong's air quality and population's quality of life.

Hong Kong's high property prices and other costs of living create difficulties for its lower and middle-income groups. While the government has introduced some measures to help these groups, including cash handouts, rates waivers and salaries tax rebates, the Institute believes that more could be done in the current stressful environment. The government should introduce policies, including increasing the tax rebates, introducing a home rental deduction allowance and enhancing employee protections under the Protection of Wages on Insolvency Fund (PWIF).

III. The proposals

The Institute's full budget submission has been prepared by its Taxation Faculty Executive Committee's Budget Proposals 2020-21 Sub-committee. The proposals, under the theme, ***"Together for a Better Hong Kong"***, cover four broad themes and make 13 specific recommendations.

Together, these initiatives will help support Hong Kong's economy in the face of global and domestic pressures, and improve the livelihoods of its residents.

[13] Greenpeace launches Hong Kong pollution campaign as volunteers talk about the impact city's bad air has on their health, South China Morning Post, https://www.scmp.com/news/hong-kong/health-environment/article/3019320/greenpeace-launches-hong-kong-pollution-campaign

[14] Clean Air Plan for Hong Kong; 2013-2017 Progress Report, Environmental Protection Bureau, https://www.enb.gov.hk/sites/default/files/CleanAirPlanUpdateEng_W3C.pdf

I. HOLISTIC REVIEW OF THE HONG KONG TAX SYSTEM

1. Review of the tax system

We believe that a holistic review of Hong Kong tax system is needed for a number of reasons, including the following:

- International developments in taxation are having increasing influence on the tax rules and administration in Hong Kong.
- It is far from clear that Inland Revenue Ordinance (IRO) and the associated body of case law will continue to be fit for purpose, given the significant changes in the ways in which business is conducted in a globalized economy, including internet and online business, and the increasing importance of highly mobile intangible assets, such as intellectual property.
- If we continue to rely on traditional sources of revenue alone, it is questionable whether Hong Kong can still balance the books in the longer term, given an ageing population and the community's aspirations for affordable housing and a better quality of life, etc.
- We need to take a long hard look at Hong Kong's competitiveness and how we can continue to attract investment, given some the changes referred to above and growing competition from other jurisdictions, both regionally and globally.
- The tax system has not undergone a full review for almost 45 years and much water has passed under the bridge since then. While a review does not necessarily mean completely revamping the system and starting again, we have to understand what works and what does not and to assess the implications of some of developments referred to above.

Major changes have been taking place in Hong Kong's tax landscape in recent years, with the Legislative Council passing more than 10 tax bills during 2017-2019. A number of these were aimed at bringing the IRO into line with recent international tax developments. However, despite these changes, the IRO cannot be said to be adequately adapted for today's fast pace of change in ways of doing business and the ongoing conceptual developments in international tax. Hong Kong needs to take a more pro-active approach to modernizing its tax system.

The IRO was introduced more than 70 years ago and the last major review took place nearly 45 years ago. Since that time, significant changes have taken place in the way in which much business is conducted, including the growth of internet and online business, and the emergence of the "shared economy". Globalized trade has also seen a considerable expansion of franchising and licensing arrangements where huge value resides in intellectual property rights, ultimately owned by the franchiser or licensor, but which legally may be held by a related entity in a low tax jurisdiction. In the current environment, it is not unusual for new economy companies to be valued in billions of dollars by the financial markets without ever having generated a profit.

These developments have, in part, triggered tax initiatives at the international level, such as the BEPS project, that have had a knock-on effect on Hong Kong in ways that do not necessarily sit well with Hong Kong's existing source-based tax regime.

For example, international transfer pricing rules were codified via the Inland Revenue (Amendment) Bill (No 6) 2017 (the No 6 Bill), which virtually doubled the size of the IRO and brought some fundamental changes to the administration of the Hong Kong profits tax regime. These rules are aimed at helping to implement one of the main

BEPS objectives, to ensure that companies are taxed where they actually operate and create value. Such developments will inevitably affect the perspective of the IRD and will result in changes in the way in which companies that engage in business across borders will be taxed in Hong Kong.

The BEPS 2.0 proposals, which could be implemented as early as late 2020, represent a major challenge to the basis of Hong Kong tax system. The OECD has published a number of documents setting out its proposed approach to dealing with the threats to taxing rights under traditional tax laws.

The BEPS 2.0 proposals involve two pillars, namely:

- Pillar One, which proposes to allocate taxing rights for cross-border activities based on revised nexus and profit allocation rules and which relates to taxation of the digital economy; and

- Pillar Two, which looks to give the parent and source jurisdictions a right to tax untaxed/undertaxed income where an entity's income is taxed at an effective rate below a certain minimum rate (i.e., the global anti-base erosion (GloBE) proposal). This is aimed at ensuring that companies doing business internationally do not pay less than a certain minimum rate of tax on global basis.

While the Pillar One proposals focus on addressing the tax challenges of the digital economy, the GloBE proposal could have a profound impact on all businesses with cross-border activities and on the long-standing architecture of Hong Kong's tax system. Under the proposal, a company's income that is not subject to tax at an effective tax rate that is equal to, or higher than, a certain agreed minimum in one jurisdiction, may be subject to tax again in other relevant jurisdictions where that company operates, in order to bring it up to the overall minimum effective tax rate. While the minimum rate under GloBE has yet to be determined, it is believed that it will be at least 10% if not higher. This could have a significant impact on the offshore regime, various existing concessionary tax regimes and the capital gains exemption, among other things, under Hong Kong's tax system.

In addition, it is worth noting that while Hong Kong was removed from the European Union (EU)'s list of non-cooperative jurisdictions in March 2019, after undertaking a series of actions to meet the EU criteria, the EU recently issued new guidance in relation to foreign-source-income exemption regimes[15]. Under the guidance, jurisdictions that exempt foreign source income, which could include Hong Kong, will be subject to review and may be included in the EU list of non-cooperative jurisdictions, where they create situations of double-non taxation, due to, e.g.:

- An overly broad definition of income excluded from taxation, notably foreign source passive income, without any conditions or safeguards, and/or;

- A nexus definition that deviates from the definition of a permanent establishment in the OECD Model Tax Convention.

Hong Kong has already been required to make changes to its incentive measures, as a number of such measures, which ring-fenced the domestic market, might otherwise have been treated as harmful tax practices under the OECD standards. Now, in the

[15] https://data.consilium.europa.eu/doc/document/ST-13075-2019-INIT/en/pdf

light also of the latest EU guidance, Hong Kong will need to consider its future approach to tax incentives very carefully.

Setting aside for a moment the external challenges to Hong Kong's incentive regimes, there has never been a review of the effectiveness of incentives once they have been introduced under the present system. Some tax practitioners and their clients express doubts about the effectiveness of a number our incentives in attracting more business to Hong Kong. This could be for a variety of reasons, including the extensive, specific anti-avoidance provisions that often accompany new incentives, which can make the changes more complex and less business-friendly than originally intended; or the fact that when they are introduced, Hong Kong's incentives may not be substantially better than those already in place in competing jurisdictions and so, on their own, they may not be sufficient to attract much new business.

The need for stable and reliable sources of revenue over the long-term remains another issue for Hong Kong, particularly given the ageing population and increasing dependency ratio, in terms of the number of retired persons supported by the working population. There are serious concerns also about unaffordable asset prices in Hong Kong, which are due, in part, to the high price of land, itself a reflection of the reliance historically that the government has placed on land premiums in its budgeting.

Our low tax rates have helped make Hong Kong competitive in attracting investment in the past. However, a many other developed economies are reducing their income tax rates and placing greater emphasis on indirect tax. Given the situation explained above, and the fact that profits tax accounts for around 25% of the government annual recurrent revenue, coupled with the potential complications associated with the GloBE proposal, there is very little scope for Hong Kong to reduce its profits tax rate any further to compete with other jurisdictions.

Taking into consideration all of the above, the need for a holistic review of the Hong Kong tax system seems to be clear.

2. ***Tax policy unit***

The Tax Policy Unit (TPU) could take a leading role in a holistic review. The relocation of the TPU under the Financial Secretary (FS)'s Office following the 2019-20 budget should facilitate it to play a leading role in any review of the Hong Kong tax system. The oversight of the FS's Office can help ensure that the policy research and development of TPU are more closely attuned to the needs of Hong Kong and its overall economic development.

We understand that the TPU plans to expand and hire senior tax practitioners, including a directorate practitioner. To ensure the effectiveness of the TPU it needs to have a membership drawn from diverse backgrounds, including tax advisers as well as industry tax practitioners who can bring business experience and acumen to the table, to help generate sensible, practical tax policies and proposals for the long-term benefit of Hong Kong. Former senior officials from the IRD can add balance from the perspective of revenue protection, as appropriate.

With the addition of manpower and expertise, the TPU could be more forward looking in the formulation of tax policy. For instance, Singapore and New Zealand are both developed countries with smaller populations than Hong Kong. However, they have been taking a more proactive approach in the discussions in the BEPS 2.0 proposals. Early active participation in the discussions enables the participants to be in a much better position to prepare themselves for the impact that the BEPS 2.0 proposals may bring.

As Hong Kong is a comparatively modest, externally-orientated economy (like Singapore), it is unlikely that it can exert significant influence on the direction of the BEPS 2.0 proposals. However, if it followed the example of Singapore and New Zealand and actively participated in the discussions, and began the formulation of concrete action plans in response, this would help Hong Kong to soften the impact that implementation may bring. A similar proactive approach should also be taken in response to the new EU guidelines referred to earlier.

3. <u>Legal framework for new economy</u>

As indicated above, the emergence of the digital economy brings challenges to the traditional tax systems, particularly in relation to taxing rights. In fact, the digital economy also poses questions for the laws and regulation in Hong Kong. For example, Hong Kong's laws may not adequately support or encourage the development of the shared economy and fintech, e.g. crowd funding and crypto currencies.

While Hong Kong may need to modify its tax system to cater for changes due to implementation of the BEPS 2.0 proposals, the government should also take this chance to review the local laws and also see what other jurisdictions are doing, or have done, in terms of laws and regulation, to encourage, or at least accommodate, features of the shared economy. Based on this research, the government should consider the need to put through changes to make the environment more conducive to the development of shared economy business models in Hong Kong.

In short, although the digital economy poses challenges for traditional tax systems, it has also brought new and innovative business opportunities to society. If we embrace such changes, we can stimulate further innovation but if we resist change, this may create impediments to boosting Hong Kong's creativity and a building a more competitive economy.

II. SUPPORTING DEVELOPMENT OF LOCAL STARTUPS

4. <u>Provide tax credit and subsidies to the startups</u>

While evolution in ways of working has always been a constant, the pace of change over the past 10 years has been unprecedented, spurred on by the increasing prevalence of the internet.

While there is a widespread view that three key economic forces have been major drivers of change, namely automation, globalization and flexibility, the proliferation of the digital economy and the generation of unconventional, creative and disruptive new business ideas by young people are also contributing factors.

Some of these new business ideas have the potential to become game changers, e.g. developments of social media tools. It is common for young people to develop their new business ideas through business startups. In a well-developed ecosystem, young people would have necessary support from when they develop initial ideas right through to their commercialization. It is helpful, therefore, to have some incentives in place to encourage investors to build up the ecosystem and young people to take the opportunity to join the wave of innovation.

Startup investors

Although the number of venture capital (VC), and technology deals in Hong Kong remained almost the same in 2018 as in 2017, at 42 deals in total, their combined value jumped by 81%[16], from US$1.26 billion in 2017 to US$2.29 billion in 2018. To maintain and build on this momentum, the government should consider offering tax incentives to entities including venture funds and angel investors that invest in startups.

Singapore, for example, has introduced a range of tax incentives for individuals or fund management companies that are actively investing in startups and/or other Singapore companies, such as the following[17]:

	Angel Investors Tax Deduction	Section 13H Incentive	Fund Management Incentive
Amount of deduction	50% of the investment, subject to a cap of $500,000	Allowing an approved fund a zero-rated tax relief for a period of up to 10 years on: - gains arising from the divestment of approved portfolio holdings; - dividend income from approved foreign portfolio companies; and - interest income arising from approved foreign convertible loan stock.	Allowing an approved fund management company a tax relief at a concessionary rate of 5% for a period of up to 10 years on: - Management fees derived from an approved venture capital fund; and - Performance bonus received from the said approved venture capital fund.
Eligibility	1. Make the investment at the individual level 2. Angel investors must be: - experienced with track record in early-stage investments or	1. The funds should be incorporated and based in Singapore. 2. The fund management companies should be incorporated and based in Singapore. 3. The fund and the fund management companies should have obtained the necessary approvals and licences (e.g. Capital Markets Services Licence, Registered Fund Management	

[16] VC fundraising hits US$2.28b in 2018, https://hongkongbusiness.hk/sites/default/files/hongkongbusiness/print/HKB_2019_FEBMARCH-14-16.pdf

[17] Startup SG Investor, https://www.startupsg.net/programmes/4893/startup-sg-investor

	Angel Investors Tax Deduction	Section 13H Incentive	Fund Management Incentive
	- experienced with an entrepreneurial track record or - senior management professional/ executives 3. Angel investors must demonstrate the ability to nurture investee companies	Company) from the Monetary Authority of Singapore for their proposed activities.	

In the Mainland, a tax incentive is provided to VC funders investing in science and technology enterprises at the seed capital or start-up stage. Under the incentive, and provided that these enterprises have been held for two years, 70% of the investment amount can be offset against the taxable income of the VC funder for Corporate Income Tax purposes. Furthermore, the equivalent Individual Income Tax treatment will be provided for individuals investing through VC partnerships[18].

Since there has been an increasing number of holding companies that establish separate startup subsidiaries to diversify the risk of different startups, we also recommend that a form of group loss relief be introduced in Hong Kong, so that tax losses from individual startup operations could be absorbed by other profitable group companies. Anti-avoidance provisions could be used to address any concerns about possible abuse of such a measure.

Startup investees

Adopting a smart attitude and being able to learn from failure is critical to the success of startups. Successful innovation often comes as a result of modifications made based on previous failures. Therefore, aspiring startups and innovative businesses should be encouraged to try new things. For example, initiatives leveraging on technologies to help support the government’s objective to develop a Smart City should be supported. This could include, e.g., companies that enable data collection and fleet management solutions that could contribute to alleviating traffic congestion.

Tax policies have been used as a tool to encourage spending and investment in areas which the government is seeking to promote and develop. For instance, in order to develop Hong Kong as an R&D hub, a tax super deduction policy on qualifying R&D expenditure was introduced in 2019. However, many startup companies incur substantial tax losses in their early years of operation and are not able to enjoy the benefits of the super deductions.

In addition to enhanced deductions, therefore, the government should consider providing cash grants and equity financing to startups that meet certain qualifying conditions.

[18] http://szs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201705/t20170502_2591730.html

In Hong Kong, Cyberport Creative Micro provides an initial grant of up to HK$100,000 for digital tech start-up projects and business ideas with potential. However, this may not be sufficient for producing proof of concepts and prototypes, particularly as dedicated experts are often needed to transform the ideas into products.

Singapore is very supportive of startups. The Technology for Enterprise Capability Upgrading (T-Up) programme was launched to support local SMEs by seconding Agency for Science, Technology and Research (ASTAR*) research engineers and scientists to help develop and implement innovative processes into R&D projects[19]with up to 70%[20] of the secondment costs being subsidized.

5. To review and consolidate different fund schemes for startups and SMEs

The government in Hong Kong aims to support startups and SMEs to help realize their vision and take their business to the next level through different bodies/ schemes. For example[21]:

- Create Hong Kong: The government has injected a total of $2 billion to support its programmes. By end-March 2019, $1.213 billion had been committed to support programmes under the three strategy foci, namely, nurturing talent and facilitating start-ups, exploring markets and fostering a creative atmosphere[22].

- Hong Kong Cyberport Management Company Limited: wholly owned by the government, the company provides the following programmes to nurture the entrepreneurial spirit[23]:

    - Cyberport Creative Micro Fund
    - Cyberport Incubation Programme
    - Cyberport Accelerator Support Programme
    - Market Development Support Scheme
    - Cyberport Macro Fund

- HKTDC SME Centre: Led by the Hong Kong Trade Development Council, the centre provides the resources SMEs need to do business[24].

While there are more than 60 entities/ schemes providing funding programmes to startups and SMEs in Hong Kong, eligible businesses may be confused by the range of different schemes and not know which schemes they should apply for at the beginning, whether schemes are mutually exclusive, etc.

We suggest that the government should look at reviewing and, where possible, rationalizing and consolidating these different schemes. They should consider forming a centralized team or one-stop shop to assess applicants, and advise them on the most efficient route to apply for relevant preferential programmes. Singapore, for example, established Startup SG to unify efforts to support the startup ecosystem

[19] https://www.a-star.edu.sg/Collaborate/Programmes-for-SMEs/Technology-for-Enterprise-Capability-Upgrading
[20] https://www.smeportal.sg/content/smeportal/en/stages/plan/2018/singapore-business-startup-schemes-and-grants.html
[21] Government Support, https://www.startmeup.hk/government-support/
[22] Report on the Work of Create Hong Kong and Hong Kong Design Centre, http://www.createhk.gov.hk/en/services/files/panel_paper_e.pdf
[23] Cyberport Entrepreneurs, http://www.cyberport.hk/en/about_cyberport/cyberport_entrepreneurs
[24]SME Centre, http://www.hktdc.com/ncs/smecentre/en/s/AboutSMECentre.html

under its various initiatives and programmes. Its website is well organized and systematic in illustrating specific schemes[25] for different stages of startups.

[25] https://www.startupsg.net/programmes

III. COMMUNITY AND BUSINESS RELIEF MEASURES

6. Public transport fare subsidy scheme enhancement

To relieve the burden of commuters with high transportation expenses, the government introduced a public transport fare subsidy scheme[26] in 2019. Regardless of their income level, commuters can claim a subsidy for 25% of the actual public transport expenses in excess of HK$400, subject to a maximum of $300 per month. These expenses are limited to monthly public transport expenses paid by Octopus cards, including fares for the Mass Transit Railway (MTR), franchised buses, green minibuses, ferries and trams, and expenses on monthly passes or day passes of the public transport services endorsed by the government.

The government has recently increased the subsidy rate from 1/4 to 1/3 and the cap to HK$400/month, which is a welcome development.

However, further refinements could be made to the scheme to cater for the needs of different commuters. Currently, payments for residents' buses and red minibuses are not qualifying expenses under the scheme. These modes of transport are still widely used, which is a clear indication that there is a market demand for them and that they may be the preferred options of some commuters. Expanding the scope of the scheme to include residents' busses and red minibuses would put them on a level playing field with other means of transportation and strengthen competition.

7. To enhance measures to support residents

Middle-class households

The FS has recently announced a number of measures to mitigate the impact of a challenging external and local economic environment on Hong Kong citizens[27]. Among these measures, are increasing the percentage of the tax rebate from 75% to 100%, subject to a cap of $20,000, under salaries tax, personal assessment and profits tax for the year of assessment 2018-19. This will benefit about 1.43 million taxpayers and, as a result, 1.33 million taxpayers will have all taxes waived. It is estimated that this measure will cost $1.84 billion in revenue, which is equal to around 3% of the salaries tax received in 2017-18.

However, this measure may not provide much, if any, additional benefit to the middle class as they may already receive a tax rebate at the capped amount of HK$20,000 under the existing tax rebate policy. It is worth noting that the middle class constitute a key engine of Hong Kong's economy and are shouldering the biggest burden from high property prices. Furthermore, middle income earners will generally not receive any protection under the social security system if they become unemployed.

To help relieve the heavy financial burden on the middle class, in the coming year, the government should consider providing a tax rebate with an increased cap of HK$30,000 for salaries tax and individuals who choose to be taxed under personal assessment, as well as profits tax.

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[26] Public transport fare subsidy scheme
https://www.thb.gov.hk/eng/psp/publications/transport/publications/THB_pamphlet_ePage_final.pdf

[27] https://www.ird.gov.hk/eng/ppr/archives/19081501.htm

The underprivileged

Against the background of the current local and international economic, social, and political environment, the government has recently announced a HK$1.4 billion package of living and training allowances and subsidies to help the low-income, the unemployed and underemployed groups[28]. This is no doubt a welcome measure to help the underprivileged.

The government should also reach out to the excluded and the underprivileged who might not benefit from the recent relief measures, particularly the so-called "N-nothings", i.e., low-income people who are not receiving any government assistance. While it might be administratively complex to initiate specific measures to support this group of people through the Community Care Fund, the government could give out a “cash” subsidy to permanent residents aged 18 and above who are not taxpayers and do not own any property. It would be beneficial to more members of the community if any subsidy were to be paid out, wholly or partly, in a form that would encourage local spending, such as retail shopping coupons. This would also benefit the local retail trade, which has been suffering during the recent unrest and the resulting substantial drop in the number of tourists. The cash handout of HK$4,000 for Hong Kong citizens who did not benefit from the budget measures in 2018 could be used as a reference for the amount of any subsidy.

However, the government should also learn from the experience of administering the HK$4,000 handouts given out previously and aim to avoid similar delays in the implementation process. There should be improved and expedited administrative arrangements so that the subsidy could reach the intended recipients quickly.

In addition, an extra allowance for social security recipients, equal to two months of the standard rate of Comprehensive Social Security Assistance payments, Old Age Allowance and Old Age Living Allowance or Disability Allowance should be considered.

8. Home rental deduction

While the recent relaxation of the mortgage ratio for residential properties, aimed at helping the younger generation to buy their first residential property, is to be welcomed, there remains a large number of Hong Kong residents who cannot afford the high property prices and who, therefore, need to rent their accommodation.

According to the information released by the Rating and Valuation Department in 2018, the rental cost of private domestic units with usable flat size below 40 square metres in Kowloon and New Territories[29], increased by around 8.3%, compared with 2017. Although, recently the increments have slowed down, rent is still the main household expense of a typical young family. While the median income for a family of three persons in 2018 was around HK$28,000[30], the average rent for a unit less than 40 square metres on Hong Kong Island was almost HK$20,000[31], equal to over 70% of the median household income.

[28] https://www.scmp.com/news/hong-kong/hong-kong-economy/article/3030683/hong-kong-government-launches-hk300-million-scheme
[29] Private Domestic - Average Rents by Class (from 1982) (up to July 2019 figures), https://www.rvd.gov.hk/en/property_market_statistics/index.html
[30] 2018 Population and Household Statistics Analysed by District Council District, P.5, https://www.statistics.gov.hk/pub/B11303012018AN18B0100.pdf
[31] Private Domestic - Average Rents by Class (from 1982) (up to July 2019 figures), https://www.rvd.gov.hk/en/property_market_statistics/index.html

With the above in mind, the Institute continues to recommend the introduction of tax deduction for rental payments made by taxpayers on their primary residence, subject to an annual limit of HK$100,000 (i.e., the same amount as the home loan interest deduction). While we understand that the government has considered such a measure and is concerned that it could add fuel to the rising trend of residential rents,, there are other factors that determine rents in the market and the market changes from time to time. We do not believe that introducing this measure in the current environment would, in practice, lead to any significant increase in rentals. We hope, therefore, that the government will seriously re-consider the merits of this proposed measure.

9. <u>To Initiate Measures To Help Employees</u>

Enhancing employees' protection under Insolvency Fund Board

The PWIF was set up to provide timely relief in the form of ex-gratia payments to employees in the event of the closure of the business of their insolvent employers. In view of the economic downturn and impact of the social unrest in recent months, it is anticipated that a substantial number of companies in the retail and catering industries may have to close down in the coming months. As a result, employees of these companies will likely be made redundant. According to historical records, it is not uncommon that companies in the catering industry fail to pay the salaries and severance payments in arrears to their former employees when they close down their operations.

Other companies facing cash flow constraints, and without sufficient reserves, may also not be able to survive in this economic downturn and, as a result, their employees may face redundancy. Accordingly, the number of individuals who need to seek help from the PWIF may increase significantly in the foreseeable future. Payments under the PWIF are subject to certain ceiling amounts. The claim ceilings for different income classes are summarized below:

a. Arrears of wages	Up to HK$36,000 for arrears of wages of an employee for services rendered to his or her employer **during the four months** prior to the last day of service.
b. Pay-in-lieu of notice	One month's wages in lieu of notice up to HK$22,500
c. Untaken annual leave	Up to HK$10,500 for untaken annual leave and untaken statutory holidays.
d. Severance pay	HK$50,000 plus 50% of any claim over HK$50,000.
Note: Total amount of the claims above should not exceed HK$278,500.	

We recommend that the respective ceilings be reviewed. Individuals may find the relatively low levels of the ceilings for arrears of wages, pay-in-lieu of notice and untaken annual leave, in particular, to be insufficient to maintain their basic needs, even temporarily, after being made redundant, especially if they do not qualify for severance payment.

10. <u>Tax loss carry-backward</u>

Tax loss carryback is provided for in the tax systems of many developed countries. In a tax jurisdiction with tax loss carryback, taxpayers who are making a current-year tax loss may be able to get refund of tax paid for the prior year or years. The cash flow of a business can determine whether it survives or fails. The tax loss carryback feature can help taxpayers ease their cash flow problems if they suffer a sudden deterioration in their performance. Also, providing for tax loss carryback would be considered a business-friendly tax measure, especially during economic downturns.

Currently, the economic outlook, both locally and globally, is gloomy. Due to the uncertainty over the prolonged Sino-US trade negotiations and the continuing imposition of trade tariffs, as well as the impact of the social unrest in recent months, many businesses will be facing unprecedented challenges in the coming 6-12 months. Recent international political tensions will only add to this.

Confidence in investing in Hong Kong is at a low. According to the Standard Chartered Bank Hong Kong SME Leading Business Index 4Q2019[32], the overall SME index for 4Q2019 is 31.4, decreasing by 7.6 points as compared with 3Q2019. The index for 3Q2019 had already reached a three-year low, indicating a significant drop in SMEs' confidence in the business environment. The "Business Condition" and "Global Economy" aspects also registered large drops in 4Q The retail sub-index decreased by a further 7.2 points over 3Q to 27.3, which shows that the retail industry has been badly hit. In addition, at least 11 listed catering groups in Hong Kong issued profit warnings as at 31 October 2019, as a result of the present challenging business environment in Hong Kong.

In view of the above, the government should consider introducing tax loss carryback in our tax system as a means to help relieve the cash flow pressure that businesses are facing.

IV. ENVIRONMENTAL MEASURES

11. <u>Green taxes</u>

Society is becoming more aware of issues such as climate change and the need for conservation of resources and sustainability. The recent United Nations Climate Change Conference in and Madrid and devastating wildfires in Australia have put this issue in the spotlight once again. In addition, more people aspire to live a "greener" life and an improved quality of life. At the corporate level, issuing an environmental, social and governance (ESG) report is now a requirement for companies listed in Hong Kong. Even Hong Kong-incorporated unlisted companies that have to comply with the Directors" Report requirement of the Companies Ordinance (Cap, 622) need to report on their environmental policies to the extent that this is necessary to understand the development, performance or position of the company's business. ESG reporting will encourage many listed companies to become more sustainable in their operations as, increasingly, institutional investors are taking ESG considerations into account in making their investment choices.

On the policy side, many countries have introduced green taxes to encourage or discourage certain kinds of behaviour. In fact, green taxes have become an additional effective tool of environmental policy around the world, alongside public education programmes, provision of technical and financial assistance to foster industries engaged in environmental protection, or which use new environmentally-friendly production techniques, and the imposition of punitive sanctions for polluters.

[32] https://av.sc.com/hk/content/docs/hk_scb_sme_index_report_2019q4_eng.pdf

It might be time to consider the feasibility of introducing such taxes in Hong Kong. Arguments for introduction of more green taxes are:

- Market prices do not always reflect the external cost (e.g. the social cost) of an economic activity. Green taxes will encourage economic players to use resources more efficiently.

- Green taxes are not only an efficient way for governments to raise revenue (though the amount might not always be substantial) but they are also more acceptable than income taxes because they are justified on the basis of the "polluter pays" principle. The revenue is to cover the recurrent cost of cleaning up pollution and to fund environmental and other social programmes.

- Green taxes will encourage taxpayers to alter their behaviour and practices more easily and cheaply. Other taxpayers, who cannot afford the adjustment, will simply pay the tax. Pollution will thus be reduced to the least cost to the whole society.

- Such taxes can also help governments to meet climate change goals.

In view of the above, the government should explore the possibility of introducing more tax and non-tax measures in line with the "polluter pays" principle in Hong Kong. For example:

Tax measures	**Non-tax measures**
1. Emission taxes	1. Cash subsidies to companies who choose to use energy saving products and equipment
2. Taxes on polluting inputs	2. Public sector procurement policies
3. Credits for emission reductions	3. A refund system to encourage recycling
4. Accelerated commercial/ industrial building allowances for "green" buildings	4. Increased plot ratios for a wider range of specified environmental features
5. Accelerated depreciation allowances for a greater range of environmentally-friendly installations and equipment	

12. <u>Incentives for replacing aged vehicles</u>

Replacement of aged diesel vehicles

Passenger vehicles account for around 13% of the total roadside emissions[33], while commercial vehicles account for almost the rest. It is reasonable, therefore, to target raising the emission standards of commercial vehicles as an effective means of improving roadside air quality in the city.

We note that the government has launched a programme to phase out Pre-Euro IV diesel commercial vehicles (DCVs). According to the statistics of ex-gratia payment applications, over 25,000 applications, including from minibuses, have been

[33] Clean Air Plan For Hong Kong 2013-2017 Progress Reporthttps://www.enb.gov.hk/sites/default/files/CleanAirPlanUpdateEng_W3C.pdf, p.17

received, accounting for more than 80% of the total Euro III-eligible DCVs[34]. It appears that the underlying progress has been satisfactory. It could be time, therefore, to take the scheme to the next stage, by adopting the Euro VI emission standard for all commercial vehicles, and ending the use of both Euro IV and V commercial vehicles[35] within a reasonable timeframe.

Replacement of aged taxi and public light buses

This above replacement programme, however, is not applicable to taxis and the majority of public minibuses as virtually all taxis and about 72% of the public minibus fleet are powered by liquefied petroleum gas (LPG)[36]. In conjunction with their use of LPG, these vehicles need to install emissions-reduction catalytic converters which are likely to get worn out after about 12-18 months of use. However, studies have shown that these vehicle owners do not regularly replace their converters, which might result in up to 10 times more pollutants being emitted, including levels of NO_X, CO_2 and volatile organic compounds. A one-off subsidy scheme, amounting to HK$80 million, was launched in 2013 to assist and educate relevant vehicle owners about the importance of replacing their vehicles' catalytic converters.

Given the above, it would seem that relying on owners to replace the catalytic converters may not be an effective way to reduce emissions of pollutants. Therefore, it may be time to encourage a faster phasing out of old taxis and minibuses.

Consideration include:

Taxis	**Public minibuses**
Among 18,000 licensed taxis currently operating in Hong Kong[37], approximately 7,000 units are aged 10 years or above[38]; 5,000 units of which are 15 or more years old. This is not ideal. Major cities in the world have imposed age limits on their taxis, for example, Japan (5-6 years)[39] Sydney (6.5 years)[40], New York (7 years)[41] and Chicago (6 years)[42]. The current taxi replacement rate is 1,000 units per year[43]. Therefore, it will take more than 7 years to replace taxis that are older than 10 years of age. If we target to replace all those 18,000 units, we might need to wait until 2037. The	Public minibuses carry 1.8 million passengers daily (and are the 3rd most popular mode of public transportation, after the MTR and regular buses) Of 4,350 licensed vehicles, 2,760 units are aged 10 years or above (note) An estimated 450 units underwent replacement in 2019, 50% of which were eligible for the DCVs ex-gratia payment scheme for EURO III. If no ex-gratia payments are provided in 2020, this is likely to further reduce the replacement rate

[34] https://www.epd.gov.hk/epd/english/environmentinhk/air/prob_solutions/Phasing_out_diesel_comm_veh.html#statistics
[35] Phasing Out Pre-Euro IV Diesel Commercial Vehicles https://www.epd.gov.hk/epd/english/environmentinhk/air/prob_solutions/Phasing_out_diesel_comm_veh.html
[36] Clean Air Plan For Hong Kong 2013-2017 Progress Report https://www.enb.gov.hk/sites/default/files/CleanAirPlanUpdateEng_W3C.pdf, p.22
[37] Transport Department, Transport Department PARC Report https://www.td.gov.hk/en/transport_in_hong_kong/public_transport/taxi/index.html
[38] Transport Department, Transport Department PARC Report https://www.td.gov.hk/en/transport_in_hong_kong/public_transport/taxi/index.html
[39] https://www.legco.gov.hk/yr16-17/english/panels/tp/papers/tp20170317cb4-666-5-e.pdf
[40] https://www.legco.gov.hk/yr16-17/english/panels/tp/papers/tp20170317cb4-666-5-e.pdf
[41] https://rules.cityofnewyork.us/tags/vehicle-retirement-dates
[42] https://www.chicago.gov/content/dam/city/depts/bacp/publicvehicleinfo/publicvehicle/20190103publicvehiclelicensingguide.pdf
[43] Estimates with information provided by dealers and retailers

Taxis	Public minibuses
fact that replacement of taxis is not currently under any government incentive scheme could be a reason for the slow replacement rate. As compared to older generation taxis, the emission of major types of greenhouse gases by new taxis is reduced by more than 50%[44] and the new taxis are much more fuel efficient.	

Note: Figures as of Dec 2018

In view of the above, it is worthwhile for the government to introduce additional policy measures such as subsidies to encourage early replacement of old taxis and public minibuses.

Given the high demand for advanced taxis with low, flat platforms for wheelchair access for the elderly and disabled, the policy measures could include further incentives to replace old taxis with advanced taxis.

In return for replacement incentives, the government should consider making use of the opportunity to require the installation of electronic payment gateways in the new taxis.

13. Electric vehicles

Expanding the programme to incentivize non-pure fossil-fuel cars

According to the Secretary for the Environment, Wong Kam Sing, the government plans to phase out all pure fossil fuel cars and phase in electric vehicles over the next 20 years. This is indeed a huge undertaking with electric vehicle technologies yet to be perfected and a massive strain, both financially and logistically, to provide an adequate infrastructure of charging stations throughout the territory. At the same time, there continues to be debate among advanced economies and mainstream manufacturers on the standard of electric vehicle charging systems; and a consensus has yet to be reached in Hong Kong.

We contend that in the interim period, before agreement has been reached, the government should provide intermediate programmes like those adopted in European countries and the United States to encourage the replacement of pure fossil-fuel vehicles. Plug-in hybrid and hybrid vehicles have been proven over the years to be very reliable and successful in significantly reducing roadside emissions, without the need for extra investment in infrastructure. They should not be excluded as part of the Go-Green/ Electrification push in Hong Kong.

A Government Tax Incentive Scheme for “Environment-friendly Petrol Private Cars”, which was run between 2007 and 2015, showed that, with the right encouragement, car owners were willing to change from pure fossil-fuel vehicles to hybrid versions. A similar scheme would help the transition to the “fully electric” programme and immediately begin to reduce emissions from pure fossil-fuel cars. Battery electrified technology, including plug-in hybrids and hybrids has long been accepted as a

[44] Calculation based on the data on Type approval document

crucial element of Go-Green/ Electrification initiatives adopted by other advanced economies. They are considered to be an important type of electric vehicle. With this in mind, the government should also provide incentives to replace pure fossil-fuel cars with hybrids, instead of focusing on fully electric vehicles alone.

Electric vehicles and charging stations

Electric private vehicle (EPVs) buyers previously enjoyed a full exemption of first registration tax as a means to promote usage of EPVs in Hong Kong. In the 2017-18 Budget, the full waiver was reduced to a maximum of HK$97,500 under normal circumstances. However, the ceiling was increased again to HK$250,000 in the case of a purchase of a new EPV, under the "One-for-One Replacement" Scheme, introduced in the 2018-19 Budget, i.e., where an existing non-EPV is scrapped at the same time.

The revised policy has very significantly slowed down the rapid increase in the growth of EPVs that was evident before 2017-18. The number of first registrations of EPVs decreased annually from 1,482 to 277 between 2017 and 2018[45]. For the seven months ended 31 July 2019, the number stayed at 223, showing no significant improvement.

In fact, the availability of electric vehicle charging stations is another factor impeding the growth of EPVs in Hong Kong. According to the Environmental Protection Department, there were 2,308 electric vehicle chargers for public use in Hong Kong, as of June 2019, but there were nearly 12,000 electric vehicles registered in Hong Kong[46], as at 31 July 2019. This ratio of 1:5.2 cannot meet the market demand. By way of comparison, the ratio of publicly-available parking spaces as against the number of private cars in Hong Kong is about 1:1[47].

Since roadside air pollution could be improved if the number of fossil-fuel vehicles running on the road were reduced, the government should consider limiting the first registration tax under the One-for-One Replacement Scheme to the amount required for setting up a charging station for EPVs. Currently, the charge for an authorized charging station installer to set up a charging station is around HK$50,000. The first registration tax collected in this way could be earmarked for setting up new charging stations.

Providing subsidies for constructing charging stations in private buildings, as proposed by the Chief Executive in the Policy Address, would give an incentive to private building developers to install more EPV charging stations. On top of this, the government could use the income from the first registration tax, under our proposal above, to install more charging stations in the public car parking spaces that it owns.

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[45] https://www.td.gov.hk/en/transport_in_hong_kong/transport_figures/monthly_traffic_and_transport_digest/index.html

[46] https://www.td.gov.hk/filemanager/en/content_4943/table44.pdf

[47] Number of car parks: https://www.td.gov.hk/en/transport_in_hong_kong/parking/carparks/index.html
Number of cars: https://www.td.gov.hk/filemanager/en/content_4943/table41s.pdf

Appendix 1: Proposed changes for salaries tax allowances and deductions

Allowances and deductions	Existing (HK$)	Proposed (HK$)
Allowances[1]:		
- Basic	132,000	135,300
- Married person	264,000	270,600
- Child (annual, each dependant, the 1st to 9th child)	120,000	123,000
- Child (initial, each dependant, the 1st to 9th child)	120,000	123,000
- Dependent brother or sister (each dependant)	37,500	38,438
- Dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the Government's disability allowance scheme	50,000	51,250
- aged 55 or above but below 60	25,000	25,625
- Additional dependent parent/ grandparent (each dependant)		
- aged 60 or above or is eligible to claim an allowance under the Government's disability allowance scheme	50,000	51,250
- aged 55 or above but below 60	25,000	25,625
- Single parent	132,000	135,300
- Personal disability	75,000	76,875
- Disabled dependant (each dependant)	75,000	76,875
Deductions, maximum limit:		
- Self-education expenses	100,000 limited to claims by taxpayer	100,000 limited to claims by taxpayer
- Private healthcare insurance premiums	8,000	8,000
- Rental payment for taxpayer's primary residence	-	100,000

[1] For illustration purposes, the proposed allowances are increased on the assumption that the benchmark is set at current levels and the inflation rate is 2.5%.

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

Example: Single person

This example illustrates the impact of[2]:

- an increase of basic allowance to HK$135,300
- a deduction of rental payment with annual limit of HK$100,000

	Existing		Proposed		Savings	
	(HK$)		(HK$)		(HK$)	(%)
Income		300,000		300,000		
Allowances/ deductions:						
Basic allowance	132,000		135,300			
Mandatory MPF contribution	15,000		15,000			
Private healthcare insurance	8,000		8,000			
Rental payment	-		100,000			
Total allowances/ deductions		155,000		258,300		
Net chargeable income		145,000		41,700		
Tax payable		8,500		834	7,666	90%

[2] Assumptions are as for Appendix 1.

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

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

This example illustrates the impact of[3]:

- an increase of basic allowance to HK$135,300
- an increase in child allowance to HK$123,000
- an increase in dependent parents allowance and additional allowance to HK$51,250

	Existing (HK$)			Proposed (HK$)			Savings	
							(HK$)	(%)
Income			750,000			750,000		
Allowances/ deductions:								
Basic allowance		132,000			135,300			
Child allowance	2 children 120,000 each	240,000		2 children 123,000 each	246,000			
Dependent parent allowance and additional allowance	2 parents 100,000 each	200,000		2 parents 102,500 each	205,000			
Mandatory MPF contribution		18,000			18,000			
Private healthcare insurance	1 taxpayer and 2 children 8,000 each	24,000		1 taxpayer and 2 children 8,000 each	24,000			
Total allowances/ deductions			614,000			628,300		
Net chargeable income			136,000			121,700		
Tax payable			7,600			6,170	1,430	19%

[3] Assumptions are as for Appendix 1.