Hong Kong General Chamber of Commerce
香港總商會 1861

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Helping Business since 1861

31 January 2018

The Honourable Paul Chan Mo-po, GBS, MH, JP
Financial Secretary
25/F, Central Government Offices
2 Tim Mei Avenue, Tamar
Hong Kong

Dear Paul,

Hong Kong General Chamber of Commerce is pleased to enclose its submission containing proposals for the Government's forthcoming Budget.

Hong Kong is one of the premier business hubs in the world. However, we must be vigilant to ensure that we remain so amid a changing global environment. Our proposals have been selected with this objective in mind.

Our huge budget surplus makes it clear that the time is ripe for a major review of our taxation policies. Hong Kong's simple and low tax system is one of the main reasons why we are consistently ranked as one of the most competitive economies in the world. But as other economies are introducing severe tax cuts, we must be careful that our competitive margin in this area would not be narrowed.

We therefore propose that the Government should put its surplus to good use with a tax cut for a defined period of three years. This will put money back in the hands of businesses and middle class consumers, and drive Hong Kong's continued growth and prosperity.

The Chamber also continues to argue for light touch regulation so that our local businesses, especially SMEs, are not burdened by unnecessary or out-of-date requirements. To this end, we suggest that the Government should set up a working party to review all existing and upcoming regulations to eradicate anachronistic laws and inefficient procedures.

These and other proposals are developed in the attached submission, which we hope you will find helpful. As always, we look forward to working constructively with the Government for the benefit of all Hong Kong citizens.

Yours sincerely,

Stephen Ng
Chairman

HKGCC Budget Proposals for 2018-2019

1. The Hong Kong General Chamber of Commerce (HKGCC) welcomes the Administration's determination and commitment to enhancing Hong Kong's competitiveness through a number of initiatives announced in the Chief Executive's maiden Policy Address in October 2017. Other than a bevy of incentives and schemes directed at strengthening Hong Kong's pillar industries, we can also look forward to a review of the SAR's taxation regime to backstop our comparative advantages and nurture new growth engines. New measures such as the introduction of a two-tiered tax and super-deduction for research and development (R&D) expenditure, as well as the organisation of a Tax Summit in October all point to the Government's commitment to bring about meaningful and substantive change. The establishment of a Tax Policy Unit (TPU) by the previous Administration is also an encouraging development although progress in scaling up operations has been slow.

2. Significant changes driven by geopolitical developments and technological advances have transformed the operating landscape in recent years and in the process thrown up new challenges while also presenting unprecedented opportunities. In response, we should be vigilant about staying relevant through such means as maintaining a balanced budget, amplifying core strengths and fine-tuning bread-and-butter competencies for the primary purpose of sustaining our position as a premier international business hub.

3. **Particular emphasis should be given to maintaining our comparative advantage in areas where we are already ahead of the curve.** Hong Kong has consistently ranked as one of or the most competitive economies in the world due to virtuous qualities such as a simple and low tax, rule of law, and an efficient government. Given our track record, it is easy to be lulled into a sense of complacency and assume that these attributes are self perpetuating and therefore a given. As well, it is important to be mindful that Hong Kong's overall ability to compete in the world marketplace is based on the sum of many factors. A decline in a particular metric may not therefore be immediately obvious because it may be masked by robustness in other elements. This insidious erosion of a core strength can be damaging because it could reduce overall competitiveness if left untended for too long. **Although remedying shortcomings is warranted, these should not be made at the expense of honing our existing strengths. In the area of taxation, this means being mindful of developments in our backyard and beyond, and to act nimbly in taking pre-emptive measures to minimise the risk of marginalisation**.

4. **By the same token, Hong Kong should capitalize on the national Belt and Road initiative to broaden and deepen our role as the preferred international financial centre.** We should seize on our expertise and capacity in the areas of financial and professional services to increase the share and size of Hong Kong's financial market, and in doing so become the default option for funding the vast number of infrastructural projects that are expected to take place along Belt and Road countries. In particular, Hong Kong is the perfect corporate treasury centre

location for Mainland companies to go global and also for multinational corporations which are increasingly trading in RMB. We should also concentrate on enhancing the liquidity of our capital market through further developing our debt market. Hong Kong possesses a well-developed financial infrastructure for both debt securitisation and project financing, which will be needed to bridge the funding gaps for Belt and Road projects.

5. There are two important points of principles that the HKGCC has been and continues to advocate as being integral to good public governance with respect to economic and budgetary matters. These are the overlapping issues of **maintaining a balanced budget and intervening only when justified and as a last resort**.

6. Our comments on economic and fiscal policies to advance and shore up Hong Kong's competitive edge are set out as under.

A) <u>A balanced budget and Intervention/regulation only where necessary</u>

7. Hong Kong has been running a budget surplus for the last 12 years and boasted accumulated fiscal reserves of HK$988 billion as of October 2017. Running a surplus is undesirable because this implies that the Government is collecting more money than it needs to fund its outgoings.

8. There are opportunity costs in doing so since the monies collected could have been deployed for other uses such as capital investment or the creation of new jobs. We are therefore encouraged by the Chief Executive's decision to break from the tradition of fiscal conservatism and adopt proactive measures to help Hong Kong become more competitive.

9. There have been calls for the Government to reinvest or return the money to the economy. In this regard, we would strongly urge the Government to give serious consideration to the latter and then the former in that order of priority. In the case of returning any budget surplus to taxpayers, this would mean respecting market forces while upholding the established principle of a small government. This is because despite the best of intentions, businesses and consumers are better placed to decide how resources should be allocated. This would also avoid creating a bloated public sector that encroaches onto private sector activities. Reinvesting surpluses, as an alternative but secondary consideration, for such purposes as enhancing human capital also merit support as this would pay dividends over the longer term.

10. Ultimately, the Government should adhere to the Basic Law principle of a balanced budget to avoid intervening in the market. The massive surplus that Hong Kong enjoys should give the Government plenty of leeway in living up to this constitutional obligation. It is equally encouraging to note that in his last Budget, the Financial Secretary has emphasized the need to ensure that *public spending must be fit for purpose*[1] and, more importantly, *to spend only when necessary and to act with prudence and strive for an overall fiscal balance over time*[2].

[1] The 2017-18 Budget, paragraph 41
[2] Ibid, paragraph 42.

11. We believe that this **credo of small government should be reaffirmed and upheld by the Administration so as to impart greater confidence to existing and prospective businesses looking to either expand their presence or establish a foothold in the region**. The Chamber is especially concerned about the rise in regulatory creep in recent years with the upshot of heavier compliance burden on business operators particularly SMEs. It is instructive to note from the Cato Institute's annual Economic Freedom of the World Report that two of the five metrics to measure economic freedom concern the *Size of Government* and *Regulation*. If we are not careful, we run the real risk of being perceived as providing a less than favourable business environment to operate in.

B) <u>Sustaining international trade</u>

12. Trade is Hong Kong's lifeblood. When considered in aggregate with logistics, the combined sectors account for a little over 22% of our total GDP. Other than the completion of the Trade Facilitation Agreement dubbed the Bali Package in 2013, the Doha round of trade talks has come to a virtual standstill. This has given rise to a proliferation of bilateral and plurilateral trade agreements in an attempt to fill the gap left by the latest round of multilateral talks.

13. Hong Kong is a signatory to a number of bilateral trade and investment agreements in its own right but is fairly new to FTAs and CDTAs having first entered into such agreements in 2003. Hong Kong has, to date, signed 6 Free Trade Agreements (FTAs), 38 Comprehensive Double Taxation Agreements (CDTAs), and 20 Investment Promotion and Protection Agreements (IPPAs).

14. There is obviously a lot of ground to cover and the Government is aware of the need to increase its treaty network as quickly as possible. In this regard, the Chamber hopes that more resources could be deployed to help expedite the expansion process. As pointed out in our previous submissions to the Government **on potential CDTA partners for Hong Kong, priority should be given to our top trading partners and jurisdictions along the Belt and Road Initiative**, which, in the case of the latter, would be conducive to enhancing our role as a super-connector for promoting trade and investment between Mainland China and the rest of the world.

15. The Chamber has previously written to the Government with recommendations on developing Hong Kong's port, maritime and logistics capabilities and is pleased to note that there has since been the introduction of various measures, such as setting aside land for high value-added logistics services, to support the industries' growth. However, more needs to be done in terms of ensuring that there is adequate statutory backing to grease the wheels of trade.

16. The Chamber has been lobbying for **a review of the Import and Export Ordinance to accommodate the unique nature of air-freighted transhipment cargo**. Currently, our development as an air cargo hub is constrained by the fact that transhipments (including cargo trucked across the border with the Mainland), which account for 85% of the Hong Kong International Airport's (HKIA) cargo throughput, are treated as both import and re-export cargo in Hong Kong. As a

result, the transhipment process is complicated by additional paperwork and time-consuming procedures for controlled items. These put the HKIA at a distinct disadvantage when compared to the free trade zone treatments in competing hubs such as Singapore, Seoul, Taipei and Guangzhou. **To strike a balance between the control of strategic commodities and enhancement of Hong Kong's cargo hub status, the Government should consider such measures as eliminating trade declaration charges, streamlining permits system, and reviewing import and export processing requirements, among other legislative and administrative arrangements to facilitate intermodal transhipments and strengthen Hong Kong's role as a gateway for the Chinese market**.

C) Facilitating business

17. Helping business does not necessarily have to involve government spending whether in the form of disbursements or subsidies. Rather, companies would benefit considerably from an operating environment that is not overly regulated. The Chamber has been quite vocal about the inefficiencies and the resultant wastage in compliance costs due to onerous legislations, and has submitted detailed recommendations on retooling the Government's "Be the Smart Regulator" Programme with a view to making it easier to run a business in Hong Kong.

18. In this regard, we have been calling on the Government to **draw reference from the UK's approach in applying regulatory impact assessments (RIAs) to improve policy making and reduce the costs to business**. The purpose of RIAs is to explain the objective of regulations or regulatory proposals, the risks being addressed and the likely costs and benefits of options for delivering the objective. By applying the RIA process effectively, the Government will be better placed to achieve the five principles of good regulation, namely, transparency, proportionality, targeting, consistency and accountability.

19. We truly believe by adopting an evidence-based, cost-benefit approach to the evaluation of new and existing legislation, this would have a material effect in providing much needed relief to Hong Kong companies particularly SMEs while also helping to improve our appeal as a place to do business. We would like to re-emphasize that the Chamber is not, as a matter of principle, against legislation. Legislation can safeguard the public, promote prosperity and protect the environment but it can also impose costs that are ultimately borne by society. As such, we are opposed to bad or poorly thought through legislation.

20. The following are but a few examples of existing legislation that would benefit from a thorough review to identify provisions that have outlived their usefulness.

    I One of the areas that warrant a re-examination concerns the IRO, which is no longer aligned with changes in Hong Kong's business climate or its position over the next 10 to 20 years. **A review and update of the IRO would help ensure that its provisions are consistent with economic and commercial conditions that businesses now operate under**. We appreciate the task involved to be difficult and challenging but as pointed out in our last submission to the Policy Address, the benefits of a comprehensive review would more than offset the costs of doing so by creating an optimal and competitive taxation framework that is predictable, understandable, stable, and as a result, easy to comply with.

II In the same vein, **legislation should be revisited for the purpose of removing regulatory controls that impede the development of electronic commerce in Hong Kong** often out of such well-meaning intentions as consumer protection and safety. This has had the unfortunate effect of constraining the online retail of such commodities as over-the-counter medicines. Although there has been some progress with respect to the online sale of Chinese herbal medicines, the licensing authority's decision to address this through administrative rather than a regulatory arrangement gives rise to legal uncertainties. We suggest **drawing on the experience and approach in other economies such as the UK, Canada and the US to strike an appropriate balance between enabling e-commerce and protecting consumers**.

III Similarly, **building codes could benefit from a revamp in the interest of promoting efficiency, clarity and certainty**. Under the current regime, building plans are required to be vetted by three different departments according to three different sets of standards. Needless to say, applicants find the existing practice to be extremely frustrating and difficult to navigate. Likewise, **the town planning process would benefit from refinements that include but are not limited to a streamlining of the existing town planning model**. An increasingly worrying trend of judicial review applications against the Town Planning Board's decisions is symptomatic of the inherent structural deficiencies that the Government must address as a matter of urgency.

IV Closely intertwined with the issue of inconsistent building codes are **anachronistic regulations in the realm of fire safety**. This is exemplified by the continuing disconnect between fallow industrial buildings and pent up market demand. The lack of flexibility in use has driven legitimate activities and businesses such as gyms, art galleries, performance venues and artisan shops to operate underground as the premium on space becomes prohibitively expensive. Although public safety is paramount, the inability to provide bridging solutions to address market needs is preventing Hong Kong from achieving its full economic potential.

21. We recognise that the task of reviewing existing legislation for relevance and purpose to be intrinsically difficult and complex given the number of laws that would have to be scrutinised. This makes the process of 'cleaning house' much more compelling, which arguably should commence as soon as practicable to help deepen and widen Hong Kong's competitive 'moat'. To go about this, **we suggest that the Government set up a working party to oversee the work of evaluating Hong Kong laws. We further recommend involving members from the private sector in the proposed advisory body to assist in fulfilling its mandate**. The Chamber is keen to contribute to the foregoing initiative and shall be pleased to participate. We are also compiling information on examples where legislation has had a dampening effect on legitimate business undertakings and will be presenting such details to the Government in due course.

D) Fiscal Initiatives and Administrative Enhancements

- ***Reduce profits and salaries taxes by 1% for a finite duration***

22. The Government could more than afford to 'share its wealth' with taxpayers and we suggest that this be done through **cutting taxes for both individuals and corporates**. A tax reduction would also be more substantive than the *ad hoc* concessions that are often too low to be meaningful.

23. On the other hand, we understand the impact such a reduction would have on recurrent government income especially in the context of Hong Kong's narrow tax base and dwindling workforce. With that in mind, we further **suggest an intermediate arrangement whereby such tax cuts have a limited shelf-life of 3 years**. This would have the twin benefit of (1) providing relief to the middle class and businesses, which contribute the bulk of individual and corporate income taxes, and (2) limiting public income foregone while enabling the Government to better assess and prepare for the short-term diminution in revenues.

- ***Allow carry back of tax losses and group loss relief***

24. This is useful to businesses especially SMEs in promoting cash flow and particularly critical to weathering choppy economic conditions. It is instructive to note that the Financial Services Development Council (FSDC) has issued a paper proposing a policy framework to allow corporate groups to transfer tax losses amongst wholly owned companies operating in Hong Kong. As noted in FSDC's paper, providing Group Tax Loss Relief would be conducive to entrepreneurial risk taking and innovation, which are in turn of critical importance to nurturing start-ups and businesses in the technology sector.

25. Despite concerns about anti-avoidance, revenue loss, and legal complexities, these are not insurmountable issues based on the experience of other jurisdictions such as Australia, Singapore, and the UK. **To avoid possible abuse, reference could be made to the aforementioned jurisdictions and companies can carry back losses for 2 years only**.

- ***Amend Section 39E** of the IRO to grant tax depreciation allowance for plant and machinery (P&M) used under import processing arrangement outside Hong Kong.*

26. Denial of the depreciation allowance contradicts the basic principle of allowing taxpayers to deduct costs incurred in the production of profits. It is also unfair not to mention prejudicial to manufacturers who are forced to pay a higher tax as a result of the production arrangement but have no intention whatsoever to avoid Hong Kong tax.

27. The language of the law has had the unintended effect of disallowing depreciation allowance even when the plant and machinery were used to generate profits taxable in Hong Kong but solely because these were used by

others outside Hong Kong.

28. Hong Kong suffers from a distinct disadvantage in this regard compared to Singapore, where an Integrated Investment Allowance for capital spending overseas for outsourced manufacturing arrangements was introduced in 2012 and has been further extended to 2022 in the 2017 budget.

29. The Government has cited undesirable asymmetrical tax treatment for allowing tax depreciation but not assessing "offshore" rental income under import processing arrangements in Mainland China or elsewhere in respect of the P&M concerned. This could be overcome by way of treating any actual or notional rental income as onshore. This is the case given that (i) there is no authoritative case law indicating that the source of rental on movable property is necessarily located in the place where the P&M are used; and (ii) the arrangement for the Hong Kong taxpayers to allow their sub-contractors to use the P&M are part and parcel of their business carried on in Hong Kong. Furthermore, any withholding tax suffered on any actual or notional rental income on the P&M concerned in Mainland China or overseas should be granted a tax credit or a deduction where applicable.

- ***Incentivise the establishment of regional headquarters***

30. Hong Kong is already a premier location for regional headquarters (RHQs) in Asia. Hong Kong's advantage lies in its well developed financial infrastructure including but not limited to its deep and liquid foreign exchange and money markets, absence of capital restrictions, stable and free exchange rates. Furthermore, Hong Kong possesses a simple and competitive tax regime, a common law system, an excellent pool of well educated labour force and business professionals. More importantly, its proximity to Mainland China makes Hong Kong an ideal and preferred location for setting up RHQs.

31. Although Hong Kong possesses all the right attributes for attracting RHQs, there is growing competition from other jurisdictions, which have introduced tax concessions for the expressed purpose of attracting RHQs. For instance, Singapore offers a concessionary corporate tax rate of 0%, 5% or 10%, respectively, on income derived from qualifying activities, under its Pioneer Certificate Incentive and Development and Expansion Incentive. The Shanghai Municipal government has been encouraging MNCs to establish regional headquarters in Shanghai since 2002 and boasted 580 RHQs as of 2016. Earlier this year, the Shanghai Municipal Government issued a notice ([Hufufa [2017] No.9][3] to provide several upgrades on top of the previous incentives, which include subsidies and awards for newly incorporated RHQs.

32. We cannot afford to be complacent in the face of such developments and would therefore suggest that tax incentives modelled more or less on those introduced recently for Corporate Treasury Centres ("CTC"). **Under the CTC regime, qualifying profits derived by the CTC can enjoy a 50% reduction in the prevailing corporate tax rate, equivalent to 8.25% at the current tax rate of 16.5%. A similar incentive should be granted to regional offices**

[3] New Shanghai Regulations on RHQ
http://www.shanghai.gov.cn/nw2/nw2314/nw2319/nw12344/u26aw51294.html

/headquarters in Hong Kong in respect of management and consultancy income derived from associated entities overseas.

33. **To qualify for such a concession, prospective taxpayers would have to meet a predetermined set of criteria, which could include such factors as number of employees and turnover size. We suggest that the TPU be tasked with formulating conditions under which RHQs can enjoy the proposed concession**.

- ***Zero Withholding Tax for Hong Kong companies investing overseas***

34. Hong Kong does not impose withholding tax (WHT) on dividends and interest payments to non-resident parties. Where possible, Hong Kong should strive for reciprocity treatment, namely, 0% dividend WHT on payments from CDTA parties to Hong Kong investors.

35. **As a priority, the Mainland China-Hong Kong CDTA should be reviewed with the objective of reducing the dividend WHT rate to 0%.** It is noted that such a precedent already exists in the CDTA between Mainland China and Georgia whereby a 0% WHT rate is provided for dividends remitted from China subject to certain conditions being met.

36. This proposal benefits both Mainland and Hong Kong businesses in the following ways. It:

    I Encourages investments into Mainland China through Hong Kong, which ranks as one of the world's largest direct investors;
    II Enhances Hong Kong's role as a super-connector between Mainland China and overseas economies; and
    III Reinforces Hong Kong as a base for establishing regional/international headquarters.

37. **Hong Kong already enjoys 0% WHT on dividends with Ireland, Mexico, Spain and Switzerland through CDTAs entered into with the foregoing jurisdictions. It follows that Hong Kong should also strive for 0% dividend WHT for investments with its top trading partners.**

38. A 0% WHT on dividends is also compelling in the context of the Greater Bay Area (GBA) initiative. As the borders between Hong Kong and Southern China become increasingly blurred, artificial impediments in the form of discrepancies in taxation policies should also be reviewed in the interest of providing national treatment to Hong Kong investments in other parts of the GBA so as to achieve symmetry in the 0% WHT that investments to Hong Kong from the latter now enjoy.

- ***Enhance clarity in source-based tax system***

39. **Legislative amendment to enhance certainty on factors to be taken into account to determine the source of different types of income is urgently needed**. Hong Kong's source-based tax system has long been a clear and clean competitive offering, but court decisions – and particularly the way the IRD responded to those decisions – have obfuscated the rules for determining the source of profits, in particular trading profits. Our members tell us that IRD assessors have taken different views on the importance of certain factors, and then seek to re-assess companies as far back as 6 years. **The uncertainties arising, if not removed promptly, are likely to harm our reputation as having a certain, simple and fair tax system.**

- ***Review tax reassessment period***

40. Under the current IRO, the IRD can re-open or issue additional tax assessments within 6 years after the end of the related year of assessment i.e. the time-bar period is 6 years. For tax loss cases, however, the 6-year time bar rule does not apply. We note that it is a common practice by the IRD not to issue a Statement of Loss where the taxpayer has filed a tax loss claim. Even if a Statement of Loss is issued for a year of assessment, the IRD has the right to adjust the losses claimed after the 6-year period. In other words, there is neither finality nor certainty for tax losses claimed by a taxpayer.

41. The Companies Ordinance and the IRD require a company to keep books and records for a period of 7 years. However, in cases where the company is in a tax loss position, and considering that the 6-year time bar rule does not apply to tax loss cases, this effectively means that the taxpayer has to retain books and records indefinitely in order to discharge its burden of proof.

42. **To enhance tax certainty, the Government should consider reducing the time-bar period to 3 years. For tax loss claims, the IRD should endeavor to issue the Statement of Loss upon submission of the tax return and the 3-year time bar rule should be consistently applied to Statement of Loss cases**.

- ***Conclusion***

43. We appreciate that the recommendations put forward above, if adopted, will necessarily take time and resources to complete. **In the interest of creating the most and lasting impact, we suggest priority be given to the proposals of (1) establishing a working party, with private sector participation, to formulate and institute an appropriate RIA framework for reviewing new and existing legislations, and (2) reducing profits and salaries taxes by 1 percent for a limited period of 3 years**.

HKGCC Secretariat
(January 2018)