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Mr. Eric Li Ka Cheung
Chairman
Bills Committee on Revenue (No. 2) Bill 2003
Legislative Council
Hong Kong Special Administrative Region
of the People's Republic of China
Legislative Council Building
8 Jackson Road
Central
Hong Kong

(Attn: Ms Polly Yeung, Clerk to Bills Committee)

22 May 2003

Dear Sir

Revenue (No. 2) Bill 2003

We refer to your letter dated 14 May 2003 inviting us to provide our comment on the Revenue (No.2) Bill 2003 ("the Bill"). On behalf of ACCA ("Association of Chartered Certified Accountants") Hong Kong, we would like to submit our comment as follows for your consideration:

(1) In our Budget Proposal submitted to the Financial Secretary on 23 December 2003, a copy of which is attached, we have stated our position that any policies introduced should be targeted at restoring a sound business environment so as to encourage investment in Hong Kong. We believe that at this juncture of time, it is not to the benefit of Hong Kong to propose any measures to increase taxes albeit the restoration of personal allowances and marginal tax bands/rates to the 1997/98 level. We do not agree to the proposed increase of corporate profits tax rate from 16% to 17.5% and the proposed increase of standard tax rates from 15% to 16%.

We strongly believe that low tax regime will help maintaining Hong Kong's tax competitiveness position when comparing with our neighbouring countries. It will also help restoring Hong Kong's business environment and hence

ACCA Hong Kong 香港分會
Room 1901 19/F World Wide House 19 Des Voeux Road Central
中環 德輔道 19 號 環球大廈 19 樓 1901 室
tel 電話: +852 2524 4988 fax 傳真: +852 2868 4909 http://hongkong.accaglobal.com

stimulating investment in the economy. When the re-investments / new investments register growth in profits, it will in turn increase the tax revenue.

The statement that we are still the lowest tax rate country in the region and thus the increase in tax rates should have no impact on our overall competitiveness is not true. Now our competitive advantage has narrowed down. The small difference in tax rates would definitely not a factor for multinational considering the place to invest and also for good quality of people choosing a place to work. We are running a risk of losing both inbound investments and good quality of people.

The recent outbreak of Severe Acute Respiratory Syndrome in Hong Kong has caused much damage to our economy which is not anticipated to recover in the near future. Whilst the government and various associations have initiated measures to help stimulating the economy, increasing the profits tax rate at this stage will increase the burden of businesses and counteract the effects of any relief measures proposed.

(2) Referring to the details of the Bill, we note that in clause 5 relating to the computation of assessable profits from cinematograph films, patents, trademarks, section 21A(1)(b) has been repealed and is substituted by the following:

"(b) the following percentages of the sum in any other case, including any case of the description mentioned in the proviso to paragraph (a) -

(i) for any sum received by or accrued to the person before 1 April 2003, 10%;
(ii) for any sum received by or accrued to the person on or after 1 April 2003, 30%."

The proposed change is not clear and may cause confusion. An example is where an amount is accrued to a person before 1 April 2003 but is however received by the person on or after 1 April 2003. It is not clear whether it should be taxed at 10% or 30%. We propose that the legislation should be re-written to spell out exactly what the government would like to enact, which according to our understanding, the amount should be taxed at 10% if it is either received or accrued before 1 April 2003, notwithstanding it being received on or after 1 April 2003 consequent to such accrual.

If you have any questions on the above, please do not hesitate to contact any of the following persons at 2524 4988:

Mr Leo Lee, President
Mr K C Law, Chairman, Tax Committee
Ms Sonia Khao, Head of Technical Services, ACCA Hong Kong

Yours faithfully

Leo Lee
President

Enclosures

Budget Submission 2003/04

23 December 2002

ACCA
The Association of Chartered Certified Accountants
Hong Kong

Budget Submission 2003/04
Boosting Economic Recovery

EXECUTIVE SUMMARY

The theme of this submission is "Boosting economic recovery". Our submission is focused on fiscal measures to attract new investments so as to stimulate the recovery of Hong Kong's economy.

In order to develop a long-term sustainable economic growth model, ACCA[1] Hong Kong is of the view that policies introduced should be targeted at restoring a sound business environment so as to encourage investments in Hong Kong. Our submission therefore includes proposals that are industry-specific and general in nature with the key objective of attracting investments and new businesses to Hong Kong. The success of these recommendations should also depend on other government policies and strategies working together.

We summarize our suggestions as follows:

- High technology industries

  - tax holidays;
  - allowance of 200% deduction for research and development expenses;

- Tourism

  - one-off deduction for refurbishment costs;
  - profits tax exemption of specific eligible events;

- Financial services

  - profits tax exemption of trading Hong Kong listed bonds;
  - further reduction or full exemption of stamp duty on security trading;
  - profits tax exemption on certain activities of fund management companies;

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[1] ACCA ("The Association of Chartered Certified Accountants ") is the largest international professional accounting body in the world. In Hong Kong, ACCA currently has more than 14,300 professional members.

- General

  - tax incentives to operational headquarters
  - full deduction for capital expenditure incurred in the acquisition of plant and machinery;
  - group relief;
  - abolition of estate duty; and
  - tax incentives to unincorporated businesses.

Despite the fiscal deficit, we propose that the profits tax rate should remain status quo. This would send out a message to investors at large that:

- the government would deal with the deficit not at the investors' expenses, and

- the government's key objective is to maintain Hong Kong's competitiveness in taxation as compared to other jurisdictions in the Asia Pacific region.

We propose that the government should review the salaries tax framework and appropriately adjust personal allowances to take account of the current deflation and also as a measure to avoid further contraction of the narrow tax base.

Last but not the least, we are conscious that SMEs play an important role in Hong Kong's economic development and we propose that certain policies should be introduced to facilitate SMEs' operations.

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The above proposals are prepared based on a survey conducted on our members' views towards introduction of tax incentives, and discussions by the Tax group [2] of ACCA Hong Kong.

We believe that the suggestions presented in this submission are practicable. Though they may have an immediate impact in reducing revenue collection, the proposed measures will support the key objective of stimulating economic recovery and help in steering the direction of future investments.

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[2] The Tax group of ACCA comprise members who are engaged in a wide spectrum of business spreading from professional practice to quasi-government and commercial sectors of the HKSAR community. A composition of the Tax group members is included as an Appendix.

PROPOSALS IN DETAIL

1 Boosting Economic Recovery

Given the current size of public expenditure and the freeze on land sale and asset disposal (e.g. the MTRC shares), we accept that the fiscal deficit would not be resolved in the short term. Whilst cost containment measures should be taken to reduce deficit, we propose that revenue measures should be introduced to stimulate economic recovery. The proposed measures, which will be in the terms of incentives, could reduce businesses' outgoings and encourage reinvestments or new investments so that the community could as a whole benefit from long-term economic growth.

Experience in Singapore and Mainland China has shown that tax incentives coupled with other favourable business factors could attract foreign investments. In order to maintain Hong Kong's competitive position versus these neighbouring jurisdictions, we suggest that both industry-specific and general tax incentives should be considered.

1.1 Industry-specific

1.1.1 High technology industries

Technology and innovation are two major driving forces for our future economic growth.

We recommend the following incentives be considered:

- Tax holidays

  To shorten the payback period of start-up businesses, we suggest that incentives be given to advanced technology industries as follows:

  - full exempt from profits tax for the first operation year.
  - 50% reduction in tax rate for the second and third years.

  The tax revenue foregone would be compensated by new investment activities and job opportunities that would help to grow our economy and future revenue base.

- 200% deduction for research and development expenses

Double deduction could be considered for research and development expenses incurred by businesses engaged in advanced technology. The proposed incentive should be extended to businesses involved in other industries in order to encourage innovations to facilitate business development across the board.

1.1.2 Tourism

Tourism is one of the major pillars of our economy. There has been a significant increase in tourists coming from the Mainland China after the abolition of the quota system for the Hong Kong Group Tour Scheme in January 2002. With the planned opening of the Disneyland Theme Park and cable car attraction, we believe that the number of tourist arrival will continue to grow.

Tax incentives could be considered to further reinforce the effort of promoting Hong Kong tourism industry as follows:

- One-off deduction for refurbishment costs

  Under the current tax legislation, hotel refurbishment costs are deducted over 5 years. We consider that a one-off deduction for refurbishment costs could encourage renovation and refurbishment of hotel premises to prepare for meeting the increasing demand of the tourists. As this incentive will only create a timing difference in revenue collection, the incentive will have a neutral impact to the fiscal deficit in the intermediate to long term.

  This incentive could also be extended to restaurants, shopping malls and retail outlets to encourage upgrading of facilities in the retailing, leisure and entertainment sectors of industry so as to boost tourism.

- Profits tax exemption of specific events

  Income derived from “big” events which help to attract tourists to Hong Kong such as concerts, conference and exhibitions, should be tax exempted. A detailed study should be conducted with the cooperation of the Hong Kong Tourist Association to explore this initiative, including the definition of eligible events.

1.1.3 Financial services

Hong Kong is a recognized international financial center. However, efforts are required to maintain its competitiveness in this business sector as other jurisdictions are taking keen steps to attract regional and international investors.

- Exemption of profits tax on trading of Hong Kong listed bonds

  We recommend that profits derived from trading Hong Kong listed bonds should be exempt from Hong Kong profits tax. This could help to develop Hong Kong into an Asian Bond Center. Currently many bond listings by Asian borrowers are arranged through overseas markets such as the Luxembourg Stock Exchange. This does not result in revenue collection, job opportunities or other economic benefits in Hong Kong. With appropriate tax incentives, a center of debt raising and bond trading activities can be created in Hong Kong.

- Reduction of stamp duty

  We recommend a further reduction leading to eventual full exemption of stamp duty on securities trading. This would bring Hong Kong on par with most international financial centers where securities trading is not chargeable to stamp duty.

- Profits tax exemption on certain activities of fund management companies

  We would also reiterate the recommendation in our 2002/03 Budget Submission regarding exemption from profits tax of certain activities of fund management companies in order to encourage inflow of capital into Hong Kong and to promote the setting up of centers of excellence in fund management in Hong Kong. Earlier this year the fund industry has raised concern on inquiries conducted by the Inland Revenue Department on the activities of overseas fund management companies. Given that these companies are rather mobile (they will chase after stable and low cost operation environment), it is important that Hong Kong projects a clear message that we can provide the necessary support and low (or “no”) tax base for them to establish their operations here.

1.2 Other Measures

We consider that other tax measures should be introduced to supplement the industry specific tax incentives in order to boost the economy.

1.2.1 Regional/Operational headquarters

We would reiterate our proposal in previous years of establishing a tax policy providing incentives to operational headquarters located in Hong Kong.

Hong Kong is traditionally tax competitive because of its low tax rate and simple tax system. However, when compared with other Asian countries, Hong Kong offers little specific tax incentives in attracting the establishment of regional headquarters.

We therefore suggest that the HKSAR government should consider ways to improve the taxation competitiveness of Hong Kong as a location for regional headquarters type of activities. In this respect, reference could be drawn from other countries such as Singapore, Malaysia, and the Philippines. Concessionary tax rate for regional headquarters type of activities could be given to activities which are of a substantial scale and are in the nature of investment, general management, financial management, and / or marketing with a good geographic coverage.

If regional headquarters were clustered in Hong Kong, it would assist us in maintaining our leading position as an international financial center and also create business and employment opportunities to our society.

Regional headquarters will result in talents of high caliber relocated to Hong Kong. These expatriates will pay tax and spend their income in Hong Kong. As such, Hong Kong will overall benefit from increase in salaries tax collection, in addition to the positive impacts on the property and retailing section of businesses.

1.2.2 Full deduction of capital expenditure incurred in acquisition of plant and machinery

Under the existing tax legislation, only the costs of acquiring plant and machinery used for manufacturing process and computer hardware and software can qualify for 100% deduction in the year of acquisition.

We propose that full depreciation allowance should be granted in the year of acquisition for all types of depreciable plant and machinery. Currently, 64% to 72% of the costs of plant and machinery acquired is deductible as depreciation allowances (in the form of initial and annual allowances) in the first year when the assets are acquired. A deduction for full depreciation allowances will therefore only have a timing difference on revenue collection on the remaining 36% to 28% of the asset costs. The incentive will provide a clear message of encouraging investment whilst the impact to revenue collection is merely a timing issue.

1.2.3 200% deduction for research and development expenditure

As mentioned above, we recommend a 200% deduction for research and development expenses incurred by any business in order to encourage innovations and enhance business development.

1.2.4 Group relief

The fact that our neighboring countries provide different forms of tax incentives to attract foreign investments will threaten the attractiveness of Hong Kong as a center of business location. Accordingly, in addition to introducing tax incentives for regional headquarters, we are of the view that group relief should also be available for losses.

For various commercial reasons such as limitation of liabilities, establishing of different reporting lines or holding of accountability on operation results, a common organization model for many local as well as overseas investors is to have separated operating companies under one or more umbrella holding companies. As far as investors are concerned, these group companies are viewed as arms or divisions of a central unit. There is as such a strong request from the commercial sector for the introduction of group relief so that the losses of one arm can be offset by the profits of another to achieve an equitable tax basis. On the basis that losses can be immediately utilized by group companies, the relief will provide a cashflow benefit to investors when venturing into new activities which may initially be non-profitable.

In our opinion, group relief only creates a temporary timing difference in revenue collection as tax losses could, under the current tax law, be carried forward without any time limit for setting off future assessable profits. The proposed group relief will also bring Hong Kong's tax system into alignment with that of other major jurisdictions where similar relief exists.

1.2.5 Abolition of estate duty

In order to attract more investments to Hong Kong, we reiterate our previous recommendation of abolishing estate duty.

The revenue derived from estate duty amounted to HK$1,927 million for 2001/02. As estate duty in Hong Kong follows the basic "territorial concept", estate duty could therefore be avoided by locating one's assets outside Hong Kong. Estate duty is our view not an important revenue raising tool. On the contrary, it drives assets out of Hong Kong.

In addition, we consider that estate duty is contradictory to the "one-tier" tax system adopted in Hong Kong as it imposes a second tier duty on the assets of an individual.

We understand that estate duty is often viewed as a mechanism to detect tax evasion of individuals during their lifetime and provides a window to recover back duty. However, we consider that maintaining the existing probate procedure could also serve the purposes.

If estate duty is abolished, Hong Kong can position itself as a location for estate planning and this will attract foreign funds. This proposal is therefore in line with our suggestion of maintaining and improving the competitiveness of Hong Kong as a financial center.

1.2.6 Tax incentives to unincorporated businesses

SMEs play an important role in Hong Kong's economy. Research indicates that over 98% of the establishments in Hong Kong are SMEs.

To encourage entrepreneurship in the SME sector, where the size of a business justifies an unincorporated (as opposed to limited liability) undertaking, the unincorporated business should be exempt from:

(a) profits tax on a prescribed limit of earnings; and
(b) first year business registration fee

In respect of (a), if the tax free income were set at a level similar to the amount of personal allowance, this would avoid the need of these SMEs in electing for personal assessment in order to have their taxable income offset by allowances. This would in turn reduce the workload and processing cost of the Inland Revenue Department.

2. Profits tax rates

We consider that no change should be made to the profits tax rate, in spite of the fiscal deficit.

Given that other jurisdictions in the Asia Pacific region have reduced their profits tax rates and introduced tax incentives to attract foreign investments, we consider that any increase in the profits tax rate would hamper Hong Kong's tax competitiveness. Whilst increase in profits tax rate will marginally increase tax revenue (estimated to be $2,600m if there is a 1% increase in rate), a possible side effect is that existing businesses may push back their re-investment plans and new businesses may not proceed as the after-taxed return becomes less attractive.

We believe that not altering the profits tax rate could help restoring the business environment and hence stimulating investment in the economy. In the long run, tax revenue would pick up as economy turns around and the re-investments / new investments register growth in profits.

3. Salaries tax rates

The Final Report to the Financial Secretary by the Advisory Committee on New Broad-based Taxes ("the Report") confirms that Hong Kong's operating deficit is to a major extent structural in nature. To address the problem, the Report suggests the introduction of a general consumption tax ("GST"). The current economic environment is however not suitable for the launch of GST and, as such, we consider that certain short to medium term measures should be taken to tackle the structural problem of narrow tax base.

According to the Report, only 1.2 million out of 3.2 million employed populations are paying salaries tax. Statistics available also show that the top 100,000 taxpayers bear 61.4% of all salaries tax while the top 300,000 pay 85%. In addition, Hong Kong's personal allowance is nine times that of Singapore and double that of United Kingdom.

We recommend that personal allowances should be revised downward to the level in the year of assessment 1997/98 in order to take account of the deflation over the last few years. In addition, the gap on each tax bracket of the progressive rates under salaries tax could be slightly narrowed so that the tax burden can be more fairly distributed among different income groups.

We estimate that the personal allowance and tax bracket adjustments will have an effect of increasing tax revenue by approximately $2,000 million and will contribute towards reducing the fiscal deficit.

We need to point out that the proposed measures are suggested on the ground that GST is not implemented at the same time. When the timing is appropriate to introduce GST, direct tax should be reduced to release the burden of the public.

4. Charitable donation

Under the existing tax legislation, deduction of charitable donations is limited to 10% of the assessable income / profits. We suggest that the 10% limit could be uplifted in order to encourage donations to approved charitable organizations. This in turn could relieve the expenditure pressure on the government as subsidies are currently granted to many charitable organizations. There will of course be cases where the donations received by approved charitable bodies are not immediately or timely spent on activities which are the key objectives based upon which these bodies are granted their charitable status. To encourage proper and timely use of donated funds, a new policy or guideline should be introduced in respect of new funds received.

5. SME policies

SMEs generally face more difficulties in doing business than larger corporations due to limited resources, especially during times of economic downturn. Accordingly, we suggest assistance be given to support SMEs' operations as follows:

5.1 Cross border customs procedures

Based on figures available, 33.6% of the Hong Kong SMEs as of March 2002 are involved in import and export activities. Mainland China is undoubtedly a huge market and the majority of our SMEs are engaged in trading with Mainland China.

Under the current customs clearing system, two sets of documents have to be prepared in order to clear the Hong Kong and the PRC customs respectively. This creates unnecessary burdens to the SMEs (as well as bigger organizations) in deploying additional resources in dealing with the administrative procedures.

To encourage a closer economic partnership arrangement with PRC, we recommend the HKSAR government to liaise and negotiate with the PRC government so that a unified set of document could be acceptable for both the Hong Kong and the PRC customs. This would improve the logistics in customs administration and also help the SMEs to reduce their operation costs.

5.2 The SME Supporting Funding Schemes

We note that a significant amount of fund has been contributed to the SME Business Installation and Equipment Loan Guarantee Scheme which is operated through financial institutions. We suggest the Trade and Industry Department to review the policy with the relevant financial institutions to ensure a simple application procedure which could be easily understood by SMEs.

In addition, although there is a SME Marketing Fund helping SMEs to explore business opportunities through active participation in export promotion activities, only a very small amount of the fund has been utilized. We suggest putting more efforts to promote this fund so that SMEs could have more resources to promote their businesses, hence sourcing more new businesses.

5.3 Electronic infrastructure helping SMEs to link up with investors

As institutional investors will generally be interested in large-scale projects, SMEs generally have limited access to external funding.

Whilst there are always potential investors seeking for investment opportunities matching their particular needs, it is generally not easy for SMEs to access these angel investors on their own. We note that in many other countries (such as the United States) there are government-sponsored platform to facilitate the linking up between SMEs and angel investors. We therefore suggest that the HKSAR government could study the feasibility of building an electronic platform to facilitate communication between SMEs and these potential investors.

CONCLUSION

We note that the proposed tax incentives in this submission may cause a further short-term reduction in revenue. However, part of the impact is only timing in nature. In our view, the immediate as well as long term objective is to boost economic recovery and therefore we strongly recommend adopting the proposed measures, which will help shape our recovery and future business direction and growth.

- End -

APPENDIX
- Members of Tax Group – 2002/03

Co-chairmen

Jimmy Chung	Partner	PricewaterhouseCoopers
Calvin Lam	Partner	Deloitte Touche Tohmatsu

Members

Florence Chan	Partner	Ernst & Young
Rio Chan	Senior Manager	Ernst & Young
Brenda Cheung	Tax Director	Grant Thornton
Spencer Chong	Partner	PricewaterhouseCoopers
Alexandra Hui	Tax Director	Mazars Ltd
K C Law	Partner	PricewaterhouseCoopers
Julian Lee	Partner	Deloitte Touche Tohmatsu
Leo Lee	Director	Securities & Futures Commission
Aldous Mak	Lecturer	Institute of Vocational Education
Susan Mak	VP	HSBC Republic Tax Consulting Services Ltd
Dicky To	Director	Smartlink Asia Limited
Alex Wong	Partner	C.B. Wong & Co, CPA
Caesar Wong	Senior Manager	PricewaterhouseCoopers
Jennifer Wong	Partner	KPMG

Secretary

Sonia Khao	Head of Technical Services (Hong Kong)	ACCA