For discussion on
15 May 2018

Legislative Council
Panel on Financial Affairs

Tax Deduction for Deferred Annuity Premium and MPF Voluntary Contribution

PURPOSE

This paper seeks Members' comments on the proposed implementation details for introducing tax deduction for taxpayers who take out a deferred annuity or make Mandatory Provident Fund voluntary contribution (MPF VC).

JUSTIFICATIONS

Developing the third pillar

2. To address aging population, the World Bank has advocated a multi-pillar conceptual framework for reforming pension systems worldwide[1]. Many recent pension reforms in overseas economies involve improvements to or development of a voluntary "third-pillar" which may take many forms but is essentially flexible and discretionary in nature[2] to compensate for the rigidities in the design of other pillars. Introducing tax incentive to encourage taxpayers to purchase deferred annuities and/or make MPF VC will meet the criteria of flexibility and discretionary in nature.

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[1] The five pillars are –
(a) Non-contributory zero pillar – publicly-funded pension or social security schemes
(b) Mandatory first pillar – publicly-managed mandatory contributory plans
(c) Mandatory second pillar – privately-managed mandatory occupational or private contributory pension plans
(d) Voluntary third pillar – voluntary contributions or savings to occupational or private pension plans
(e) Voluntary fourth pillar – public services, family support and personal assets

[2] An example of such a flexible third pillar is Switzerland's private pension plans which include a restricted option where withdrawal is restricted and an unrestricted option which allows withdrawal anytime without restrictions. However, participants in the unrestricted option will enjoy less tax advantages.

MPF VC

3. MPF is the second pillar of retirement protection in Hong Kong. It is complementary to other pillars of the retirement protection framework to provide retirement security for the population of Hong Kong. The Mandatory Provident Fund Schemes Authority (MPFA) has been encouraging scheme members to make voluntary contributions to better prepare for their retirement. In 2017, of the $68.99 billion total MPF contributions received, $3.60 billion were voluntary contributions made by scheme members. There have been suggestions that the Government should introduce tax incentive to encourage scheme members to make more contributions for retirement planning in addition to the current contribution rate of 5% of relevant income (which is further subject to a maximum level of $30,000 per month).

Deferred Annuities

4. An annuity is a long-term insurance contract [3] under which accumulated savings are turned into a stable stream of income over a period of time. There are many variants of annuities. For example, Hong Kong Mortgage Corporation (HKMC)'s life annuity is an immediate annuity where the purchaser pays HKMC a lump sum in exchange for immediate regular payments. Deferred annuities involve an accumulation phase and an annuitization phase. During the accumulation phase, a purchaser pays premiums regularly over a period of time. Usually, there is an interim period between payment period and the annuity period to allow the paid up sum to grow through investment by the insurer. Upon annuitization, the annuitant will receive regular payments during the annuity period.

5. An annuity may cover joint annuitants which are usually couples. It is therefore also a retirement planning tool for an income earner's spouse. Annuities often come with optional riders such as death benefits, waivers, etc. for extra protection against premature death or loss of earning abilities of the holder during the accumulation period.

6. A retiree has to hedge against longevity risk, i.e., the possibility that an individual outlives his own resources. Annuities are a retirement planning tool that can help an individual transfer investment risk and longevity risk (if the annuitization phase is sufficiently long) to insurance undertakings. Although annuities may not be suitable for all, many countries do have policies to encourage the development of the annuity market to enrich the range of

[3] Annuities fall under "Class A Life and annuity" of Classes of Long Term Business in the Insurance Ordinance (Cap. 41).

retirement planning tools for members of the public[4]. However, whether an annuity is a suitable complementary retirement planning option will depend on an individual's liquidity needs, bequest motive, financial discipline and the availability of other alternatives.

7. In Hong Kong, there has been increasing consumer interest in annuities as public awareness of retirement planning is getting higher[5]. We aim to encourage the development of the market of deferred annuities due to the following considerations –

(a) financial discipline – retirement financial planning is about gratification deferment. It requires strong financial discipline to control spending to save more during the accumulation phase and to execute post retirement preservation to mitigate longevity risk. The very design of deferred annuities with an accumulation phase and annuitization phase will help inculcate a culture of financial discipline to save regularly for a stable stream of post-retirement income;

(b) choices for tax incentivized savings – an individual may choose to make MPF VC to invest in MPF constituent funds that suit his circumstances and risk appetite. The accumulated sum can be withdrawn in a lump sum or gradually drawn down upon retirement. By taking out an annuity, an individual transfers investment risk and longevity risk (if the annuitization phase is sufficiently long) to an insurer and enjoys a stable stream of payments upon annuitization. Providing tax incentive for deferred annuities and MPF VC will allow choices for members of public to allocate their tax-incentivized savings according to their needs and preferences; and

(c) no overlapping with HKMC's immediate annuity – the target group of HKMC's product is retirees who are aged 65 or above and can afford to pay a lump sum premium from $50,000 to $1 million. The proposed tax incentive aims to encourage the working population to save a relatively small sum continuously for a stable stream of post-retirement income. There is no overlap between the two target groups.

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4 Rusconi, R. (2008), "National Annuity Markets: Features and Implications", OECD Working Papers on Insurance and Private Pensions, No. 24, OECD publishing.

5 The number of annuity policies in force has increased 88.16% from 63,420 in 2012 to 119,334 in 2016 and the amount of premiums has increased 189.83% from HK$2,941.2 million in 2012 to HK$8,524.6 million in 2016.

IMPLEMENTATION DETAILS

MPF VC

8. At present, MPF mandatory contributions (MPF MC) by employees are tax deductible under salaries tax, tax under personal assessment and profits tax (for self-employment cases) and subject to preservation requirements, i.e., withdrawal is allowed only upon retirement at age 65 or on statutorily permissible grounds[6]. MPF VC by employees are usually deducted from the employees' monthly salary and paid to MPF trustees by employers, in the same manner as MPF MC. It is not tax deductible and can be withdrawn relatively flexibly (for example, upon termination of employment).

9. To meet the purpose of encouraging extra savings for retirement, the tax incentivized MPF VC must be subject to preservation requirements. At the same time, we do not want to discourage scheme members who prefer to have more flexible withdrawal options from making MPF VC. After consulting MPF service providers, we propose to allow scheme members the option to continue their existing MPF VC without subjecting them to preservation requirements but such VC will not be tax deductible. If scheme members wish to benefit from tax deduction, they must put the MPF VC in a new separate Tax Deductible Voluntary Contribution (TVC) account. All existing MPF MC preservation requirements will apply to the accrued benefits in the TVC account. The proposal is considered to be the optimal arrangement after taking into account the following considerations –

(a) minimization of administrative costs;

(b) maintaining flexibility to meet different financial needs and preference of different scheme members; and

(c) enhancing competition among trustees. Currently, it is employers who choose the MPF schemes for their employees. Under the TVC proposal, employees are free to choose the MPF scheme to open a TVC account.

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[6] Such grounds include early retirement at age 60, total incapacity, terminal illness, permanent departure from Hong Kong, death and small balance.

10. For scheme members of Occupational Retirement Schemes (ORSO schemes) who are exempted from the provisions of the Mandatory Provident Fund Schemes Ordinance (Cap. 485) (MPFSO) by virtue of section 5 of the MPFSO (i.e. MPF-exempted ORSO schemes)[7], they can also open a TVC account for making voluntary contributions with any MPF trustee of their choice and enjoy the proposed tax deduction.

Deferred Annuity

(A) *Eligibility criteria*

11. We propose that premiums paid for deferred annuity products that satisfy a set of criteria set out in the guidelines to be issued by the Insurance Authority (IA) will be eligible for tax deduction under salaries tax and tax under personal assessment. To meet the objective of promoting the development of a voluntary "third-pillar" for retirement protection, the eligibility criteria should not be too rigid. After consulting insurers, the proposed eligibility criteria are as follows:

(a) Minimum total premium of $180,000 and minimum payment period of 5 years

To encourage people to save a small sum regularly for a stable stream of post-retirement income, the eligible minimum total premium should not be too high to exclude low income earners nor too low for generating meaningful income payouts.

(b) Minimum annuity period of 10 years

We consider that too short an annuity period may not be meaningful for retirement planning. We recommend a minimum annuity period of 10 years after consulting the industry.

(c) Annuitization at the age of 50 or beyond

We consider that 50 is a reasonable minimum annuitization age for retirement purpose.

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[7] ORSO schemes are set up voluntarily by employers to provide retirement benefits for their employees. Since the launch of the MPF System in 2000, the MPFA has exempted a number of ORSO schemes that meet the relevant requirements in accordance with the Mandatory Provident Fund Schemes (Exemption) Regulation from the MPFSO.

(d) Disclosure requirements

There are three major disclosure requirements –

(i) the Internal Rate of Return (IRR)[8] of the product must be clearly stated in the sales brochure and relevant communications with the holder of an eligible annuity. The IRR is a useful standard yardstick for clients to evaluate and compare eligible products before making an informed purchase decision;

(ii) clear presentation of the guaranteed payment and variable payment, if applicable, where the guaranteed payment should not be less than 70% of the total projected payment; and

(iii) clear separation of premiums of all riders such as death benefits, waivers, etc. from the premiums for the eligible annuity. Premiums of such riders are not tax deductible.

(B) Maximum tax deductible limit per year

12. We propose that the maximum tax deductible limit should be $36,000 per year to provide adequate incentive to encourage people to save more for retirement. An illustration of the tax savings with a maximum limit of $36,000 is at the **Annex**.

13. It is an aggregate limit for MPF VC and deferred annuity premium for greater flexibility, meaning that a taxpayer may claim tax deduction for deferred annuity premium and MPF VC in aggregate up to the maximum limit.

(C) Public education and point-of-sale conduct

14. The IA will publish the list of eligible deferred annuity products on its website for public information. It will collaborate with the Investor Education Centre and the industry to enhance public understanding of annuity products and how to evaluate different retirement planning tools including MPF VC to suit one's needs. The MPFA will launch publicity and education programmes to let scheme members better understand the operations of TVC as appropriate.

[8] IRR is the rate at which future cash flows are discounted to equate them to a present value.

15. Insurers will be encouraged to enhance training on annuity products for intermediaries. At the same time, the IA and the MPFA will continue to closely monitor the point-of-sale conduct of intermediaries.

FINANCIAL IMPLICATIONS

16. It would be difficult to assess the tax revenue forgone arising from the proposed tax deduction. The revenue forgone arising from the existing tax deduction for MPF mandatory contributions and contributions to Recognized Occupational Retirement Schemes is about $1.25 billion based on the deductions claimed for the year of assessment (YA) of 2016/17. The potential tax revenue forgone is unlikely to be large.

IMPLEMENTATION TIMETABLE

17. The current target is to introduce the amendment bill into the Legislative Council in the last quarter of 2018. Subject to the passage of the bill, the proposed deduction will be effective from YA of 2019/20.

BACKGROUND

18. In the 2018-19 Budget Speech, the Financial Secretary suggested introducing tax concessions to encourage the development of the deferred annuity market so as to offer more options to people in making financial arrangements for retirement, and the same tax concessions will also be applicable to MPF VC. The IA has been tasked to issue guidelines such that premiums for deferred annuity products that meet the requirements in the guidelines will be tax deductible. MPF VC that enjoys tax deduction will be subject to the same preservation requirements as applicable to mandatory contributions.

19. The Bureau, IA and MPFA have discussed the implementation details with the industry before drawing up the proposal.

ADVICE SOUGHT

20. Members are invited to comment on the proposed implementation details set out in paragraphs 8 to 15 above.

Financial Services Branch
Financial Services and the Treasury Bureau
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Annex

Illustrative examples of tax savings for 2018-19 for MPF VC or deferred annuity premium

A. With existing deduction for MPF mandatory contribution only

	A	B	C	D	E
	Single, monthly salary $15,000	Single, monthly salary $20,000	Single, monthly salary $30,000	Single, monthly salary $60,000	Married, 1 child, monthly salary $60,000, Spouse not working
Income	180,000	240,000	360,000	720,000	720,000
Less: deduction (MPF mandatory contribution)	9,000	12,000	18,000	18,000	18,000
Less: Allowances	132,000	132,000	132,000	132,000	264,000 120,000
Net Chargeable Income	39,000	96,000	210,000	570,000	318,000
Tax payable (A)	780	3,760	17,700	78,900	36,060

B. With an additional maximum tax deductible of $36,000 for MPF VC or deferred annuity premium

	A	B	C	D	E
	Single, monthly salary $15,000	Single, monthly salary $20,000	Single, monthly salary $30,000	Single, monthly salary $60,000	Married, 1 child, monthly salary $60,000, Spouse not working
Income	180,000	240,000	360,000	720,000	720,000
Less: deduction (MPF mandatory contribution)	9,000	12,000	18,000	18,000	18,000
Less: deduction (MPF VC or premium for deferred annuities)*	9,000	12,000	18,000	36,000	36,000
Less: Allowances	132,000	132,000	132,000	132,000	264,000 120,000
Net Chargeable Income	30,000	84,000	192,000	534,000	282,000
Tax payable (B)	600	3,040	14,880	72,780	29,940
Tax savings (A) - (B)	**180**	**720**	**2,820**	**6,120**	**6,120**

*For scenarios A, B and C, it is assumed that given his relatively low income, the income earner will not make claims with the full tax deductible amount for MPF VC or deferred annuity premium.