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Paper for the House Committee meeting on 1 March 2019

Report of the Bills Committee on Inland Revenue and MPF Schemes Legislation (Tax Deductions for Annuity Premiums and MPF Voluntary Contributions) (Amendment) Bill 2018

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue and MPF Schemes Legislation (Tax Deductions for Annuity Premiums and MPF Voluntary Contributions) (Amendment) Bill 2018 ("the Bills Committee").

Background

2. In the 2018-2019 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 would also be applicable to Mandatory Provident Fund Voluntary Contributions ("MPF VCs"). The Insurance Authority ("IA") has been tasked to issue guideline such that premiums for deferred annuity policies that meet the requirements in the guideline will be tax deductible. MPF VCs that enjoy tax deductions will be subject to the same preservation requirements as applicable to MPF Mandatory Contributions ("MPF MCs").

Mandatory Provident Fund Voluntary Contributions

3. At present, MPF MCs by employees are tax deductible under salaries tax, personal assessment and profits tax (for self-employment cases) and

subject to the preservation requirements, i.e. withdrawal is allowed only upon retirement at the age of 65 or on statutorily permissible grounds[1]. MPF VCs by employees are usually deducted from the employees' monthly salary and paid to MPF trustees by employers, in the same manner as MPF MCs. MPF VCs are not tax deductible and can be withdrawn relatively flexibly, i.e. not subject to the preservation requirements.

4. The Administration has proposed to continue to exempt MPF VCs from the preservation requirements but such VCs will not be tax deductible. If a scheme member with an MPF contribution account or personal account wishes to benefit from tax deduction under salaries tax and personal assessment, he or she must put the MPF VCs in a new separate Tax Deductible Voluntary Contribution ("TVC") account in an MPF scheme of his or her own choice. All existing MPF MCs' preservation requirements will apply to the accrued benefits in the TVC account.

5. Occupational Retirement Schemes ("ORSO schemes") exempted from the provisions of the Mandatory Provident Fund Schemes Ordinance (Cap. 485) ("MPFSO") by virtue of section 5 of Cap. 485 (i.e. MPF-exempted ORSO schemes) are grandfathered ORSO schemes established before the MPF System was introduced. Under the proposal, members of these MPF-exempted ORSO schemes can also open a TVC account with an MPF scheme of their own choice for making MPF TVCs and enjoy the proposed tax deduction.

Deferred annuity

6. The Administration proposes that premiums paid for deferred annuity products that satisfy a set of criteria set out in the guidelines to be issued by IA will be eligible for tax deduction under salaries tax and personal assessment. According to the Administration, IA will closely monitor market development and update the eligibility criteria to strike a reasonable balance between promoting market development and protecting the interests of policy holders. IA may allow slight deviations from the criteria if it is satisfied that the deviations are not detrimental to the interests of policy holders.

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

Maximum tax deductible limit per year

7. In the proposal discussed by the Panel on Financial Affairs in May 2018, the maximum tax deductible limit, being the aggregate limit that a taxpayer may claim tax deductions for MPF TVCs and deferred annuity premiums, was set at $36,000 per year. In response to calls from the industry and Legislative Council ("LegCo") members, the Administration has raised the aggregate maximum tax deductible limit from $36,000 to $60,000 and extended the coverage of tax deductions to deferred annuity premiums for a taxpayer's spouse.

The Bill

8. The Inland Revenue and MPF Schemes Legislation (Tax Deductions for Annuity Premiums and MPF Voluntary Contributions) (Amendment) Bill 2018 ("the Bill") was introduced into LegCo at the Council meeting of 12 December 2018 to implement the proposed tax deduction for taxpayers who take out a qualified deferred annuity or make MPF VCs.

9. The Bill seeks to:

(a) amend the Inland Revenue Ordinance (Cap. 112) to introduce new concessionary deductions concerning salaries tax and tax under personal assessment that may be allowed for annuity premiums paid under certain deferred annuity policies and for certain TVCs;

(b) amend the MPFSO and the Mandatory Provident Fund Schemes (General) Regulation (Cap. 485A) to provide for the TVCs; and

(c) provide for related and transitional matters.

Details of the major provisions of the Bill are set out in paragraph 20 of the LegCo Brief (File Ref.: INS/2/18C). If the Bill is passed, the proposed amendments would come into operation on 1 April 2019.

The Bills Committee

10. The House Committee agreed at its meeting on 14 December 2018 to form a Bills Committee to study the Bill. The membership list of the Bills Committee is in **Appendix I**. Under the chairmanship of Hon WONG Ting-

kwong, the Bills Committee has held two meetings to meet with the Administration and received views from deputations. A list of the organizations/individuals which/who have submitted views to the Bills Committee is in **Appendix II**.

Deliberations of the Bills Committee

Deferred annuity policies eligible for tax deduction

11. Members note that in the proposed section 26N of Cap. 112, "qualifying deferred annuity policy" is defined to mean an insurance policy that is, among others, certified by IA to be in compliance with the criteria specified for such purposes in the guidelines published by IA under section 133 of the Insurance Ordinance (Cap. 41). Under section 133 of Cap. 41, the guidelines may be published in the Gazette but are not subsidiary legislation. Members including Mr CHUNG Kwok-pan and the Legal Adviser to the Bills Committee have enquired about the factors which IA will take into consideration in formulating the criteria for a qualifying deferred annuity policy; whether IA would conduct any public consultation on the criteria to be specified in the guidelines; and how taxpayers would know whether a deferred annuity policy is certified by IA as in compliance with the criteria.

12. The Administration has advised that the guidelines to be published by IA are to set out the technical details of the eligibility criteria and other related requirements for compliance by insurers. IA has conducted an industry consultation on the guidelines given the technical nature of the exercise. In formulating the criteria for a qualifying deferred annuity policy to be specified in the guidelines, IA will take into consideration the following two factors:

(i) whether the product serves the purpose of long-term retirement financial planning (some products are more akin to short-term savings plan); and

(ii) consumer protection.

13. As regards publicizing of eligible deferred annuity products, the Administration has advised that as mentioned in paragraph 17 of the LegCo Brief on the Bill, IA will publish the list of the qualifying deferred annuity products on its website (www.ia.org.hk) for public information. The list will be maintained and updated by IA. Members of the public can visit IA's website to find out which deferred annuity products are eligible for tax

deduction. The Administration is also considering a compliance mark system such that the product brochures of a qualifying product will bear an indication that it is a compliant product for consumers' easy identification.

14. Mr Kenneth LEUNG has sought information on the number of existing deferred annuity products with structure and design that satisfied the criteria set down by IA; and whether the internal rate of return ("IRR") as disclosed in the sales brochure of eligible deferred annuities would be a guaranteed return rate which would enable purchasers to have the expected return, and whether there would be any prescribed minimum IRR for eligible deferred annuities. Mr LEUNG has also enquired whether any requirement has been set down with respect to the amount of premiums to be charged by eligible deferred annuities.

15. The Administration has advised that there are 44 existing deferred annuity products in the market but, for the time being, only one of them satisfies the intended guidelines to be set down by IA. IA is in consultation with the industry on the criteria for eligible deferred annuities. Upon confirmation of the guidelines, it is expected that there will be more qualifying products as insurers are likely to be able to adjust some existing products to meet the qualifying criteria.

16. The Administration has further advised that the respective IRRs of the guaranteed payouts and total payouts of eligible annuities have to be clearly stated in the sales brochures and relevant communications with the prospective purchaser of the eligible annuities to enable him to evaluate and compare eligible products before making an informed decision to purchase. Annuities sold under regulated insurance contracts are subject to asset-liability matching by insurance companies. The IRR of eligible deferred annuities will also be subject to regulation and certification by IA based on calculations and scenarios specified in the guidelines. There will be no prescribed minimum IRR for eligible deferred annuities as the return will depend on various factors including individual circumstances of purchasers and the terms of the annuities.

17. As regards premium, the Administration has explained that the purchase of deferred annuity is governed by insurance contracts and the amount of premiums to be charged under such contracts is to be agreed by the parties to the contract after taking into account the individual circumstances of the insured. It would be impossible for IA to prescribe a unified premium for all such contracts.

Commissioner's power in claims for qualifying annuity premiums paid

18. Members note that the proposed new section 26R of Cap. 112 provides that the Commissioner of Inland Revenue ("the Commissioner") may exercise a power under Subdivision 1 (Qualifying Annuity Premiums) in a way that the Commissioner, having regard only to the information then in the Commissioner's possession, considers appropriate. The Legal Advisor to the Bills Committee has sought explanation on why the proposed section 26R is necessary for Subdivision 1 but not for Subdivision 2 (Tax Deductible MPF Voluntary Contributions).

19. The Administration has advised that under the proposed section 26P(2) in Subdivision 1, a deduction for qualifying annuity premiums paid may be allowed to either a taxpayer, or the taxpayer's spouse (not being a spouse living apart from the taxpayer), or to both of them. If the qualifying annuity premiums paid are claimed for deduction by both the taxpayer and the taxpayer's spouse and the amounts claimed exceed the actual amounts paid, the Commissioner will need to deal with such double claims. In such situations, the proposed section 26R allows the Commissioner to decide on these claims based on the information in his possession since the information provided might be conflicting.

20. Under the proposed section 26S in Subdivision 2, a deduction for tax deductible MPF VCs paid can only be claimed by and allowed to the taxpayer. As such, no double claims will arise and the power under the proposed section 26R (i.e. Exercise of Commissioner's power) is not necessary.

Claims for voluntary contributions paid by way of deductions from salary

21. Members note that the proposed new section 26S of Cap. 112 provides that subject to the proposed new sections 26T and 26U, a deduction in respect of tax deductible MPF VCs paid by a person into a TVC account (i.e. for holding tax deductible VCs) during a year of assessment is allowable to the person for the year of assessment. The Legal Advisor to the Bills Committee has sought clarification on whether a taxpayer may authorize his/her employer to pay VCs out of his/her salary direct into the taxpayer's TVC account (i.e. similar to the way MPF VCs are paid to the MPF trustees by employers) and claim deduction under the proposed section 26S.

22. The Administration has advised that TVCs are a new type of contributions which are different from the VCs as defined in section 11 of the MPFSO. Unlike the existing employment-related VCs, a taxpayer who wishes to make TVCs could open a TVC account with an MPF trustee of his

or her own choice and make TVCs directly to the account without going through his or her employer. The taxpayer can make TVCs to his/her TVC account at any time at any amount.

23. According to the Administration, the above arrangement is the optimal arrangement after taking into account the following considerations:

(i) minimization of administrative costs;

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

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

24. Under the proposed section 26S, a taxpayer may claim a deduction in respect of tax deductible MPF VCs paid by him/her into his or her TVC account in a year of assessment. Notwithstanding the above, a TVC account holder can authorize his or her employer to make TVCs into his/her TVC account as a private arrangement. It would depend on the agreement between the scheme member, his or her employer and the MPF trustee concerned. However, in practice, it may be administrative cumbersome for an employer to make TVCs on behalf of his or her employees because different employees may open TVC accounts with different trustees and make TVCs of varying amounts at different intervals.

<u>Order of deductions for tax deductible MPF VCs and qualifying annuity premiums</u>

25. Members note that under the proposed new section 26U of Cap. 112, if deductions are allowable to a taxpayer for both qualifying annuity premiums and TVCs paid by the taxpayer, the deductions are to be allowed for the TVCs first and then for the qualifying annuity premiums. The Legal Advisor to the Bills Committee has sought explanation for allowing deductions in such order.

26. The Administration has advised that a deduction for qualifying annuity premiums paid may be claimed by a taxpayer or the taxpayer's spouse (not being a spouse living apart from the taxpayer) while a deduction for TVCs paid can only be claimed by the taxpayer. The deduction order under the proposed section 26U(2) (i.e. deductions are to be firstly allowed for TVCs

and secondly allowed for qualifying annuity premiums) ensures that married couples will receive a more favourable taxation consequence. Tax deduction in respect of qualifying annuity premiums exceeding the reduced cap (i.e. $60,000 reduced by TVCs) is allowable to the taxpayer's spouse. In case the deduction order is reversed, TVCs exceeding the reduced cap (i.e. $60,000 reduced by qualifying annuity premiums) cannot be claimed by the taxpayer's spouse for tax deduction.

Maximum tax deductible limit and claims by married couple

27. Some members including Mr CHUNG Kwok-pan have enquired about the reasons for not raising the aggregate maximum tax deductible limit further to $100,000 per year as some of industry's views have suggested and details on how a married couple can claim the deductions if they elect for joint assessment or personal assessment.

28. The Administration has advised that in determining the revised limit of $60,000 per year, it has made reference to the maximum tax deductible limit of other deduction items under the salaries tax regime and new measures under contemplation. The Administration will make reference to the market response and LegCo Members' views when reviewing and considering the maximum deductible limit in due course.

29. As regards claims by a married couple, the Administration has further advised that at present, under salaries tax, taxpayers, including married couples, are individually assessed on their incomes under separate taxation. Hence, tax deductible limits are usually based on individual taxpayers. If a married couple elects for joint assessment or personal assessment, the incomes and tax deductions of the couple will be aggregated. Under joint assessment or personal assessment, the maximum tax deductible limit for qualifying annuity premiums of a married couple will be $120,000. The current proposal allows a taxpaying couple to allocate tax deductions for deferred annuity premiums among themselves in order to claim the total deductions of $120,000, provided that the deductions claimed by each taxpayer does not exceed the individual limit of $60,000. Assuming that a taxpaying couple has only one qualifying deferred annuity policy with an annual premium of $120,000 and the policy is taken out by the husband on his own (i.e. the husband is the sole policy holder and sole annuitant). Under this circumstance, while the husband can claim a maximum tax deduction of $60,000, his wife may also claim a maximum tax deduction of $60,000 for the remaining portion of the premium despite that she is neither a policy holder nor an annuitant of the said policy, allowing the taxpaying couple to claim a total tax deduction of $120,000.

Treatment of benefits in the TVC accounts in means tests

30. Mr WU Chi-wai considers that contributions made to TVC accounts and MPF MCs are of the same nature in the sense that both will be subject to preservation requirements. In this connection, he has sought clarification on whether the accrued benefits in the TVC accounts could have the same status and enjoy the same protection as MPF MCs, in that the benefits would not be regarded as scheme members' assets for the purpose of applying for social assistance (e.g. Comprehensive Social Security Assistance). Furthermore, Mr WU considers that accrued benefits from TVCs and MPF MCs should both be excluded from being counted as assets in means tests required by certain public services and social welfare schemes. Noting that the Financial Services and the Treasury Bureau has been in discussion with Bureaux/Departments on how TVCs are to be treated in their respective means-tested public services and welfare schemes, Mr WU has sought information on the outcome, if any, of the discussions.

31. In its written reply to Hon WU[2], the Administration has advised that TVCs are a new type of contributions which are different from the existing MCs and VCs. On the one hand, same as MCs, TVCs are subject to the preservation requirements, i.e. withdrawal is allowed only upon retirement at the age of 65 or on statutorily permissible grounds. On the other hand, unlike the existing MCs, for which there are statutory requirements in respect of the timing, frequency or amount of contributions, employees can make TVCs at any time at any amount. Given the differences between TVCs and MCs, the Administration considers it inappropriate to uniformly require Bureaux/Departments to exclude the accrued benefits of TVCs from the calculation of assets of the applicants for public services/social welfare benefits solely because TVCs and MCs are subject to the same preservation requirements.

32. The Administration has further advised that each of the means-tested public services or welfare schemes has its unique policy objective, target beneficiaries to be covered by the policy, and implementation details (such as how assets should be defined, etc.). Hence, there might not be a one-size-fits-all treatment of accrued benefits of TVCs for all these means-tested public services or schemes.

33. As per Mr WU's written request, the Administration has advised that based on the response from Bureaux available thus far, in general, if the

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2 LC Paper No. CB(1)650/18-19(01) issued on 27 February 2019.

accrued benefits of TVCs of the applicants cannot be withdrawn at the time of applications for means-tested public services and welfare schemes[3], their accrued benefits of TVCs will not be regarded as assets.

Return of annuity products

34. Mr LUK Chung-hung considers that private annuities were not popular in the past mainly due to their low return with high administrative fees and commission charges. In view of the higher return and lower administrative fees and charges of the public annuity offered by the Hong Kong Mortgage Corporation ("HKMC") when compared to private annuities, he has enquired whether the Administration would consider providing tax concessions to premiums paid for deferred annuity products if they are launched by HKMC.

35. The Administration has advised that the IRR of HKMC's immediate life annuity was about 4%, which was among the highest in the market. With a view to achieving balanced market development of public and private annuities, the Administration does not consider it appropriate for HKMC to offer deferred annuity products with high IRR of about 4% as this may crowd out private annuities. With the increase in popularity of annuity products, the Administration will take into account the community's response to the proposed tax concessions for MPF VCs and deferred annuity premiums before considering more measures to encourage the development of appropriate retirement planning products.

36. Some members including Mr LUK Chung-hung and Mr CHUNG Kwok-pan do not subscribe to the view that the high IRR of the public annuity of HKMC would crowd out private annuities and consider that on the contrary, the IRR of HKMC's public annuity could serve as a yardstick against which private annuities could benchmark. The Administration has responded that it is unlikely that insurers are able to issue a product with as high IRR as the annuity offered by HKMC.

Regulation of intermediaries and public education

37. Some members including Mr YIU Si-wing have sought information on the measures, if any, to regulate intermediaries in marketing/selling

[3] For example: the Samaritan Fund of the Food and Health Bureau, the application for public rental housing of the Housing Department, and the Comprehensive Building Safety improvement Loan Scheme of the Buildings Department, etc.

deferred annuities to the public and promote the public's understanding of them in meeting their retirement needs.

38. The Administration has advised that it attaches great importance to public education and the point-of-sale conduct of intermediaries. As mentioned in the LegCo Brief, the Administration encourages insurers to enhance training on annuity products for intermediaries. IA and the Mandatory Provident Fund Schemes Authority ("MPFA") will also continue to closely monitor the point-of-sale conduct of intermediaries. On the other hand, the Administration is collaborating with the Investors and Financial Education Council, IA and the MPFA to prepare a publicity and public education campaign to enhance public understanding of how to evaluate different financial planning tools to suit one's retirement needs.

<u>Other issues</u>

39. In the course of deliberations, members have taken the opportunity to express concerns and make suggestions on various issues including the performance and management fees of MPF schemes, "universal" retirement protection, etc.

40. Members including Dr KWOK Ka-ki have pointed out that the high management fees charged by MPF trustees remained a problem and stressed the need for the Administration to keep on reviewing and refining the MPF system.

41. Dr KWOK Ka-ki has criticized the investment performance of MPF schemes and the Government's reluctance to launch universal retirement protection. He has enquired about the reasons for not allowing tax deductions for contributions and savings in other retirement plans and financial products, such as long-term bank deposits. Noting that the annualized IRR of the Investment Portfolio managed by the Hong Kong Monetary Authority ("HKMA") since 2007 was about 6.1% on average, and about 13.5% for the Long Term Growth Portfolio since its inception in 2009 up to the end of September 2017, which are much higher than those from the MPF schemes, Dr KWOK has urged the Administration to establish a fund to be managed by HKMA for employees to mitigate the problem of high management charges and mediocre return of many MPF schemes.

42. The Administration has advised that to address aging population, the World Bank has advocated a multi-pillar conceptual framework for reforming pension systems worldwide[4]. 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 to compensate for the rigidities in the design of other pillars.

43. The Administration has further explained that 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 to mitigate longevity risk. Since some saving products such as time deposits with banks will serve the accumulation purpose but not the annuitization purpose, the Administration considers it appropriate to encourage the use of deferred annuities as a voluntary retirement planning tool for the public. That being said, the Administration has also emphasized that voluntary retirement planning tools form only part of the retirement protection tools. In addition, annuity may not be suitable for everyone. Various factors such as ones' liquidity needs, bequest motive, financial disciplines and any other alternatives should be considered.

Commencement date

44. Pursuant to clause 1(2) of the Bill, subject to the passage of the Bill, the proposed amendments will come into operation on 1 April 2019, which is also the commencement of the year of assessment 2019-20.

Resumption of Second Reading debate on the Bill

45. The Administration and the Bills Committee will not propose any amendment to the Bill. The Bills Committee raises no objection to the resumption of the Second Reading debate on the Bill at the Council meeting of 20 March 2019.

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[4] 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; and
(e) voluntary fourth pillar - public services, family support and personal assets.

Advice sought

46. Members are invited to note the deliberations of the Bills Committee.

Council Business Division 1
Legislative Council Secretariat
28 February 2019

Appendix I

Bills Committee on Inland Revenue and MPF Schemes Legislation (Tax Deductions for Annuity Premiums and MPF Voluntary Contributions) (Amendment) Bill 2018

Membership List

Chairman	Hon WONG Ting-kwong, GBS, JP
Members	Hon Starry LEE Wai-king, SBS, JP Hon CHAN Kin-por, GBS, JP Hon WU Chi-wai, MH Hon YIU Si-wing, BBS Hon LEUNG Che-cheung, SBS, MH, JP Hon Kenneth LEUNG Dr Hon KWOK Ka-ki Dr Hon Fernando CHEUNG Chiu-hung Hon CHUNG Kwok-pan Hon Holden CHOW Ho-ding Hon LUK Chung-hung, JP Hon Jeremy TAM Man-ho Hon Vincent CHENG Wing-shun, MH
	(Total : 14 members)
Clerk	Mr Derek LO
Legal Adviser	Ms Clara TAM

Appendix II

Bills Committee on Inland Revenue and MPF Schemes Legislation (Tax Deductions for Annuity Premiums and MPF Voluntary Contributions) (Amendment) Bill 2018

List of organizations/individuals which/who have submitted views to the Bills Committee

1. Liberal Party
2. Miss CHAN Po-ying
3. Miss Sister Reasonable
4. Mr LEUNG Kwok-hung