Revitalising Hong Kong's economy for greater success

March 2020

Foreword

Hong Kong possesses a wide range of competitive advantages that have long established the city as one of the world's most attractive destinations for investing and doing business. It has played a pivotal role in Mainland China's economic expansion of recent decades, and has offered ample business opportunities to local and foreign investors.

However, Hong Kong's privileged position has not gone unchallenged. Amid ongoing uncertainties in the global economy, we have seen a rising tide of trade protectionism and growing competition from neighbouring markets. These factors are coupled with internal constraints that sap growth, such as high land prices and a shortage of technology talent. The recent protests and novel coronavirus outbreak have also taken a heavy toll on the local economy. The Financial Secretary reported in the 2020/21 Budget[1] that there had been a fiscal deficit for 2019/20 – the first in fifteen years – and that deficits are forecast for the next five years. The 2019/20 deficit is estimated to be about 1.3% of GDP. The economy is contracting for the first time since 2009.

[1] https://www.budget.gov.hk/2020/eng/speech.html

Given this background and the forecast fiscal deficits in the coming years, we believe it is time for the Government to take bold and swift action to drive economic growth and explore new sources of revenue. The Government needs to be visionary and map out a set of clear strategies to attract funds, businesses and talent to the city.

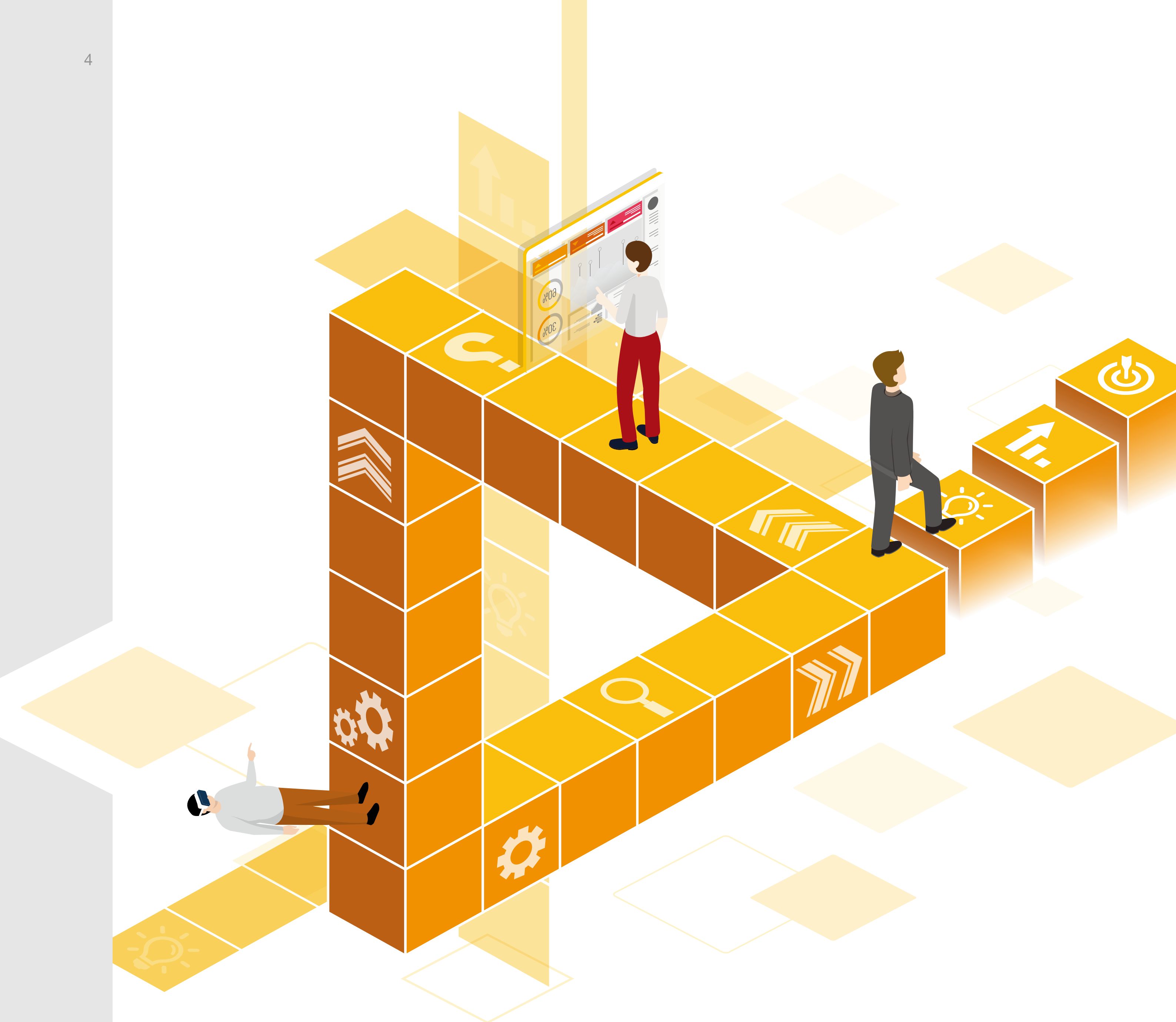
While this paper addresses a broad range of macro challenges facing Hong Kong, our main emphasis is on fiscal measures. The city's attractiveness due to its low and simple tax system cannot be relied upon forever. Other jurisdictions are catching up and we have seen major economies, such as the US and the UK, reduce tax to attract investment. So Hong Kong needs to ensure that it continues to boast a truly competitive tax system – one that offers clarity and certainty to businesses established here or contemplating such a move. Strategic tax incentives will play an important part in this. But if incentives are to be deployed at any scale, the "global effective minimum tax" proposed by the OECD will need to be addressed.

Tax reform is a vital part of a broader change in policy direction that we believe necessary to revitalise Hong Kong. Rather than its traditional *laissez-faire* approach, the Government should actively consolidate the city's position as a global business and financial centre, while providing a business-friendly and competitive tax environment for it to capture the new opportunities arising from industries with high growth potential. This requires a holistic, long-term development plan for Hong Kong. But, above all, it calls for efficient and effective execution of Government initiatives.

At PwC, our purpose is to build trust in society and solve important problems. This is the very reason why we issued this paper. The paper is intended to arouse public interest, provoke discussion and encourage exploration of different options and most importantly, to revitalise Hong Kong's economy. We hope you find this paper useful.

Peter Ng
Managing Partner, Tax
PwC China

Charles Lee
South China (incl. Hong Kong SAR) Tax Leader
PwC China



Our key recommendations to revitalise the Hong Kong economy are:

Attracting funds and businesses to Hong Kong and capitalising on GBA opportunities

1. Strengthen Hong Kong's role in RMB internationalisation and as an offshore RMB centre. Further facilitate trading on the Hong Kong stock exchange in RMB and promote more IPOs in RMB.
2. Develop competitive business and tax incentives to attract MNCs to set up RHQs in Hong Kong (e.g. rental subsidies, concessionary profits tax rate, school availability for expatriates, etc.)
3. Extend the super tax deduction for R&D expenditure to R&D activities conducted outside Hong Kong but within the Greater Bay Area (GBA).

Redefining the Government's role in driving economic development and revenue growth

4. Go beyond the current 'facilitator and promoter' role and act as a 'driver' in fostering industries with high growth potential.
5. Adopt a holistic rather than piecemeal approach to formulating and implementing policies. Ensure effective policy execution across different bureaus and departments.

Nurturing, attracting and retaining talent

6. Attract more high-tech enterprises, venture capital funds and overseas talent to Hong Kong to build a vibrant local innovation and technology ecosystem.
7. Use financial incentives (e.g. housing subsidies and cash bonuses) to attract overseas talent to work and stay in Hong Kong. Establish an employment matching programme for local STEM graduates with employers in Hong Kong and the GBA.

Making the Hong Kong tax system more competitive

8. Conduct a comprehensive review of the tax system. Ensure tax incentives are business-friendly, commercially viable and actively promoted. Conduct regular reviews to enhance their effectiveness.

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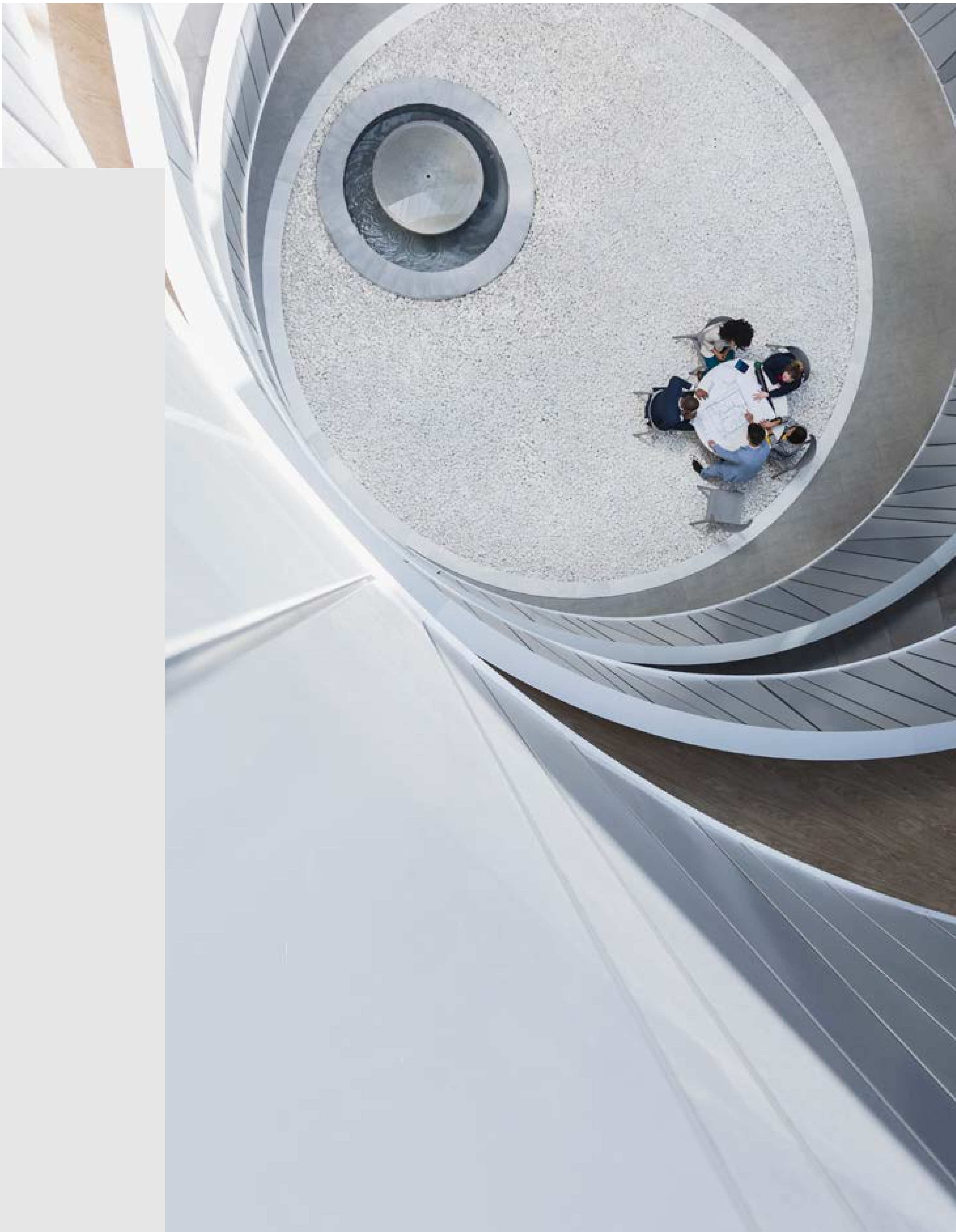

Introduction

Hong Kong possesses numerous competitive advantages that make the city one of the world's most attractive destinations for investing and doing business. It has played a privileged role in China's market development since the 1980s. More recently, it has been central to the Greater Bay Area (GBA) and the Belt & Road Initiative (BRI). In addition, the city has long been envied for its strategic location at the centre of East Asia. It enjoys open markets, world-class transport infrastructure and the free flow of capital and information. All of these are supported by reputable legal and financial systems and a simple and low tax system.

Hong Kong has been awarded top rankings in several global competitiveness indices. For example, it was ranked third in both the World Bank's Doing Business 2020 Report[2] and the 2019 Global Competitiveness Index from the World Economic Forum[3] (see Appendix 1). However, these rankings were carried out before the recent social unrest and therefore do not reflect the impact on Hong Kong's economy.

But Hong Kong's attractiveness to business is not without challenges and there is keen competition from neighbouring markets, such as Singapore, Shenzhen and Shanghai. As can be seen in Appendix 1, the World Bank and the World Economic Forum have consistently ranked Singapore ahead of Hong Kong. According to *CEOWORLD* magazine, Hong Kong ranked just 48th among 'The best countries to invest and do business' for 2020 and 54th among 'Most start-up friendly countries in the world' for 2019. This places it far behind China, India, Japan, Malaysia, Singapore and South Korea in both rankings[4]. Being a small and open economy, Hong Kong has also been exposed to the economic turbulence that has rocked other parts of the world, such as the China-US trade tensions and Brexit.

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[2] https://www.doingbusiness.org/

[3] https://www.weforum.org/reports/how-to-end-a-decade-of-lost-productivity-growth

[4] https://ceoworld.biz/2020/02/17/worlds-best-countries-to-invest-in-or-do-business-for-2020/ and https://ceoworld.biz/2019/01/02/most-startup-friendly-countries-in-the-world-2019/

Hong Kong also has some specific challenges of its own. These include scarcity of land – with consequently high property prices – and high labour costs. Historically, Hong Kong has relied on its four 'pillar industries' (financial services, tourism, trading and logistics, and professional services) to support its economy. The total contribution of the four pillar industries to Hong Kong's Gross Domestic Product (GDP) has consistently been over 55% in the past decade. However, there is a sign that the contribution from the trading and logistics sectors is weakening (see Appendix 2). This trend, coupled with today's technology-focused global economy, serves as a wake-up call for Hong Kong to diversify its economy so as to ensure sustainable economic growth.

The recent social unrest has also reshaped the international community's perception of Hong Kong's business environment and social stability. Businesses are looking to relocate their Hong Kong regional headquarters (RHQs) and Hong Kong people are considering emigrating to other countries or cities. In September 2019, Fitch downgraded Hong Kong's credit rating from AA+ to AA and changed the outlook from stable to negative. In January 2020, Moody's also downgraded Hong Kong's credit rating to Aa3 from Aa2, but changed its Hong Kong outlook from negative to stable.

While the impact of the unrest on Hong Kong's economy has yet to be finally determined, the novel coronavirus outbreak has clearly dealt a further blow to an already weakened economy. Government statistics[5] show that GDP fell by 2.8% and 2.9% respectively in the third and fourth quarters of 2019 from a year earlier, marking the first year-on-year decline since the global financial crisis in 2009. On a quarter-to-quarter comparison, GDP fell 0.4%, 3% and 0.3% respectively in the second, third and fourth quarters of 2019. The consecutive decline in the second and third quarters means that Hong Kong entered into a technical recession in the second half of 2019. The Hong Kong economy is forecast to contract by 1.2% for 2019 as a whole, marking the first annual decline since 2009. In the 2020/21 Budget[6] the Financial Secretary reported a fiscal deficit for year 2019/20 – the first in fifteen years – and deficits are forecast for the next five years. The estimated deficit in 2019/20 is about 1.3% of GDP.

The Financial Secretary has announced four rounds of supportive measures targeted at enterprises and individuals since August 2019, involving a total of over HK$30 billion. The Government also announced the setting up of a HK$30 billion Anti-epidemic Fund in February this year. In the 2020/21 Budget, additional relief measures were proposed to further ease the financial burden on enterprises and the public during the economic downturn, including a cash payout of HK$10,000 for each Hong Kong permanent resident aged 18 or above. While these measures can help in the short term, most do not address the long-term challenges faced by Hong Kong.

Given this background and the prospect of fiscal deficits for the next five years, it is time for the Government to change its long-held *laissez-faire* approach and take bold and swift action to drive Hong Kong's economic growth while exploring new sources of government revenue. The Government needs to consider how Hong Kong can best consolidate its existing competitive advantages, develop new strengths for continuous economic growth and boost its competitiveness within the region. The Government needs to be visionary and map out a set of clear strategies to attract funds, businesses and talent to the city. This in turn requires the Government to take a pivotal role in driving the development of key industries and formulating a holistic, long-term economic plan, rather than implementing piecemeal and short-term measures.

The purpose of this paper is to identify the key macro issues currently facing Hong Kong and to provide recommendations to the Government on how to address them. The aim is to revitalise the Hong Kong economy over the medium to long term, although the paper also contains some short-term suggestions.

[5] https://www.hkeconomy.gov.hk/en/pdf/er_19q4.pdf
[6] https://www.budget.gov.hk/2020/eng/speech.html

Recommendations for revitalising the Hong Kong economy

Hong Kong faces a wide range of macro-economic issues which could hinder the city's economic development and weaken its attractiveness to foreign capital and talent. The many detailed measures that are outlined in this paper can be summarised into the following six areas:

1. attract funds and businesses to Hong Kong and capitalise on GBA opportunities;
2. redefine the Government's role in driving economic development and revenue growth;
3. address shortage of land and high property prices;
4. nurture, attract and retain talent;
5. make the Hong Kong tax system more competitive; and
6. foster the development of industries through tax and non-tax measures.

Some of the above areas are interrelated. For example, redefining the Government's role in driving economic development would help attract more funds and businesses to Hong Kong and make the tax environment more competitive.

While Hong Kong enjoys considerable advantages (e.g. the freest economy in the world, a sound legal system and reputable financial infrastructure), we are of the view that properly addressing these areas would significantly improve the city's overall competitiveness.

1. Attracting funds and businesses to Hong Kong and capitalising on GBA opportunities

(i) Internationalisation of the RMB and Hong Kong as an offshore RMB centre

The Mainland's central bank announced on 30 August 2019 that a pilot programme would be launched in Shenzhen whereby non-banking financial institutions would be allowed to convert hard currency into RMB without prior approval. The new regulation would make it easier for companies and individuals based in Shenzhen to convert foreign exchange into RMB.

Although the above programme represents a step by the Mainland Government to make the RMB more convertible within Shenzhen, we do not foresee the city taking up Hong Kong's role as an international RMB centre unless the currency becomes freelyconvertible. We believe Hong Kong can play a bigger role in RMB internationalisation and as an offshore RMB centre.

Currently, most initial public offerings (IPOs) in Hong Kong are in Hong Kong or US dollars, with very few in RMB. One way of facilitating further internationalisation of the RMB through Hong Kong is for the authorities to relax regulations and requirements so as to promote the launch of more IPOs in Hong Kong in RMB.

Corresponding changes to facilitate trading of Hong Kong stocks in RMB on the Hong Kong Stock Exchange (i.e. dual currency stocks) would also need to be considered. This can help attract significant further RMB inflows and enhance the liquidity of the RMB pool in Hong Kong.

(ii) Regional headquarters

According to Government statistics, the number of RHQs in Hong Kong increased from 1,401 to 1,541 between 2015 and 2019[7]. The US, Japan, Mainland China, the UK and Germany are the top five parent company jurisdictions. There is an increasing trend for companies from the Mainland to set up RHQs in Hong Kong – from 133 in 2015 to 216 in 2019 – up over 60% in five years.

[7] Census and Statistics Department, Hong Kong SAR Government: https://www.censtatd.gov.hk/hkstat/sub/sp360.jsp?tableID=133&ID=0&productType=8; https://www.policyaddress.gov.hk/2019/eng/pdf/PA2019.pdf

As a regional transport hub with close links to other major Asian cities, along with a reputable financial and legal framework, Hong Kong is a strategic location for foreign and Chinese multinational groups looking to set up regional operations, such as trading or procurement hubs. This is especially true for China-based groups planning to invest overseas.

There is, however, increasing competition from other jurisdictions offering tax and other incentives to attract multinational companies (MNCs). According to the *Singapore Business Review*[8], the state beats Hong Kong as the top Asian location for MNCs wishing to set up RHQs: 46% are stationed in Singapore, compared to 37% in Hong Kong. Singapore offers both tax and non-tax incentives to encourage MNCs to use the city as a regional or global base. It offers a 5% or 10% concessionary tax rate on income above a level based on the average of the company's previous three years' income. Similarly, the Malaysian government offers concessionary tax rates under its Principal Hub Incentive scheme.

As it is not uncommon for RHQs to house the senior management and various group supporting functions (e.g. procurement, accounting, finance and treasury, human resources, legal, information systems and training), we are of the view that a critical mass of RHQs in Hong Kong can have a multiplier effect in terms of economic benefits. This would be the case even if the tax revenue generated may not be very significant per se. The direct and indirect economic benefits include: projecting Hong Kong as an international business centre; raising the confidence level of MNCs in Hong Kong; promoting Hong Kong as a regional trading or procurement hub; attracting new funds, businesses and talent; and creating business and job opportunities for other sectors (e.g. transport and logistics, professional services) in the city.

In the 2020/21 Budget, the Financial Secretary mentioned that enterprises could set up their RHQs in Hong Kong to leverage the city's role as a platform for Belt and Road projects and for opening up new markets. However, no fiscal or tax incentives specific to RHQs were proposed in the Budget.

Despite Hong Kong's comparative non-tax advantages, in order to attract foreign and Chinese MNCs to set up new RHQs or retain existing RHQs, we suggest the following incentives:

- offering rental subsidies to RHQs to set up in Hong Kong, subject to certain criteria including minimum local spending and local employment requirements;

- introducing a concessionary tax regime for both existing and newly-established RHQs. Hong Kong income tax is source-based. While supporting services of RHQs are provided in Hong Kong, the service recipients are often outside the city. For this reason, as with the existing Corporate Treasury Centre (CTC) and aircraft leasing concessionary tax regimes, the Government should consider a concessionary profits tax rate for RHQ activities. In designing the tax incentive, the Government needs to ensure that it is competitive relative to what is available within the region and attractive from a business perspective. The scope of RHQ activities qualifying for the tax incentive should be broad enough to cover key corporate functions, including sourcing and procurement;

- allowing time apportionment claims on employment income earned overseas by employees of RHQs under Hong Kong employment[9]; and

- good quality education for children is a key consideration for the senior management of MNCs when deciding on RHQ location. The Government can liaise with international schools in Hong Kong to reserve a quota of places in these schools for the children of RHQ senior management[10]. This could form part of the conditions when these schools apply for or renew their business license or land lease.

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[8] https://sbr.com.sg//

[9] A time apportionment claim means an individual can exclude from his taxable income the portion of employment income derived from services rendered outside Hong Kong. Under the current tax law and practice, the time apportionment claim is available to individuals with non-Hong Kong employment only. For individuals with Hong Kong employment, such income exclusion is available only if (1) tax has been paid on that income in the overseas jurisdiction where the services are rendered and (2) that overseas jurisdictions does not have a tax treaty with Hong Kong.

[10] In Singapore, international schools are intended to primarily cater to expatriate children. Singapore citizens who wish to enrol their children in an international school require Ministry of Education approval.

(iii) The Guangdong-Hong Kong-Macau Greater Bay Area: opportunities for Hong Kong

On 1 July 2017, the National Development and Reform Commission, Guangdong Province, the Hong Kong Special Administrative Region and the Macau Special Administrative Region jointly signed the *Framework Agreement on Deepening Guangdong-Hong Kong-Macao Cooperation in the Development of the Bay Area*[11]. As part of the 13th Five-Year Plan, this is an important national economic development strategy for China. The HKSAR, as a constituent economy of the GBA, can leverage its economic potential for future development.

For Hong Kong to play a bigger role in the GBA's economic development, the Government could consider providing incentives or financial assistance to:

- young people in Hong Kong who are interested in gaining work experience in the GBA (e.g. a secondment or employment in the GBA for one to two years); and
- Hong Kong enterprises that are interested in expanding their existing businesses in Hong Kong to the GBA.

Hong Kong's society and economy may benefit when these individuals and enterprises apply the experience, skills and knowledge they have thereby acquired to their future careers and business operations in Hong Kong.

Other than the above, we have also published a series of insights and perspectives on the issues that matter most for the business sector. The *New Opportunities for Guangdong-Hong Kong-Macao Greater Bay Area*[12], report published in 2017, summarises the economic potential of the GBA. The report identifies two key business sectors where there are economic synergies in the GBA and the role that Hong Kong can play:

- High-value added manufacturing: Promoting the competitiveness of the manufacturing sector and cultivating high value-added industries.

[11] https://gia.info.gov.hk/general/201707/01/P2017070100409_262244_1_1498888409704.pdf

[12] https://www.pwchk.com/en/research-and-insights/editors-pick/new-opportunities-for-the-guangdong-hong-kong-macau-greater-bay-area.pdf

We identified many parts of the manufacturing sector in the GBA that are still at the lower end of the value chain. A short-term solution is to establish a fund to capture mature overseas core technologies. A longer-term solution is to encourage innovation, as outlined in other parts of this paper.

- Fintech and innovation: Enhancing cooperation while reducing competition to build a world-class financial and technology innovation centre.

We highlighted the attractiveness of Hong Kong to professionals in the finance and technology sectors due to its low individual income tax, English-language environment and superior medical and education services. It is therefore important that talent that settles in the region should be able to enjoy freedom of movement for work without restraints. We suggest that governments in the region should jointly develop preferential tax policies regarding corporate operations and flow of talent so as to encourage the exchange of high-value employees.

Seamless connections between transport infrastructure facilities and public services between the cities in the region, along with simplified immigration procedures for foreign talent, are also vital to encourage the flow of people[13].

The 2020/21 Budget reported good progress in discussions between Hong Kong and the Mainland regarding the establishment of the two-way Wealth Management Connect scheme. We recommend that the Government collaborate more closely with regulators in the Mainland to expedite the launch of the 'Insurance Connect' and 'Wealth Management Connect' schemes within the GBA. These should be a natural progression from the Stock Connect and Bond Connect schemes. One of the major hurdles to implementing such schemes is the different regulatory frameworks between Hong Kong and the Mainland. Insurance Connect and Wealth Management Connect could be launched on a trial basis within the GBA first and limited to certain eligible and mutually recognised products. Given mutual market access, if Hong Kong intermediaries were allowed to operate within the GBA, the market for Hong Kong products would be significantly expanded.

Other than the above suggestions, our recommendations on (1) a programme to help match Hong Kong STEM graduates with potential employers in the Innovation and Technology (I&T) sector in the GBA on page 22 and (2) RMB internationalisation on page 12 should also encourage greater flows of talent and capital within the GBA.

[13] Seamless travel between cities in the region is considered important for business travellers. See our 2018 report Fintech and the Greater Bay Area: Breaking down the barriers. https://www.pwccn.com/en/research-and-insights/Fintech/fintech-greater-bay-area-breaking-down-barriers.pdf

2. Redefining the Government's role in driving economic development and revenue growth

(i) The roles of facilitator, promoter and driver

The Chief Executive has advocated that the current Government should play the roles of facilitator and promoter, and be more proactive in handling economic and livelihood issues. We strongly support this approach, but believe that it needs to be embraced by all government departments at operational level and reflected in their day-to-day work.

For example, the Government's approach to attracting multinationals to set up in Hong Kong needs to be more effective. We have seen neighbouring countries and cities be very proactive and flexible in attracting foreign investment which could otherwise have gone to Hong Kong. Their business-friendly environments and supportive government policies are among the reasons multinationals choose not to set up in Hong Kong, or even relocate their existing business.

An illustration of this is the different roles played by InvestHK[14] and Singapore's Economic Development Board[15] (EDB) in attracting foreign direct investment.

Singapore's EDB versus InvestHK

The mission of Singapore's EDB is to create sustainable economic growth, with vibrant business and good job opportunities for the city. It undertakes investment promotion and industry development in the manufacturing and internationally tradeable services sectors. Besides facilitating investments, it engages Singapore's existing base of companies to transform their operations and boost productivity, and to generate growth in adjacent and disruptive areas by growing new businesses out of Singapore. It works with companies by providing information, connections to partners and access to government incentives for their investments, as well as their transformation and growth initiatives. It also works closely with other Singapore government agencies to constantly improve Singapore's pro-business environment, and ensure that the industries are supported by a globally competitive workforce through talent development[16].

InvestHK's vision is to strengthen Hong Kong's status as the leading international business location in Asia. Its mission is to attract and retain foreign direct investment which is of strategic importance to the economic development of Hong Kong. InvestHK works with overseas and Mainland entrepreneurs, Small and Medium sized Enterprises (SMEs) and multinationals that wish to set up an office – or

[14] https://www.investhk.gov.hk/en.html
[15] https://www.edb.gov.sg/
[16] https://www.edb.gov.sg/en/about-edb/who-we-are.html

expand their existing business – in Hong Kong. It offers free advice and services to support companies from the planning stage right through to the launch and expansion of their business[17].

While both EDB and InvestHK offer one-stop services for foreign investors to set up or expand their businesses locally, the EDB takes up a more strategic role in driving sustainable economic growth and industrial development in Singapore (e.g. its roles also include engaging with existing companies to transform their operations and boost productivity and constantly improve the pro-business environment and talent development of Singapore). This contributes to the development of the city's strengths. In contrast, based on its 2019 report to the Legislative Council Panel on Commerce and Industry, the role of InvestHK is more to promote the existing advantages of Hong Kong and advise foreign investors on existing government policies and regulations, rather than identify ways to develop new competitive advantages for the city.

We recommend that, in addition to being an 'ambassador' for foreign investors, InvestHK's role can be expanded to include exploring ways to enhance the attractiveness of Hong Kong as a place for doing business and formulating macro strategies to strengthen the city's position as a global business centre.

To enable Hong Kong to be a first mover and grasp business opportunities in emerging industrial sectors, other Government departments and organisations also need to be empowered to be more flexible and bold enough to formulate and implement policies that are innovative, commercially-minded, and that will bring real benefits to local business. An example of how Government policies can be more business-friendly is section 39E of the Inland Revenue Ordinance (IRO). Under this section, taxpayers engaged in cross-border processing trade may be denied tax depreciation allowances for their plant or machinery used outside Hong Kong by their subcontractors, despite the profits from such trade being fully taxable in Hong Kong. To support Hong Kong companies operating under this cross-border processing trade model, section 39E should be amended or concessionary tax relief should be given in lieu of the tax depreciation allowances.

To achieve this change in approach requires a fundamental shift in the mind-set of government officials at all levels. One way to drive this change is to include business targets among their KPIs.

Separately, for high-growth sectors such as I&T and R&D – where Hong Kong is already lagging – the Government should be more than just a facilitator and promoter. It should be a 'driver' of development.

[17] https://www.investhk.gov.hk/en/about-investhk.html

(ii) A holistic, long-term approach

Another recommendation is to adopt a holistic, long-term approach to Government policies. Under the current government structure, each bureau is responsible for certain specific policy areas. However, many economic and social issues are quite often interrelated. Resolving such issues requires coordinated long-term efforts across different bureaus. Without proper coordination, there is a risk that government policies are piecemeal and short-term.

For example, developing the I&T industry and promoting R&D involve addressing a wide spectrum of issues from land availability to attracting talent, building up the technological capability of local enterprises, attracting angel and venture funding, taxation, and so on. Similarly, developing the aircraft leasing sector not only requires a concessionary tax regime for the industry (which Hong Kong has already introduced) but other business-friendly measures such as simplifying the rules for getting a tax deduction on interest expenses paid to overseas group companies for financing aircraft acquisition.

A need for better coordination between different Government departments can be seen in another example: it is government policy to develop the I&T sector in Hong Kong and promote Hong Kong as an Intellectual Property (IP) trading hub. However, the Inland Revenue Department (IRD) has recently changed its assessment practice by denying a tax deduction for foreign withholding tax paid on overseas royalty income that is also subject to profits tax in Hong Kong. This results in double taxation of income when it is derived from a non-treaty jurisdiction, where tax credit is also not available.

The Tax Policy Unit was established under the Financial Services and the Treasury Bureau (FSTB) in April 2017 to comprehensively review tax issues from a macro perspective. We applaud the Government's initiative in setting up such a unit and the unit's contributions to the introduction of the two-tiered profits tax rates, the super tax deduction on R&D and a number of tax incentives for specific sectors. However, there has not been any comprehensive review of the tax system so far, though it is encouraging to see that the Unit has now been renamed the Budget and Tax Policy Unit (BTPU) and that its function has been expanded to cover budgetary matters. More importantly, it has been transferred from the FSTB to come directly under the Financial Secretary's Office from 1 July 2019. This should enable it to better coordinate with different bureaus to execute policies in a more holistic way.

Given the current advisory role of the BTPU to the Financial Secretary, we suggest the function and authority of the BTPU to be further expanded to playing a strategic leadership role in (1) formulating holistic, long-term economic and tax policies for Hong Kong and (2) directing the work across different bureaus to ensure their effective, integrated implementation. In addition to full-time government officials, the Unit should also include part-time advisory members who can bring a commercial perspective to policy formulation. Examples of similar advisory bodies include the Financial Services Development Council in Hong Kong and the Board of Taxation in Australia[18].

(iii) Efficiency in policy execution

The Government can also enhance the efficiency of policy execution so as to maximise the benefits that policies and other measures can bring to society.

One example is the Caring and Sharing Scheme announced in the 2018/19 Budget, under which the Government distributed HK$4,000 to each eligible Hong Kong resident. It is a good initiative but there is room for improvement in implementation. The Scheme was announced at the end of February 2018 but only opened for applications on 1 February 2019 – almost a year later. There were various implementation issues: applications could only be submitted in paper form, there was not enough promotion of the Scheme, some applicants found the form difficult to fill in, processing time was slow and administration costs were as high as HK$300 million. By the end of September 2019, there were still around 20,000 outstanding cases.

The 2020/21 Budget announced a cash payout of HK$10,000 to each Hong Kong permanent resident aged 18 or above. It is important that the Government learns from past experience and improves on execution this time.

(iv) Enhancing government services and achieving efficiency through technology

One of the electronic services offered by the Government is eTAX. Currently, the eTAX platform provides a number of online tax services, including (1) filing of profits tax, salaries tax, property tax and employer's returns, (2) applications for business and branch registration, (3) stamping of property documents and (4) payment of tax bills, business registration fees and stamp duty.

Based on statistics from the IRD, for year of assessment 2018/19, about 190,000 profits tax returns, 2,680,000 salaries tax returns, 130,000

[18] http://taxboard.gov.au/

property tax returns and 310,000 employer's returns (i.e. Form BIR 56A) were issued[19]. However, only 661,587 profits tax, salaries tax and property returns in total and 15,335 Forms BIR 56A were filed electronically. This means an overall e-filing rate of just 20.5%. In addition, there were only around 885,000 registered eTAX users as at 31 March 2019[20].

One of the reasons for the relatively low utilisation rate of e-filing is the current system limitations of the eTAX portal, which only allows 'small' corporations/businesses to file their profits tax return electronically. Small corporations/businesses are those for which the gross income for the basis period does not exceed HK$2 million. They must also meet a number of other conditions, including not claiming any treaty benefits under a Hong Kong double tax arrangement. Because of the low gross income threshold, many medium-sized and large multinational companies will not be eligible for e-filing services.

The IRD has recently revealed a plan to upgrade the department's IT infrastructure, modernising the department's website, as well as making use of artificial intelligence, robotics and advanced data analytics to improve operational efficiency and service performance. According to the plan, the IRD's target is to launch voluntary e-filing of profits tax returns by April 2021 and the first phase of mandatory e-filing of profits tax returns for big businesses by April 2025.

We welcome the IRD's initiative to enhance its electronic tax services for taxpayers. However, Hong Kong has lagged behind a number of advanced economies in using cutting-edge technologies in tax administration, so we urge the IRD to expedite this upgrade to enhance operational efficiency and provide better services to taxpayers.

Another area where the Government can improve its service to businesses through the use of technology is to introduce e-filing of employment visa applications. Currently, the original hard copies of application forms and supporting documents have to be submitted to the Immigration Department for both initial application and extension of employment visas. In addition, according to the performance pledge of the Immigration Department, the target is for 90% of employment visa applications to be finalised within four weeks of receipt of all necessary documents. That means it generally takes as long as a month to obtain an employment visa. We recommend that the Government (1) introduce an online system to allow users to submit visa applications electronically so as to make the application process more convenient and (2) shorten the time for processing the application.

(v) The Future Fund

The Future Fund was established by the Government in 2016 as a long-term investment scheme. The main objective is to secure higher investment returns for the fiscal reserves in the medium to long term to help meet increasing future spending needs. The Fund achieved a composite rate of return of 4.5%, 9.6% and 6.1% in its first three years of operations.

The 2020/21 Budget reported that the Government has accepted recommendations on the Future Fund's investment strategy by representatives from the financial services sector. These include using part of the Future Fund to set up a Hong Kong Growth Portfolio for direct investments in projects with a "Hong Kong nexus". The aim is to enhance returns and reinforce Hong Kong's status as a financial, commercial and innovation centre.

In Singapore, the Monetary Authority of Singapore (MAS), Temasek and the Government of Singapore Investment Corporation (GIC) are the three government-linked financial institutions that are responsible for managing and investing the government's reserves as well as its assets and investments.

Since 2016, the Net Investment Returns Contribution (NIRC) has been the single largest source of Singapore government revenue. In 2019, the NIRC amounted to S$17.05 billion and contributed to 18.5% of total government revenue[21].

We welcome the Government taking this new step to enhance the investment returns of the Future Fund. We look forward to the swift and effective implementation of this measure. Going forward, we believe the Future Fund should play the following roles: (1) increasing government revenue (the additional income can be used to compensate for the reduction in tax revenue should the Government introduce any new tax incentives) and (2) fostering the development of industrial sectors (e.g. financial services, innovation and technology) and the Hong Kong economy as a whole when the Fund invests in, for example, Hong Kong start-ups with high growth potential.

[19] https://www.ird.gov.hk/eng/ppr/archives/19040101.htm

[20] https://www.ird.gov.hk/dar/2018-19/table/en/ar_1819.pdf

[21] https://www.singaporebudget.gov.sg/docs/default-source/budget_2020/download/pdf/fy2020_analysis_of_revenue_and_expenditure.pdf

3. Addressing shortage of land and high property prices

Land scarcity and the Government's land development policy have contributed significantly to high prices and rentals for commercial and residential properties in Hong Kong. This, in turn, drives up the cost of doing business in Hong Kong. According to the Economist Intelligence Unit's *Worldwide Cost of Living 2019* report, Hong Kong, Singapore and Paris are now the three most expensive cities to live in[22].

On 29 June 2018, the Chief Executive and senior officials announced that a fee would be imposed on newly built flats which are left vacant for a year or more. This so-called vacancy tax[23] mainly targets first-hand private residential units where the occupation permit has been issued for twelve months. The fee will amount to 200% of the rateable value, which is roughly equal to 5% of the property value. At the time of the announcement, the Government estimated that there were 9,000 unsold first-hand residential units in completed projects, compared to 4,000 in March 2013.

On 13 September 2019, the Government gazetted the Rating (Amendment) Bill 2019 on the above mentioned Vacancy Tax to deter property developers from hoarding flats and to expedite the supply of first-hand homes.

According to the Hong Kong Property Review 2019[24] published by the Rating and Valuation Department, the vacancy rates of different types of properties in the private sector in the past five years are as follows:

[22] https://www.eiu.com/n/worldwide-cost-of-living-2019/

[23] https://www.info.gov.hk/gia/general/201806/29/P2018062900967.htm

[24] https://www.rvd.gov.hk/doc/en/hkpr19/PR2019_full.pdf

	2014	2015	2016	2017	2018
Residential	3.8%	3.7%	3.8%	3.7%	4.3%
Offices	6.3%	8.0%	8.2%	9.5%	8.6%
Commercial	7.3%	7.7%	9.0%	9.0%	9.4%
Retail	5.6%	5.0%	5.8%	6.1%	6.3%
Industrial	7.5%	6.8%	8.9%	7.4%	9.3%

Notes:
1. The vacancy indicates the percentage of units (or floor area) not physically occupied at the time of survey.
2. The vacancy bears no relation to whether the property is held by the developer.

According to statistics from the Transportation and Housing Bureau, there were around 9,900 unsold first-hand residential units in completed projects as at 31 December 2019[25].

Governments in Australia, Canada and the UK have imposed vacancy levies or taxes for residential units that are left vacant.

In December 2017, the Australian Government introduced a vacancy fee[26] for foreign owners of residential dwellings that are not occupied or rented out for more than 183 days (six months) in a year.

The British Columbia provincial government of Canada introduced the Speculation and Vacancy Tax in 2017. This is paid by some owners of residential properties in designated taxable regions of the province. For 2019, the tax rates are 2% of the property's assessed value for foreign owners and satellite families[27] and 0.5% for Canadian citizens or permanent residents who are not members of a satellite family[28]. In the City of Vancouver, there is an additional tax distinct from the Speculation and Vacancy Tax, which is the 1% Empty Homes Tax[29] .

The vacancy tax in Hong Kong should help speed up sales by developers and boost the short-term supply of residential units, though this also depends on other commercial considerations. But a vacancy tax is not by itself a solution to addressing high property costs in Hong Kong. Resolving supply and demand issues will require a long-term planning strategy which includes land reclamation, redevelopment of older districts and development of new satellite cities. In the 2020/21 Budget, the Financial Secretary reported on the Government's medium to long-term planning for increasing land resources and housing supply and the progress made. Measures include rezoning sites for housing development, developing brownfield clusters for public housing and the Lantau Tomorrow plan.

In the short term, the Government should consider:

- expediting revitalisation of vacant industrial buildings;
- offering rental subsidies to (i) multinationals which agree to deliver certain economic benefits to Hong Kong and (ii) overseas talent in certain fields (e.g. technology) who commit to stay in Hong Kong for a given period of time;
- providing salaries tax deduction for rent paid by individuals on their principal residence, subject to a deduction cap of HK$150,000 per year of assessment[30].
- increasing the salaries tax deduction cap for home mortgage interest incurred by individuals to HK$150,000 per year of assessment and extend the maximum period of deduction to 25 years.

[25] https://www.thb.gov.hk/eng/psp/publications/housing/private/pshpm/stat201912.pdf

[26] https://www.ato.gov.au/General/Foreign-investment-in-Australia/Annual-vacancy-fee/

[27] A satellite family is an individual or family unit where the majority of their total worldwide income for the year is not reported on a Canadian tax return.

[28] https://www2.gov.bc.ca/gov/content/taxes/speculation-vacancy-tax

[29] https://vancouver.ca/home-property-development/empty-homes-tax.aspx

[30] Under current tax law, rental expenses incurred by employees for their principal residence that are reimbursed by their employers can be taxed in a preferential way if the employers have implemented a qualifying rental reimbursement scheme. However, not all companies implement such schemes due to administrative costs. A salaries tax deduction for rental expenses incurred by individuals on their principal residence can provide tax relief for all salaries taxpayers who incur these expenses even if their employers do not provide a reimbursement scheme.

4. Nurturing, attracting and retaining talent

The Government has identified the I&T sector as a major engine for driving future economic growth in Hong Kong. Talent is key to developing this sector. The shortage of scientific and technological talent in Hong Kong is a major constraint on Hong Kong catching up in this area. Over the long term, talent needs to be nurtured locally.

According to the latest statistics (up to 2018/19) released by the University Grants Committee, the number of undergraduates studying Science, Technology, Engineering and Mathematics (STEM) subjects in the past three years has consistently accounted for around 30% of the total; around 55% of research-based postgraduates have been STEM students over the same period[31]. These figures suggest that, rather than not having enough young people studying STEM subjects, the problem is that they do not go on to pursue careers in the science and technology field after graduation.

The Financial Secretary announced in the 2020/21 Budget that he will set aside HK$40 million to subsidise short-term internships for undergraduates and postgraduates taking STEM programmes in local universities. While this would help create short-term employment opportunities for local STEM graduates, something more sustained will be required to entice these young people to stay in the I&T sector for the long term.

To attract young talent to develop their career in the I&T sector, there need to be good employment opportunities and promising career prospects in the long term. This cannot be achieved without a vibrant I&T commercial ecosystem in Hong Kong. Our view is that the prerequisite for nurturing local talent in this sector is to attract more high-tech enterprises, venture capital funds and overseas talent to come to Hong Kong to build up that ecosystem.

To encourage I&T businesses in Hong Kong to hire local talent, we suggest providing super tax deductions for the cost of employing local STEM graduates. This would be in line with the super tax deduction for R&D expenditure, even if these graduates are not directly involved in R&D projects. The Government could also establish an employment matching programme and act as a middleman to help match eligible STEM graduates with potential employers in the I&T sector in both Hong Kong and the GBA. For this to be effective, support and buy-in from the business community will be crucial. This, in turn, requires soliciting inputs from industry players on the design and content of university curricula to make sure graduates are equipped with the qualities that employers in STEM industries are expecting.

[31] https://cdcf.ugc.edu.hk/cdcf/searchStatSiteReport.action

As short or medium-term measures, both tax and non-tax incentives (e.g. subsidised housing, cash bonuses and tax deductions for children's education, etc.) could be used to attract overseas I&T talent to work in Hong Kong and to stay here for a given period of time.

The Technology Talent Admission Scheme (TechTAS) was launched on 25 June 2018 with an annual admission quota of 1,000 persons in the first year. By the end of September 2019, 291 applications had been received and all were approved[32].

We suggest making the scheme more attractive by temporarily removing or relaxing the local talent employment requirement. Currently, for every three non-local technology staff approved under the scheme, the technology company or institute has to employ three new local staff (one new full-time employee and two new interns) for technology-related work. While we support creating job opportunities for locals, given the shortage of such talent at the moment and the small size of many local I&T start-ups, this requirement may be difficult to meet, thus defeating the purpose of the scheme. We note that a similar admission scheme in Singapore[33] does not impose such a requirement.

[32] https://www.itb.gov.hk/en/legislative_council_business/questions/2019/pr_20191030.html

[33] https://www.edb.gov.sg/en/news-and-events/news/pilot-programme-to-facilitate-access-to-talent-and-support-growth-of-singapore-technology-ecosystem.html

5. Making the Hong Kong tax system more competitive

Hong Kong has always been proud of its low and simple tax system. However, the competitive advantage of low tax rates is diminishing as many other tax jurisdictions are either reducing their headline corporate income tax rates (e.g. the UK) or introducing various concessionary tax rates or tax holidays for specific industrial sectors (e.g. China, Malaysia, Singapore and Vietnam). This is the case even though many of these jurisdictions impose indirect or turnover taxes in addition to direct income tax. The overall competitiveness of Hong Kong's tax system has been further eroded by increased tax uncertainties, including uncertainties in lodging an offshore claim on profits – a cornerstone of our tax system. Other issues include effectiveness of tax incentives, protracted tax disputes and the current orientation of the tax administration. There is too much focus on tax revenue protection and anti-avoidance and not enough on the importance of a commercially-minded approach.

(i) Effectiveness of tax incentives

We are pleased to see that in recent years the Government has enacted a number of items of tax legislation to align the Hong Kong tax system with fast changing international standards. It has also introduced tax incentives to promote the development of specific industrial sectors with high growth potential, such as Islamic financing, CTCs, aircraft leasing, investment funds and R&D. This is the right direction, but there are better ways for the Government to execute and implement these tax incentives, such as the one for CTCs. For some other tax incentives (e.g. the R&D super tax deduction which applies from 1 April 2018), their effectiveness has yet to be assessed as they are quite recent.

The table below shows the utilisation of some tax incentives:

Concessionary tax regimes	Utilisation
Islamic finance	• The incentive was introduced in July 2013. Five international *sukuk* had been issued up to 31 December 2018 (with three under the *HKSAR* Government Bond programme[34]). Their total value represents 1.27% of all international *sukuk* issuances[35].
CTCs	• Around ten CTCs have been set up since the launch of the regime in April 2016
Aircraft leasing	• Eight qualifying aircraft lessors and one qualifying aircraft leasing manager have received relevant tax benefits under the regime since its launch in July 2017, based on the IRD's announcement in January 2019[36].
R&D super tax deduction	• Up to the end of October 2019, there were 60 applications for the deduction for year of assessment 2018/19[37]. • As of November 2019, five applications for Designated Local Research Institute status were received: three have been approved, one was withdrawn and one was rejected[37].

[34] https://www.hkeconomy.gov.hk/en/pdf/er_19q2.pdf (paragraph 4.12) and https://www.hkeconomy.gov.hk/en/pdf/er_19q3.pdf (paragraph 4.12). One of the sukuk issued under the programme was redeemed in September 2019 so there are two outstanding sukuk under the programme as of the end of September 2019.
[35] https://www.iifm.net/wp-content/uploads/2019/08/IIFM-Sukuk-Report-8th-Edition_4.pdf
[36] https://www.ird.gov.hk/eng/ppr/archives/19011601.htm
[37] https://www.ird.gov.hk/eng/ppr/archives/19112001.htm

As can be seen from the above table, some of the tax incentives have already been in place for a few years (e.g. Islamic financing and CTCs), but they have had little effect. This is very often due to regimes imposing conditions that are difficult or impractical to fulfil from a commercial perspective, contain burdensome anti-avoidance provisions that make them non-user friendly, or are not perceived as bringing significant benefits to the business. The way in which these incentives are administered may also discourage MNCs from moving their operations to Hong Kong. We suggest that the tax administration take a more commercially-minded and business-friendly approach to the implementation of these incentives.

A few examples are the ‘separate entity requirement’ of the CTC regime; the ‘subject to tax test’ for interest expense deduction applicable to CTCs and the lack of immediate benefits from the super R&D tax deduction for I&T start-ups – as they are usually loss-making and so do not need to pay any taxes. The requirement that all or the majority of the R&D work has to be performed in Hong Kong also means very few can benefit from the incentive, given the R&D capability constraints of Hong Kong at the moment.

In this regard, we recommend that the Government take the following steps to enhance the effectiveness of tax incentives:

During the policy formulation and incentive design stage:

- conduct more thorough consultation with industry players/stakeholders and make sure their concerns/comments are properly addressed;
- avoid including features that are incompatible with prevailing business models/practices or requirements that are impractical to meet; and
- remove any overly cumbersome anti-avoidance provisions.

In the past, while the policy bureaus did conduct consultation with stakeholders when proposing a tax incentive, the concerns raised by stakeholders were in some cases not fully addressed in the final tax legislation. While it is understandable that the IRD is concerned about the possible abuse of tax incentives and loss of tax revenue, these concerns should not be the most important factors to consider when implementing a tax incentive. We recommend that the Government take a more open-minded approach to encouraging business to make use of tax incentives. Instead of including cumbersome anti-avoidance provisions upfront, the IRD can deter possible abuse by imposing heavy penalties and/or introduce supplementary anti-avoidance provisions when there is evidence of actual misuse of the incentives.

During the implementation/execution stage:

- actively promote the incentives within the business community;
- provide assistance to taxpayers who wish to apply for the incentives;
- conduct regular periodic review of the effectiveness of the incentives; and
- solicit feedback from industry players/stakeholders on opportunities for improving the incentives.

The BTPU – newly transferred to come directly under the FSO – could have a role to play in the above (see a more detailed discussion on page 18).

(ii) Tax certainty and clarity

The offshore regime (i.e. the exemption for profits which do not arise in, nor are derived from, Hong Kong) is a unique and attractive feature of Hong Kong's tax system. However, lodging an offshore claim has become an increasingly uncertain and resource-consuming process for taxpayers in recent years. Extensive time is spent on dealing with lengthy enquiries raised by the IRD. Uncertainties also arise as in some cases more lenient treatment is accepted, whereas in others a relatively strict approach is adopted. In practice, because of the high costs involved in litigation, taxpayers will very often choose to come to a compromise with the IRD.

To avoid uncertainties in tax exposure and protracted argument with the IRD, some multinationals have opted to base their trading or procurement hubs in locations that offer certain and preferential tax treatments and where the tax authority is more business-friendly. An example is Singapore, which offers a reduced tax rate of 5% or 10% on qualifying trading income for three or five years under its Global Trader Programme (GTP). Once approved by Enterprise Singapore as being qualified for the reduced rate under the GTP, companies have certainty on their potential tax exposure in Singapore.

We encourage the IRD to put more emphasis on the intent of the tax law and adopt a more commercially-oriented approach in reviewing offshore claims so as to minimise uncertainty for taxpayers.

(iii) Other business-friendly tax measures

To make the Hong Kong tax system more competitive, we suggest structural changes to the treatment of tax loss incurred by businesses. In the profits tax review conducted in the 1998-99 Budget, the then Financial Secretary said "Introduction of group relief in our tax regime would complicate tax administration and create scope for abuse… the absence of group relief has not affected our competitiveness[38]".

It has been nearly 20 years since this report and it is therefore time for the government to reconsider this rather conservative approach. Businesses and professionals have advocated for group loss relief for decades. Introducing a group loss relief can make Hong Kong's tax system more competitive, and abuse risk can be overcome. We concur with the recommendation of the Financial Services Development Council (FSDC) in its Paper No. 33, which suggests the introduction of group loss relief in Hong Kong[39]. We also suggest allowing individual entities to carry losses backward for three years.

Finally, to strengthen Hong Kong's position as an international business centre, we urge the Government to continue its effort in expanding Hong Kong's tax treaty network. The Government has targeted to increase the number of tax treaties signed by Hong Kong to 50 in the next few years. But this number is still far below that of Singapore, which has signed more than 90 tax treaties. In addition, it is important for Hong Kong to have a tax treaty with its major trading partners, such as Australia, Germany and the US.

[38] https://www.budget.gov.hk/1998/english/green/report.htm

[39] https://www.fsdc.org.hk/sites/default/files/A%20Proposal%20for%20the%20Introduction%20of%20Group%20Tax%20Loss%20Relief%20in%20HK-English_0.pdf

(iv) Responding to the changing international tax landscape

In the past few years, the Government has put in a lot of effort to ensure the tax system complies with the latest international tax standards advocated by the OECD (mainly under the BEPS project[40]) and the European Union. We fully understand and support the government's work in this area to the extent that it is necessary to uphold Hong Kong's reputation as a co-operative tax jurisdiction and avoid Hong Kong being put on any blacklists.

The latest development in this area has been called BEPS 2.0 by some. The two key aspects of BEPS 2.0 are: (1) reallocating taxing rights in favour of the user/market jurisdictions and (2) introducing a global minimum effective tax rate for MNCs with cross-border transactions. New tax rules have been proposed in respect of these two key aspects, with an aim of developing a consensus solution by the end of 2020. We are particularly concerned about the proposed global minimum tax, which could make the offshore regime and existing tax incentives in Hong Kong become much less attractive, as elaborated below.

Pillar One proposes new nexus and profit allocation rules for large 'consumer-facing' businesses. Under these proposed rules, a multinational group can create a taxable presence (i.e. being subject to tax on its business profits) in a jurisdiction if its revenue derived from the market in that jurisdiction exceeds a certain threshold, even in the absence of a physical presence in that jurisdiction. Once a taxable presence is created, the proposed profit allocation rules will allow the user/market jurisdiction to tax a greater portion of the MNC group's profits.

Pillar Two (also referred to as the 'GloBE' proposal) proposes rules that would provide the parent or source jurisdiction the right to 'tax back' untaxed/undertaxed income up to an agreed top-up rate where the income is not taxed at an effective minimum tax rate.

The proposed rules under Pillar Two would have significant impact on Hong Kong. If the global minimum tax is implemented, the reduction in Hong Kong tax costs pursuant to an offshore claim or other preferential tax treatments in Hong Kong would potentially be offset by the top-up minimum tax imposed by the other jurisdictions, making the

[40] The Base Erosion and Profit Shifting (BEPS) project is commissioned by the G20 and devised by the OECD with the main objective of closing the loopholes in domestic tax laws and tax treaties used by multinationals to shift their profits to no or low tax jurisdictions and erode the tax base in jurisdictions where economic activities and value creation take place.

offshore regime, the capital gain exemption and other tax incentives much less appealing to multinational groups. This would in turn reduce the attractiveness of Hong Kong as an international trading hub and financial centre.

We are pleased to see from the 2020/21 Budget that the Government will continue to closely monitor the OECD's work in this area. It will assess the impact on Hong Kong, seek advice from stakeholders and devise corresponding measures to ensure Hong Kong's tax regime remains competitive and is in line with the new international tax developments.

In terms of how Hong Kong should respond to BEPS 2.0, we note that:

- While it is still in a consultation stage, and many details of the proposed rules under Pillar One and Pillar Two have yet to be finalised, the Government should not wait for the final rules and should proactively formulate a strategy that would enable Hong Kong to respond promptly once the final rules have become clear.
- In formulating the strategy, the Government should solicit views and comments from the business and professional sectors on the potential impacts of the rules on businesses in Hong Kong, and what responses would be in the best interests of Hong Kong.
- When considering whether and what changes need to be made to the Hong Kong tax system, stakeholders should weigh up the consequences of not reaching a consensus solution against other changes, including elements that preserve to the greatest extent possible the current advantageous attributes of the Hong Kong tax system (including the simple and low tax system, the offshore regime and non-taxability of capital gains). In particular, the Hong Kong tax position of those businesses which would not be affected by the proposed rules under BEPS 2.0 (e.g. purely domestic businesses and SMEs that do not exceed the thresholds, if any, for triggering the BEPS 2.0 rules) could remain status quo. Moreover, even with the GloBE rules, if an internationally operating business prefers to continue to enjoy the offshore regime or other concessionary tax treatments in Hong Kong, it could be given the flexibility and choice to do so and structure its business accordingly as a matter of commercial decision.
- The OECD's public consultation document on Pillar Two issued on 8 November 2019 sought input on possible adjustments for some of the permanent differences between accounting profits and tax base in computing the income base for the effective tax rate test, as well as carve-outs or exclusions that may be considered as part of the GloBE proposal. If the Government wants to preserve the current competitiveness of the tax system in Hong Kong, it should actively engage in communication with the OECD as a member of the BEPS Inclusive Framework and spare no effort in seeking to carve out tax regimes and treatments in the Hong Kong tax system that are not regarded as harmful from the scope of the GloBE rules. This would include the offshore regime, capital gain exemption and the various existing concessionary tax regimes, to minimise the impact of the GloBE rules on businesses in Hong Kong.
- Depending on the final details of the GloBE rules, many of the existing concessionary tax regimes and beneficial treatments under the Hong Kong tax system, as well as the tax incentives proposed in this paper to promote the development of various industries/sectors, may become non-competitive under BEPS 2.0. The Government may consider the impact of using other non-tax measures (e.g. subsidies, technical assistance and friendly regulatory frameworks) to support the growth of these industries/sectors.

Finally, with a fast changing international tax environment and transformation in the ways businesses operate, we believe that a cohesive and comprehensive review of the Hong Kong tax system and the Inland Revenue Ordinance (IRO) is necessary to ensure they align with the modern business world and remain competitive among neighbouring jurisdictions.

(v) Comprehensive review of the tax system

The Hong Kong tax system and the IRO have not undergone a comprehensive review for decades. With a fundamental shift in the way modern business is conducted and a fast-changing international tax landscape, there is an urgent need for the Government to conduct a comprehensive review of the Hong Kong tax system and consider fundamental tax reform.

For example, with the rise of advanced technologies and behavioural changes among consumers, e-commerce has become an important part of today's economy. Today, it is common for companies to conduct their businesses online. However, the IRO was drafted based on the old economy and traditional business models, and has not been comprehensively updated since 1976. This has made Hong Kong tax law incompatible with modern business models and created lots of uncertainties as to the proper tax treatment of e-commerce businesses. The rise of other new business activities such as cryptocurrency mining and transactions in virtual assets also calls for an update of the tax law.

In contrast, many other jurisdictions around the world have undergone tax reform, broadened their tax base or updated their tax laws. Examples are: tax reform in the US; the introduction of digital services tax in France, India, Japan, Taiwan and the UK; the new diverted profits tax in Australia and the UK; and the anti-hybrid mismatch rules in Australia, France and the UK. All these suggest that other countries are conscious of the need to change their tax systems and laws to make them relevant and competitive amid the changing international business and tax environment. Hong Kong should do the same or it will run the risk of lagging behind other countries. The Government should also evaluate the impact of changes in other jurisdictions' tax laws on doing business in Hong Kong and proactively respond to those changes.

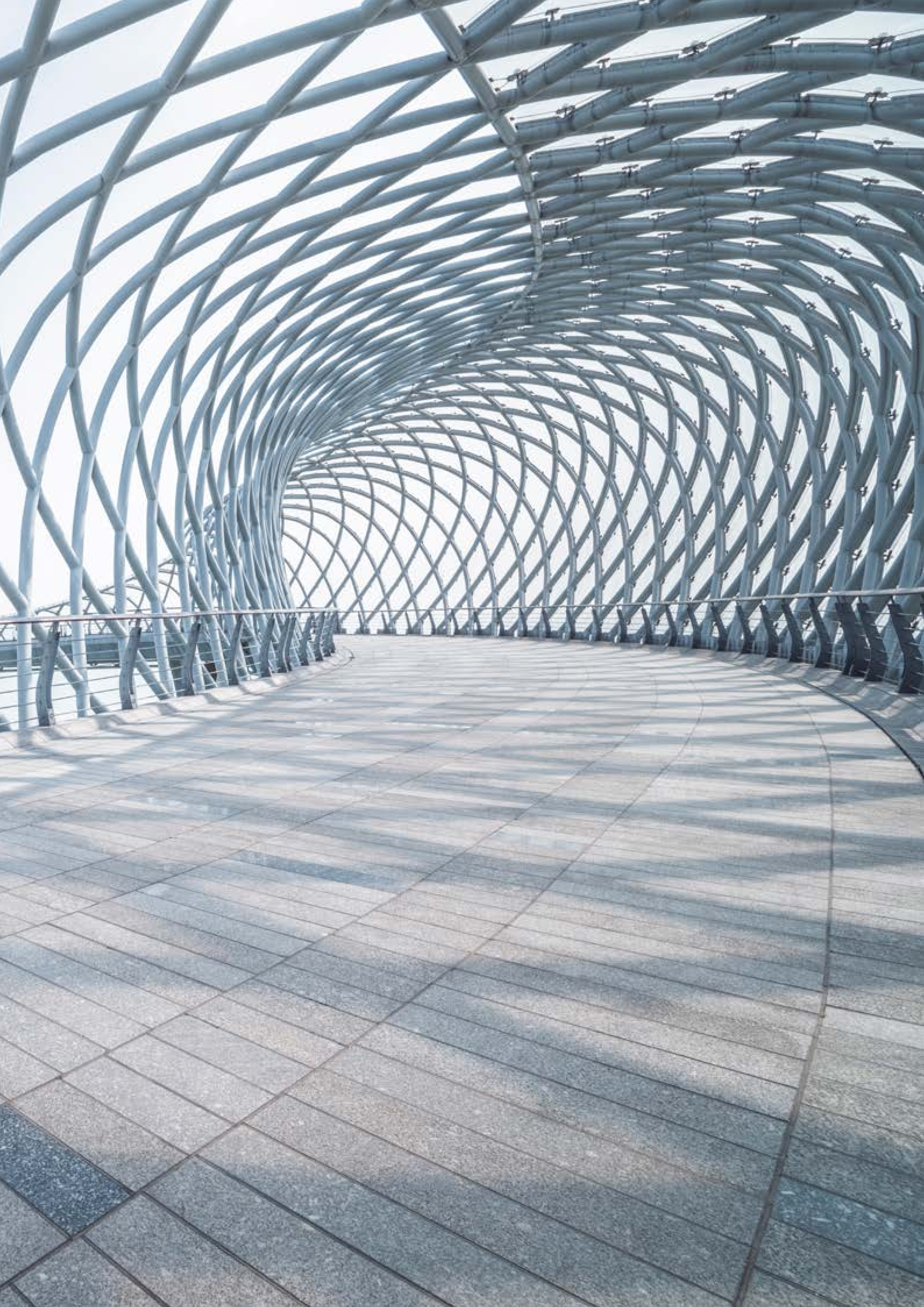
Finally, with the many changes in the international tax rules initiated by the OECD and EU (e.g. the BEPS 2.0 proposals and the economic substance requirements for no or nominal tax jurisdictions), it is imperative for Hong Kong to respond quickly rather than taking a 'wait and see' approach. The Government should assess the impact of all these changes on the competitiveness of the city's tax regime and come up with strategies to address the challenges ahead.

At the same time, there may be opportunities for Hong Kong as a result of these changes. If so, the Government should take swift action to grasp them. For example, the new economic substance requirements in the BVI and Cayman Islands may cause business groups to consider (1) winding up their existing BVI or Cayman entities and housing their investment holding, IP holding and fund management activities in a new entity set up in other jurisdictions or (2) relocating the core business activities and economic substance of the existing BVI or Cayman entities to another jurisdiction and make the entities a tax resident of that jurisdiction. The recent decision by the European Union to include the Cayman Islands on its list of non-cooperative jurisdictions for tax purposes (i.e. the EU blacklist) may also trigger some Cayman domiciled funds to reconsider whether they should re-domicile to other locations.

Hong Kong should capitalise on this opportunity to attract more businesses to come to the city. In doing so, the Government needs to revisit its current tax and non-tax policies and practices in a number of areas to enhance their attractiveness. Examples are taxation of income derived from IP, taxation of carried interest received by PE fund managers, updating the legal regime to allow offshore funds to re-domicile to Hong Kong, tax implications for offshore funds re-domiciling to Hong Kong and measures to facilitate BVI or Cayman entities to verify their Hong Kong tax residency for the purpose of the economic substance requirements.

All of the above suggest an overwhelming need for Hong Kong to conduct a comprehensive review of its tax system and tax law, so that they remain competitive and compatible with the modern business environment and international tax landscape and at the same time address the narrowness of Hong Kong's tax base. We urge the Government to engage in dialogue with key stakeholders to take further action. While the review will need to cover various areas and different issues, including those mentioned above, we recommend that priority be given to the following two areas:

- the approach to taxing digital businesses, products and services, especially financial services, including the application of approaches other than profits tax; and
- the potential impact on inbound and outbound business from the emerging changes in the international landscape raised by BEPS 2.0 (see page 28-29) and appropriate responses to maintain Hong Kong's competitiveness.



6. Fostering the development of industries through tax and non-tax measures

Financial services

The financial services sector has accounted for approximately 18-19% of Hong Kong's overall GDP in recent years. It is, and will remain, the most important sector in terms of contributing to the economy. To strengthen its development, we make the following recommendations:

Asset & wealth management (AWM)

In PwC's 2017 report, *Asset & Wealth Management Revolution: Embracing Exponential Change*[41], we estimated that total global assets under management would be around US$145.4 trillion by 2025. The highest growth rates are in Asia and Latin America. Regional growth in Asia-Pacific will be over 10% from 2020 to 2025 – probably reaching US$29.6 trillion by 2025. The Mainland is where the key growth opportunities lie for years to come. Wealthier Chinese are in need of a comprehensive range of bespoke services, such as asset protection and preservation, business succession, wealth preservation, multi-jurisdictional and cross-border investment structuring, and philanthropy. Hong Kong, as the gateway between the Mainland and the rest of the world, should be a key player in capturing these growth opportunities. The number of licensed corporations and registered institutions established by Mainland China-related groups in Hong Kong increased by 8% from 334 at the end of 2017 to 362 a year later[42].

(i) General

We believe that the competitive building blocks for Hong Kong to grow into a leading AWM centre are: regulation, innovation, marketing and incentives. These need to be strengthened or reformed for Hong Kong to become a regional or global AWM centre. Our recommendations are as follows:

Regulation – a fine balance between strength of regulation and ease of doing business is required. Regulations should be kept current and relevant to the changing needs of diverse investor groups. They should also be adjusted as the industry dynamics shift, such as with the growing connectivity between markets and the rise of innovative asset classes. Regulations should be reviewed to enable ease of doing business in a digital era (both FinTech and other aspects of digital), such as the on-boarding process. There should also be an appropriate level of oversight, recognising that there are different types of clients and not just risk-averse portfolio investors.

Innovation – one of the key trends in the AWM industry is the changing distribution landscape (e.g. online vs offline platforms) and product innovation (e.g. expanded product ranges and higher complexity of products). Given this trend, Hong Kong needs to ensure it can make the world's best AWM products available here for investment solutions and embrace some of the new emerging asset classes.

Marketing – there needs to be an effective marketing plan and product promotion strategy to promote Hong Kong to the rest of the world, perhaps involving global roadshows.

Incentives – Hong Kong can boost its competitiveness from a tax perspective by concluding more tax treaties and offering greater certainty on treaty benefits (e.g. certainty of obtaining a Hong Kong certificate of resident status from the IRD).

Hong Kong can become a combination of an asset management hub such as London, a fund centre such as Luxembourg and Ireland, and a wealth management centre such as Switzerland. For the city to become an all-encompassing AWM centre, capabilities and an ecosystem have to be built to deliver formulation of investment decisions, asset allocation, research and analysis, product development and risk management, as well as legal, accounting, fund administration and other professional services (which are high value-added activities in this value chain).

[41] https://www.pwc.com/gx/en/asset-management/asset-management-insights/assets/awm-revolution-full-report-final.pdf
[42] https://www.sfc.hk/web/EN/files/ER/PDF/Asset%20and%20Wealth%20Management%20Activities%20Survey%202018_EN.pdf

(ii) Developing a Sovereign Wealth Fund or centralised pension fund

A Sovereign Wealth Fund (SWF) or centralised pension fund can help shape the future of the AWM industry. Such a fund should look beyond profits and be purpose-driven, using its influence to drive sustainable market-wide reforms. Below are some successful examples in the region:

- Japan's Government Pension Investment Fund – driving Environmental, Social and Governance (ESG) initiatives; and
- The Government of Singapore Investment Corporation (GIC) – driving the alternative investment industry.

One of the major tasks of the Hong Kong Exchange Fund is to ensure stability of the monetary system. The Future Fund set up by the Government in 2016 could serve the above purpose. As outlined by the Financial Secretary in the 2020/21 Budget, the Future Fund can play a role in reinforcing Hong Kong's status as a financial, commercial and innovation centre. Going forward, the Future Fund could play a bigger role in enhancing the development of the AWM industry in Hong Kong.

(iii) The fund and asset management industries

Hong Kong is an attractive location for businesses raising capital and for investors seeking investment opportunities. The AWM sector in Hong Kong manages assets close to US$3.1 trillion, 62% of which are sourced from non-Hong Kong investors. The number of Hong Kong-domiciled funds represents 36% of total funds available in the retail market as of June 2019 (17% in June 2013). There has been an 11% year-on-year increase in Type 9 (asset management) licensed corporations[43].

To enhance this attractiveness to investors, the Government has taken on recommendations from the FSDC in recent years to introduce various incentives for public and private equity funds, including open-ended fund companies, onshore fund exemption and a proposed limited partnership regime for funds. There is still potential for the development of debt-focused funds. Currently, receipt of interest income on securities acquired by a fund is regarded by the IRD as an 'incidental transaction'. We recommend treating such receipt of interest income as a 'specified transaction' so that the interest income can be exempt from tax. This would be conducive to developing the bond market in Hong Kong.

For decades, Hong Kong has competed with Singapore in this sector. The taxation of carried interest in Hong Kong has been a significant issue. Carried interest is a contractual right that entitles the general partner or fund manager of an investment fund to share in the fund's profits. One view is that, if a proper interpretation of the existing Hong Kong tax law is applied, the distributions under a typical carried interest structure should not be taxable, although in some situations the obtaining of a right to share in the carried interest might itself be a taxable emolument. An alternative view is, notwithstanding the strict technical position, to re-characterise the carried interest distributions as a performance fee rewarding the general partner or fund manager for enhancing the fund's performance.

Currently, there is a great deal of uncertainty as to whether the IRD will regard carried interest distributions as taxable performance fees or non-taxable capital returns. As the tax amounts at stake can be very substantial, these uncertainties may drive away business groups which would otherwise set up their asset management arms in Hong Kong. Currently, the Inland Revenue Authority of Singapore does not seek to tax carried interest in practice.

We welcome the Government's plan to provide tax concession to carried interest issued by private equity funds operating in Hong Kong effective from year of assessment 2020/21 as revealed in this year's Budget. To enhance the attractiveness of Hong Kong as an asset management centre, we believe the Government should adopt a policy of not taxing carried interest so as to promote Hong Kong as a global asset management hub.

[43] https://www.sfc.hk/web/EN/files/ER/PDF/Asset%20and%20Wealth%20Management%20Activities%20Survey%202018_EN.pdf and https://www.sfc.hk/web/EN/published-resources/corporate-publications/annual-reports/

(iv) Wealth management centres

The quality and diversity of Hong Kong's capital markets, together with the array of investment structures that the city can offer, will attract family offices, asset and wealth managers and private banking groups to set up operations in Hong Kong. The sound and robust legal and professional services that Hong Kong can offer are also appealing.

To further develop the wealth management industry, Hong Kong needs to attract more high net worth families and investors from around the world to locate their investment management activities in Hong Kong. One of the considerations for where to locate these activities is the tax costs on returns generated from investments. We therefore suggest reviewing the existing tax regime and introducing new policies / incentives to attract high net worth families and investors to manage their personal assets and investments in Hong Kong.

One of the areas for consideration is to allow Hong Kong resident individual investors to enjoy tax exemption on the returns generated from their investments in investment funds or vehicles, subject to certain conditions for preventing abuse. Where Hong Kong resident individual investors undertake personal investments in their individual names, the investment returns are not generally taxed in Hong Kong. However, where Hong Kong resident individual investors invest through private investment funds or offshore investment vehicles which are managed in Hong Kong and have relied on the current tax exemption regimes, although the investment funds or offshore investment vehicles could enjoy a tax exemption (provided qualifying conditions are fulfilled), there is a deeming provision which imposes tax on their share of the exempted profits of the investment entities if they hold 30% or more in the investment entities or if they are associated with the investment entities. The tax is payable regardless of whether the investment entities actually distribute the returns to the investors. This feature in fact discourages Hong Kong high net worth individuals and families, or new comers from overseas (including Mainland China), to use Hong Kong as the base to manage their personal assets and investments.

In Singapore where similar tax incentive schemes for funds exist, the schemes do not jeopardise Singapore resident investors in the funds.

Insurance

Hong Kong has many attractive aspects for multinational groups looking to locate or relocate their regional or global headquarters to Asia. Its close proximity to retail and corporate customers creates ample opportunities in the region, especially in the GBA. These opportunities, coupled with robust financial and legal infrastructure, have strengthened the growth of Hong Kong's insurance industry.

According to the 2018/19 annual report of the Hong Kong Insurance Authority[44], there were 161 authorised insurers in the city. Gross premiums for in-force long term business in 2018 stood at HK$461.4 billion with over 90% coming from long-term individual life insurance.

In December 2018, the FSDC issued a report – *Enhancing Hong Kong's Role as a Leading Life Insurance Centre*[45] – which reflected the key role of long-term individual life insurance for the sector. The report made various tax and non-tax recommendations. Non-tax recommendations include those in the areas of (1) capital requirements, (2) supply for long-term assets, (3) access to the Mainland market (including the GBA and BRI), (4) creating shared value, (5) Insurtech and (6) human capital. Tax recommendations include: (1) expansion of Hong Kong's tax treaty network, particularly with its economic partners, (2) provision of tax incentives to Hong Kong consumers of insurance products, (3) provision of tax incentives for setting up RHQs in Hong Kong and (4) a concessionary tax rate for reinsurance.

Tax deductions for qualifying premiums paid under the Voluntary Health Insurance Scheme (VHIS), qualifying annuity premiums and qualifying voluntary MPF contributions for individuals have been introduced effective from year of assessment 2019/20 – all of which support the development of the local insurance sector.

[44] https://www.ia.org.hk/en/infocenter/files/IA_Annual_Report_2018_19_English.pdf

[45] https://www.fsdc.org.hk/sites/default/files/FSDC%20Life%20Insurance%20Paper%20%2817%20Dec%29.pdf

The Government has issued a bill seeking to provide profits tax concessions for (1) all general reinsurance business by direct insurers, (2) certain classes of general insurance business by direct insurers that are not driven by local demand and (3) certain insurance brokerage business by licensed insurance brokers related to the businesses of (1) and (2), effective from 1 April 2020[46]. The concession is to reduce profits tax by 50% (i.e. a 8.25% concessionary tax rate). This is in addition to existing tax incentives for captive insurance and reinsurance by professional reinsurers in Hong Kong. We look forward to the timely introduction of the new profits tax concessions for the insurance industry to make Hong Kong competitive with the regime in Singapore. Currently, Singapore offers a 10% concessionary rate for qualifying life and general insurance businesses, and provision of insurance broking and advisory services. Lower rates may apply for qualifying specialised insurance.

Marine and aviation insurance will be included in thisconcessionary regime. This would support HongKong's existing aircraft leasing and management operations and the proposed development of maritime leasing and management operations.

The FSDC also issued a paper in March 2017[47] on developing Hong Kong as an insurance hub for reinsurance, marine insurance and captive insurance. While some of the recommendations in the paper (e.g. extending the current reinsurance tax incentive to direct insurers in respect of their reinsurance businesses and offering tax incentives to insurance brokers) have already been accepted by the Government, we urge the Government to seriously consider the other recommendations made by the FSDC in the paper.

Please also refer to our recommendation on further promoting the insurance industry within the GBA on page 12 in the section entitled *'Attracting funds and businesses to Hong Kong and capitalising on GBA opportunities'*.

Blockchain and virtual assets

President Xi Jinping's endorsement of blockchain as a "core technology" last October[48] provided a boost to businesses operating in this sphere. It also renewed interest in the PBOC's plans for the potential launch of a 'DC/EP' (digital currency/electronic payments) system. According to the Bank for International Settlements[49] 70% of central banks are exploring the concept of a 'Central Bank Digital Currency'. So, while many blockchain-based crypto assets have been dismissed as niche or unfeasibly volatile, it appears that the technology and its applications are gaining momentum.

Although the trading of crypto and virtual assets is inherently risky due to the very nature of these assets (e.g. highly leveraged and with extreme price volatility), we believe there is growth potential in this area. But if Hong Kong is to grasp the opportunities arising from such emerging industries (and thereby develop its competitive advantage), the Government needs to be more open-minded. It should be bold enough to introduce policies and measures that attract the sorts of businesses that will come to Hong Kong and set up vibrant industrial ecosystems here.

[46] https://www.legco.gov.hk/yr19-20/english/bc/b201912062/general/b201912062.htm

[47] https://fsdc.org.hk/sites/default/files/FSDC%20Paper%2027%20-%20Reinsurance%2C%20Marine%20and%20Captive%28e%29_1.pdf

[48] http://www.xinhuanet.com/english/2019-10/25/c_138503254.htm

[49] https://www.bis.org/publ/bppdf/bispap101.pdf

A number of countries have either banned or restricted cryptocurrency trading and crypto exchanges, or not yet implemented a regulatory framework for them. Given this, we believe that Hong Kong can develop into a leading global or regional crypto trading centre if it can implement a safe, regulated and attractive crypto trading platform.

The Securities and Futures Commission (SFC) issued a regulatory framework and guidance for virtual asset trading platforms in early November 2019. The regulatory framework provides for a crypto exchange operating in Hong Kong to be licensed, subject to certain conditions. While the regulatory framework is a welcomed move, we have the following recommendations for the SFC to consider:

- the current licensing regime is limited to centralised exchanges that target professional investors. We recommend that the next step is for these SFC licensed firms to be able to accept appropriate retail clients with certain conditions (e.g. clients who have a good understanding of the risks involved) as it is the case in other verticals of the financial services industry;
- firms that only trade cryptocurrencies are not covered by the current framework unless they want to list security tokens. Starting a legislative process to give formal jurisdiction to the SFC for digital assets could be worthwhile as well;
- the SFC has taken a negative stance on crypto derivative platforms. Some of the biggest crypto derivative exchanges have a Hong Kong presence. Instead of simply banning them outright, one option would be to develop an appropriate regulatory framework to supervise them. Hong Kong could therefore have first mover advantage in this developing crypto derivatives market; and
- using blockchain for government services such as company registration and birth certificates would not only make the entire process cheaper and safer but would send a message to the world that Hong Kong is truly an innovative place. As a logistics hub, Hong Kong would be well placed to leverage blockchain as a means of digitising trade documentation and trade finance (letters of credit, bills of lading, etc.), thus making one of Hong Kong's pillar industries significantly more efficient.

In addition to the regulatory environment, the accounting and tax treatments of virtual assets require attention. In particular, specific guidance on the application of accounting standards to transactions involving virtual assets is not yet available. One key issue is how different types of virtual assets should be accounted for in the books of different stakeholders in the ecosystem (e.g. token issuers, crypto exchanges, brokers and investors). In Hong Kong, the profits tax treatment generally follows the accounting treatment, unless it is inconsistent with specific provisions in the tax law. So these issues are often interlinked.

While some jurisdictions have already come up with specific tax rules for transactions involving cryptocurrencies, Hong Kong has yet to do so. For instance, the taxability of changes in fair value, the determination of the source of profits in a decentralised business model, the tax treatment of crypto borrowing and lending transactions, and the availability of exemptions for crypto funds all require special consideration. We recommend that the Government put in place the following to create a tax environment that is conducive to the development of the sector:

- clear tax law and guidance specific to digital assets and crypto transactions; and
- a platform that allows industry players, taxpayers and professionals to exchange views with the IRD on the tax treatment relating to this evolving area.

Environmental, Social and Governance (ESG) / Green finance

Huge growth opportunities are evident in the ESG space. Yet there are also challenges, such as the availability of ESG information from listed issuers that investors can analyse and the risk of greenwashing.

While some listed issuers find existing ESG disclosure requirements challenging, investors are demanding more data. Without high quality, reliable data it is hard for investors to make informed decisions or grow their ESG practices. In view of this, the Hong Kong Stock Exchange has proposed additional ESG disclosures for listed issuers which may be effective from January 2020 (subject to the conclusion of consultation).

To balance demand from investors and resistance from listed issuers, especially from smaller listed companies, the Government should make reference to practice in other markets. For instance, it could apply the concept of proportionality (e.g. size of the listed companies) when applying regulations.

Regulators such as the SFC have been actively engaging the market to explore ways to address greenwashing risks, so as to support the healthy growth of green finance/ESG. While recognising that there is a regulatory need to manage greenwashing, the SFC is also mindful that any new regulations should not be over-burdensome and deter growth. Hence, the SFC is committing a great deal of effort to soliciting views from market practitioners.

Various parties in Hong Kong, including regulators, policy makers and think tanks, have been carrying out research on how to promote ESG. The Government can play an instrumental role in driving green finance and sustainability in Hong Kong and beyond – such as in the GBA. Capability building is an issue that needs to be resolved, as there are talent gaps in Hong Kong. There will be of room for professional bodies and service providers to contribute to and expand the ESG talent pool, thus enabling the Government to promote awareness and drive performance in ESG.

Other financial services

The Government introduced concessionary tax rates for CTCs and aircraft leasing in 2016 and 2017 respectively. The underlying principle behind these concessionary rates is to promote Hong Kong as a hub for regional operations. Since the economic beneficiaries of these regional hub activities are outside Hong Kong, it is justifiable to tax this income at half the normal profits tax rate. Such concessionary tax rates could be applied to other activities, including project finance and equipment leasing.

Hong Kong is one of the leading global financial centres for raising capital, due to its common law jurisdiction and free movement of capital. The city can be used to raise funds for infrastructure projects in countries along the Belt & Road, as well as for the heavy equipment they may require. As these projects are outside Hong Kong, while the income from financing such projects may be regarded by the IRD as sourced and taxable in Hong Kong, it is justifiable to tax it at a concessionary rate. We recommend a concessionary tax regime for project finance and finance leasing of equipment when certain conditions are met. Concessionary tax treatments that can be considered include tax exemption on interest income derived from these financing projects. For operating leasing of equipment, we recommend treating the equipment rentals as non-Hong Kong sourced and not taxable where the equipment leased is used outside Hong Kong.

Transport and logistics

As outlined in PwC's 2016 study – *Shifting patterns: The future of the logistics industry*[50] – the transport and logistics industry is facing immense change. Customer expectations are the key disruptor: they expect to get their goods faster, more flexibly and at little or no delivery cost. Goods are also becoming more and more customised. Hong Kong, with its strategic geographical location, has long been the logistics distribution hub for the region.

The key players in this sector are transport operators and owners. Aircraft and ship operators are currently subject to Hong Kong profits tax under special regimes which offer favourable treatments for worldwide revenue generated as Hong Kong aircraft and ship owners. In principle, offshore income is not taxable in Hong Kong. Under these special regimes, the wet lease income of owners is treated as income from ship or aircraft operations and subject to tax under the regimes. Hence, this income is only subject to tax if the lessee operates the ship or aircraft in Hong Kong. Although it is arguable, the IRD currently treats dry lease income as subject to tax under the general charging section, and it is thus excluded from special tax regimes. The consequence is that, even if the lessee operates the aircraft or ship outside Hong Kong, the lease income will be subject to tax in Hong Kong if the lease is managed from the city.

The recent introduction of a concessionary tax regime for aircraft leasing and management services solves the issue of the taxation of dry lease where the aircraft is operated outside Hong Kong. The concessionary aircraft leasing regime supports not only Hong Kong aircraft owners but also leasing services provided to owners in other jurisdictions in the region.

The issue of taxation of dry lease incomes from maritime leasing remains. We understand a similar concessionary tax regime for maritime leasing and management services will be introduced. We recommend the government expedite its introduction and provide practical concessions before introduction of the legislation.

Logistics service providers and couriers also play an important role in the sector. Some are large enough to become transport operators. There is an increasing demand for faster and cheaper logistics services for goods. The growing digital economy often requires goods to be delivered globally. Given its location, Hong Kong may well serve as a logistics/storage/distribution centre for physical goods which are transacted digitally.

The distribution services income of Hong Kong service providers and couriers is fully subject to tax in Hong Kong, irrespective of origin or destination of the goods being delivered. To support Hong Kong as a distribution hub, we suggest taxing this service income at a concessionary profits tax rate.

[50] https://www.pwc.com/sg/en/publications/assets/future-of-the-logistics-industry.pdf

Innovation and technology

Hong Kong lags far behind other jurisdictions in terms of R&D expenditure as a percentage of GDP. Much needs to be done to improve our 0.86%[51] rate in 2018 and to match neighbouring cities. Their rates range from around 2.13% for Mainland China (2017) and 2.22% for Singapore (2016) to over 3.20% for Japan (2017) and 4.55% for South Korea (2017)[52].

In particular, Shenzhen has made significant progress in developing itself into a regional innovation and R&D hub in the past few years. In 2018, the total amount of R&D expenditure invested by the city amounted to over RMB 100 billion (representing around 4.2% of the city's GDP) and there were more than 17,000 new or high-tech enterprises based there[53]. The tax and non-tax incentives provided by government to promote the development of the I&T sector have contributed to the fast growth of the sector in Shenzhen. They include: tax holidays or reduced income tax rates for profits derived by qualified new or high-tech enterprises and from transfer of qualified technologies; super R&D tax deduction; different forms of financial subsidies (e.g. up to RMB 20 million for qualified unicorn company headquarters set up in Qianhai and up to RMB 10 million for key core technology research projects in Shenzhen); rental and living subsidies for talent working for qualified headquarters in Qianhai; and Individual Income Tax rebates for qualified talent working in the GBA.

The recently introduced super tax deduction for R&D expenditure in Hong Kong is a step in the right direction. However, given that Hong Kong does not currently possess sufficient resources and capability (e.g. land space and talent) for conducting large scale R&D activities locally, it is not realistic to require enterprises to conduct all or the majority of their R&D activities in Hong Kong in order to enjoy the super tax deduction, although the policy intent is to encourage more enterprises to conduct their R&D activities in Hong Kong. We recommend that the super tax deduction for R&D be enhanced by temporarily expanding the scope of super deduction for outsourced R&D activities, such as allowing deduction for R&D activities conducted in the GBA. A review of whether the expanded scope is still necessary can be done after a given period of time. This would improve investment by Hong Kong businesses in R&D, while resolving the shortage of I&T talent locally in the short or medium-term, as previously discussed on page 22.

To encourage innovation, it is important that the outcomes of R&D should be readily converted into business opportunities. The most probable outcome is IP. This can generate economic benefit when employed in viable business operations. Encouraging local businesses to own and hold IP is a key part of fostering I&T development. With appropriate tax incentives, Hong Kong can develop into a hub for the holding and trading of IP. In addition to the IP trading platform provided by the Intellectual Property Department, we suggest that any gains from the transfer of IP developed by a group should be clearly defined as capital in nature by legislation, and therefore not taxable. Additionally, we suggest that, to avoid uncertainty arising from case law, the legislation be amended to make it clear that royalties from licensing IP for use by a person in a business carried on outside Hong Kong do not arise in nor are derived from Hong Kong (i.e. are offshore sourced), thereby ensuring they are tax exempt.

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[51] Census and Statistics Department, the Hong Kong SAR Government: https://www.censtatd.gov.hk/hkstat/sub/so120.jsp

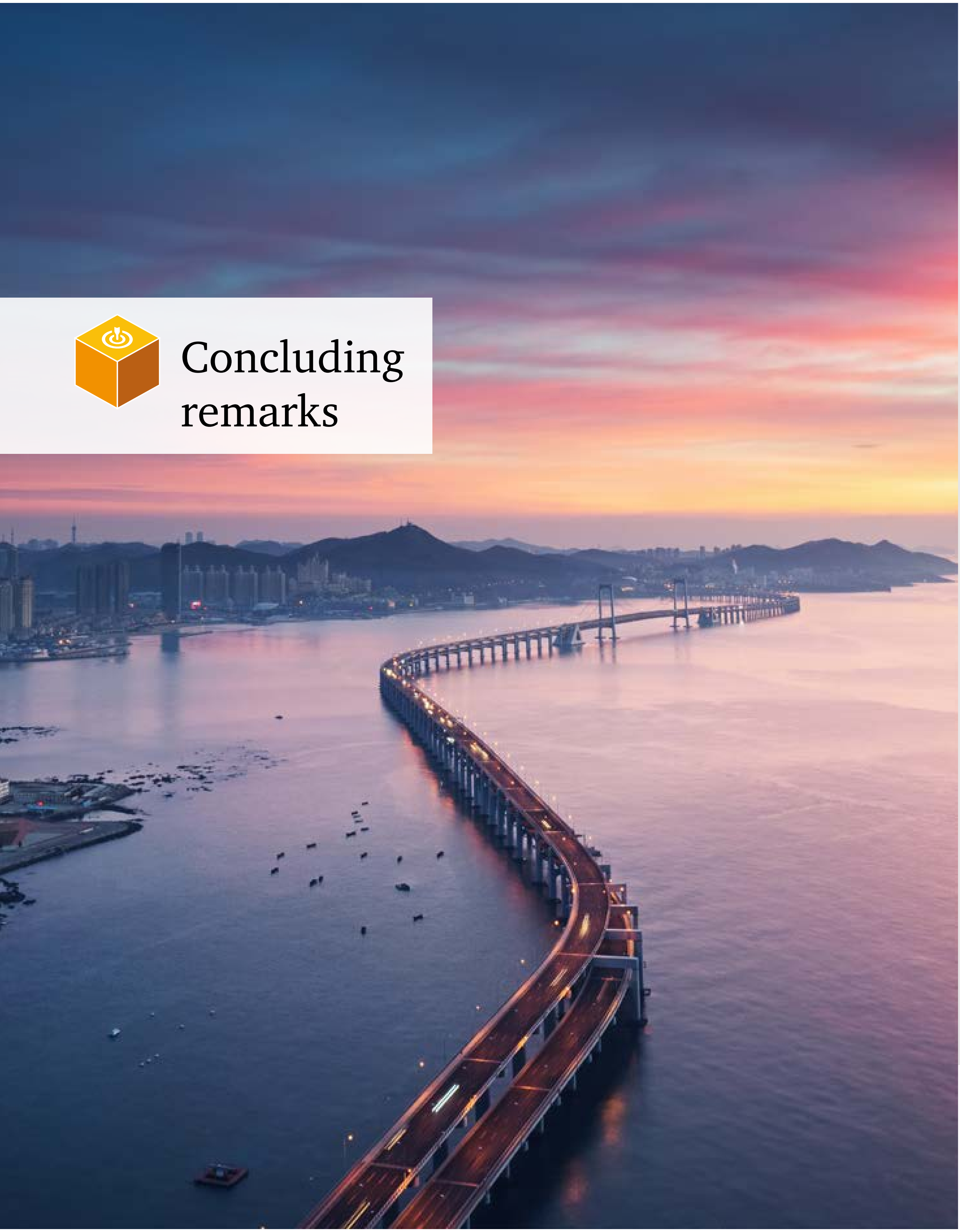
[52] The World Bank: https://data.worldbank.org/indicator/GB.XPD.RSDV.GD.ZS

[53] http://english.sz.gov.cn/business/environment/201908/t20190823_18174696.htm

If, however, the Government does not agree that the above-mentioned royalty income is non-Hong Kong sourced and not taxable, it should properly address the issue of relief for withholding taxes suffered on royalties paid from abroad. While tax treaties can mitigate the double tax which might otherwise arise on royalties from jurisdictions with which Hong Kong has a tax treaty by reducing withholding tax rates and providing a credit against Hong Kong tax payable, the position is unfavourable for royalties derived from jurisdictions with which Hong Kong does not have such a treaty.

In particular, if royalties are derived from jurisdictions with which Hong Kong has no tax treaty (for example Australia, Germany or the United States), withholding tax is levied at the non-treaty rate. There is also no tax credit or deduction for this withholding tax under the current Hong Kong tax law. For this reason, we recommend the introduction of domestic unilateral tax credit for foreign tax if the income is subject to tax both in Hong Kong and a foreign jurisdiction. The allowable credit should be up to the amount of Hong Kong tax payable for any profits also assessed to Hong Kong tax.

Concluding remarks



> There have been many good government initiatives in recent years, but effective and efficient execution is key.

This is a wide-ranging paper that touches on a variety of issues affecting Hong Kong. We may revisit some of these topics over the course of this year so that we can consider some more concrete steps for implementation of our key recommendations. It is also possible that other issues will emerge as important challenges for our city.

However, the central theme of this paper is that the Government needs to move beyond its established role as a facilitator and promoter of economic growth and evolve into an active driver of business opportunities. To do this, it must make full use of new technologies and create an environment that will attract and retain funds, businesses and talent. It must also fully leverage the opportunities presented by the GBA and the BRI, as well as Hong Kong's own, well-established strengths.

Above all, Government departments must adopt a more commercially-oriented mind-set in policy execution. To ensure good policies are executed effectively and efficiently, different Government departments need to co-ordinate with each other and ensure they are pulling in the same direction. They need to put the customer – be it an individual or a corporate entity – at the heart of what they do. And their performance needs to be measured in part against quantifiable commercial outcomes.

From a tax perspective, we urge the Government to conduct a comprehensive review of the Hong Kong tax system to make it relevant and competitive in the fast-changing international landscape. Equally important is a regular review and enhancement of existing tax incentives to make sure they are effective.

With the challenges ahead, in particular the economic downturn and the budgeted deficits for the coming years, bold and swift action by the Government to revitalise the economy and drive revenue growth are critical.

It is an inescapable fact that this paper is being issued at a time of significant uncertainty for Hong Kong. At such times, the arguments for taking a conservative approach – for maintaining the status quo – are often at their loudest. We would argue instead that there is no better time to make the radical changes that will ensure Hong Kong is best placed to bounce back.

Appendix 1: Hong Kong's rankings of global competitiveness

A. The World Bank's Ease of Doing Business rankings

Ranking	2016 Report	2017 Report	2018 Report	2019 Report	2020 Report
1	Singapore	New Zealand	New Zealand	New Zealand	New Zealand
2	New Zealand	Singapore	Singapore	Singapore	Singapore
3	Denmark	Denmark	Denmark	Denmark	**Hong Kong**
4	Korea	**Hong Kong**	Korea	**Hong Kong**	Denmark
5	**Hong Kong**	Korea	**Hong Kong**	Korea	Korea
6	United Kingdom	Norway	United States	Georgia	United States
7	United States	United Kingdom	United Kingdom	Norway	Georgia
8	Sweden	United States	Norway	United States	United Kingdom
9	Norway	Sweden	Georgia	United Kingdom	Norway
10	Finland	Macedonia, FYR	Sweden	Macedonia, FYR	Sweden

Source: Reports on Doing Business prepared by The World Bank
(https://www.doingbusiness.org/en/reports/global-reports/doing-business-2020)

B. The World Economic Forum's Global Competitiveness Index

Ranking	2015 Report	2016 Report	2017 Report	2018 Report	2019 Report
1	Switzerland	Switzerland	Switzerland	United States	Singapore
2	Singapore	Singapore	United States	Singapore	United States
3	United States	United States	Singapore	Germany	**Hong Kong**
4	Germany	Netherlands	Netherlands	Switzerland	Netherlands
5	Netherlands	Germany	Germany	Japan	Switzerland
6	Japan	Sweden	**Hong Kong**	Netherlands	Japan
7	**Hong Kong**	United Kingdom	Sweden	**Hong Kong**	Germany
8	Finland	Japan	United Kingdom	United Kingdom	Sweden
9	Sweden	**Hong Kong**	Japan	Sweden	United Kingdom
10	United Kingdom	Finland	Finland	Denmark	Denmark

Source: The Global Competitiveness Reports prepared by the World Economic Forum
(https://www.weforum.org/reports)

Appendix 2: Different sectors' contributions to Hong Kong GDP

Year	GDP (HK$'000,000)			
	Financial services	Tourism	Trading and logistics	Professional services and other producer services
2008	277,100	44,700	414,700	197,600
2013	346,200	105,900	500,500	260,200
2016	429,100	112,400	523,100	302,900
2017	480,500	114,200	548,400	311,800
2018	532,800	121,000	571,000	322,800

Year	Contribution to HK's GDP (%)				
	Financial services	Tourism	Trading and logistics	Professional services and other producer services	Total Contribution to HK's GDP (%)
2008	17.1%	2.8%	25.6%	12.2%	57.7%
2013	16.5%	5.0%	23.9%	12.4%	57.8%
2016	17.8%	4.7%	21.6%	12.5%	56.6%
2017	18.8%	4.5%	21.5%	12.2%	57.0%
2018	19.7%	4.5%	21.2%	12.0%	57.4%

Source: Census and Statistics Department, Hong Kong SAR Government

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Contacts

Peter Ng
Managing Partner, Tax
PwC China
+86 (21) 2323 1828
peter.ng@cn.pwc.com

Charles Lee
South China (incl. Hong Kong SAR) Tax Leader
PwC China
+852 2289 8899
charles.lee@cn.pwc.com

Kenneth Wong
Partner
PwC Hong Kong
+852 2289 3822
kenneth.wong@hk.pwc.com