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Welcome to Tax Flash – RSM Tax Advisory (Hong Kong) Limited's Newsletter Covering Technical Development in Taxation

HONG KONG'S NEW DIRECTIONS ON TAXATION FOR FORSTERING ECONOMIC DEVELOPMENT

On 10 November 2017, our Legislative Council passed a motion of thanks for the Chief Executive ("CE")'s 2017 Policy Address. The CE hopes that this Policy Address will set new starting points for Hong Kong in areas such as governance, economic development, housing, education, healthcare; and chart the gradual delivery of the pledge she made in her inaugural speech about connecting with us to build an even better Hong Kong.

The CE said: "Hong Kong is facing challenges on many fronts. On economic development, we need to consolidate and enhance our traditional advantages while developing new areas of economic growth as a matter of urgency. I propose that the Government should be more proactive and play the role of a "facilitator" and a "promoter" ... The economy chapter in this Policy Address elucidates our views on the prospects of various trades and industries. It reflects, in particular, the importance that we attach to innovation and technology and the creative industries, and sets out an array of measures to spur their further development."

"In the face of new dynamics arising from economic restructuring and global competition, we should strategically utilise our tax measures to enhance Hong Kong's competitiveness by promoting the development of our industries and economic diversification."

The CE also said the Government would maintain communication with stakeholders with the aim to formulate forward-looking tax policies and initiatives to promote the economic development of Hong Kong. In this connection, the Summit on New Directions for Taxation (the "Summit") was successfully held on 23 October 2017 with more than 400 government officials, academics, business leaders and tax professionals gathered together to share their views and suggestions.

In this Tax Flash, we will highlight some salient points in the new taxation proposal, some key discussions at the Summit, and our suggestions.

New Taxation Proposals

Two specific tax measures put forward in the CE Election Manifesto will be implemented as early as from 1 April 2018:

- ***Two-tier profits tax rates regime***

  The profits tax rate for the first HK$2 million of profits of enterprises will be lowered to 8.25%, or half of the standard profits tax rate, instead of 10% as proposed in the CE's Election Manifesto. Profits above that amount will continue to be subject to the standard tax rate of 16.5%. To ensure that the tax benefits will target small and medium-sized enterprises ("SMEs"), there will be restrictions such that each group of enterprises may only nominate one enterprise to benefit from the lower tax rate.

- ***Super-deduction for R&D expenditure***

  To encourage research and development (R&D) investment by enterprises, the Innovation and Technology Bureau ("ITB") will consult the industries on additional tax deduction for R&D expenditure. It is proposed that the first HK$2 million eligible R&D expenditure will enjoy a 300% tax deduction with the remainder at 200%.

With the above tax incentives and other measures, it is hoped that Hong Kong's R&D expenditure would increase from the current 0.73 percent to 1.5 percent of the Gross Domestic Product ("GDP") within the coming five years.

Our Financial Secretary elaborated on the tax measures launched by Hong Kong in recent years, such as the tax incentives for promoting development of the financial sector (e.g. profits tax incentives for intra-group corporate treasury centres) and aircraft leasing business. He shared some examples to highlight the underlying principles in considering different tax policies and measures. He remarked that the relevant measures should be able to generate economic and social benefits, be easy to operate and comply with, and allow Hong Kong to maintain the existing simple and low tax regime, and be able to meet international tax standards, and prevent tax avoidance. He said Hong Kong would not consider a board reduction in profits tax rate unless there are dramatic changes in the external environment.

Hong Kong's International Economic and Tax Networks Development

In view of establishing more bilateral and multilateral ties with the Mainland and overseas countries, Hong Kong will promote our advantages and attract more Mainland and international enterprises, investors and talents to Hong Kong.

On the enhancement of bilateral ties, Hong Kong will actively seek to sign free trade agreements ("FTAs"), investment promotion and protection agreements ("IPPAs") and comprehensive avoidance of double taxation agreements ("CDTAs") with other economies, including those along the Belt and Road to open up markets, and to further strengthen Hong Kong's position as an international trade, commercial and financial centre.

On 12 November 2017, the ASEAN – Hong Kong, China Free Trade Agreement ("AHKFTA") and ASEAN – Hong Kong, China Investment Agreement ("AHKIA") have been concluded. AHKFTA is the Association of Southeast Asian Nations ("ASEAN")'s sixth free trade agreement with external partners, after China, Korea, Japan, India, and Australia-New Zealand. It consists of fourteen chapters covering broad areas of market access liberalisation, trade facilitation, rules to promote confidence in trade, and co-operation aimed at facilitating trade in goods and services in the region. The AHKIA complements the AHKFTA by covering the protection, promotion and facilitation of investment. The agreements are expected to come into effect on January 1, 2019, at the earliest.

ASEAN is Hong Kong's the 2nd largest trading partner in merchandise trade and the 4th largest in services trade. All the 10 ASEAN member states (Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam) are also economies along the Belt & Road.

The growing economic relations between ASEAN and Hong Kong have been noted over the years. Based on ASEAN statistics, ASEAN – Hong Kong merchandise trade in 2016 was valued at US$93.3 billion, a 1.3 per cent increase from US$92.1 billion in 2015. Total foreign direct investment flows from Hong Kong to ASEAN amounted to US$9.9 billion, a 141 per cent increase from US$4.1 billion in 2015.

In addition, Hong Kong has already concluded CDTAs with 38 tax jurisdictions (including 12 out of Hong Kong's top 20 trading partners, and 16 jurisdictions on the Belt and Road).

Please refer to Appendix 1 for a summary of available preferential (withholding) tax rates for dividends, interest, royalties and technical fees from these jurisdictions. Hong Kong hopes to further expand our CDTA network, bringing the total number of such agreements to 50 over the next few years.

These make Hong Kong even more competitive and attractive for international investors to set up their investment holding companies, regional headquarters and functional centers and hubs in Hong Kong.

OECD's Comments

As long as meeting international tax standards, Hong Kong should maintain a simple and low tax regime, which is one of the important competitive advantages of Hong Kong.

The Director of Centre for Tax Policy and Administration, Organisation for Economic Co-operation and Development ("OECD") also delivered a keynote speech at the Summit. He shed light on the latest developments on international tax co-operation, and commented on Hong Kong's situation. In brief, he finds Hong Kong's profits tax rate is within an acceptable range, and it is a good move to introduce super-deduction for profits tax purpose for R&D expenditure (instead of a patent box regime) which is compliant with the international standard.

He also said that Hong Kong has been cooperative generally in Base Erosion and Profit Shifting ("BEPS") and Common Reporting Standard ("CRS") implementation; however, he hoped Hong Kong could act faster and be more proactive in the following areas:

- consider mandatory arbitration in tax treaties; and
- expedite the expansion of automatic exchange of financial account information ("AEOI") network.

Ideas and Suggestions at the Summit's Panel Discussions

The Summit featured two panel-cum-floor discussion sessions on tax initiatives for reinforcing pillar industries and promoting the development of a diversified economy. Leaders from the business sector and the tax profession shared insights and exchanged views with other participants on relevant tax issues.

Some ideas and suggestions were made for our Hong Kong Government's further consideration and studies include:

- Tax incentives to encourage registering intellectual properties ("IP") in Hong Kong and facilitate Hong Kong becomes a popular IP hub in Asia;
- Tax incentives to attract international funds to be set up in Hong Kong;
- Tax incentives to facilitate bond market development in Hong Kong;
- Tax incentives to attract regional management/functional headquarters to Hong Kong;
- Possibility for tax incentives for vessel leasing business;
- Possibility for tax deduction of capital investment in encouraged projects;
- Possibility for carrying tax losses backwards to prior years;
- Possibility for tax loss relief among group companies.

At the first glance, it seems some items on the above wish-list are mission impossible. However, Hong Kong did have proven precedent cases of drastic changes in tax policies which resulted in solid and long-term economic results.

HONG KONG'S PROVEN EXAMPLES OF CHANGES IN TAX POLICIES WITH ECONOMIC RESULTS

Hong Kong indeed has precedent cases of promising changes in tax policies which are well-received by residents and international investors, and the changes have resulted in economic success, and facilitated industrial and economic development. The precedent cases include:

➢ ***Abolition of Estate Duty in 2006***

Estate Duty on assets situated in Hong Kong was a deterrent to the holding of Hong Kong assets. Although the abolition of Estate Duty caused a reduction in tax revenue, it has reduced overseas "migration" of assets and funds from Hong Kong, and attracted more inbound investments in Hong Kong assets. The change is beneficial to the stock market, real estate market and the economy of Hong Kong as a whole, and Hong Kong's revenue from Stamp Duty on the active markets of Hong Kong stocks and real estate properties. It has made Hong Kong become a popular and high quality asset management hub in Asia. It has also facilitated the development of banking, legal, accounting, taxation, insurance, real estate management and other professional service industries.

➢ ***Reduction of tariff rate on wine from 40% to 0% in 2008***

Amid the growing demand for wine in Asia, Hong Kong removed all duty-related customs and administrative controls for wine in February 2008 to facilitate the development of Hong Kong as a wine trading and distribution centre for the region, particularly the Mainland.

The immediate economic benefits to Hong Kong as a result of wine duty exemption included:

- about 850 new wine-related companies were set up in Hong Kong in 2008 and 2009;
- the wine sector as a whole gained HK$5.5 billion worth of wine-related business receipts in 2009, representing an increase of over 30% as compared with 2007; and
- the number of employees engaged in wine-related business increased by more than 5,000 as compared with

2007, and reached 40,000 by the end of 2009.

The move also facilitated the development of wine-related businesses, including auction, retailing, warehousing, catering and transportation.

For 2016, Hong Kong imported more than 60 million litres of wine from over 50 countries and regions (a record value exceeding US$1.5 billion), and that was equivalent to more than 80 million bottles of wine, and about half of the wine imported into Hong Kong was re-exported.

Hong Kong's wine customs facilitation scheme with the Mainland under CEPA has given Hong Kong wine traders instant customs clearance of wine entering five Mainland customs districts, including Beijing, Shanghai, Tianjin, Guangzhou and Shenzhen. The arrangement has recently been extended to all 42 customs districts right across the Mainland. Hong Kong's re-exports of wine to the Mainland have increased almost 35 times over the past 10 years.

The Hong Kong International Wine & Spirits Fair 2017 successfully held in Hong Kong this month featured a record of 1,070 exhibitors from nearly 40 countries and regions across the world. Hong Kong is now the home to the world's first wine-storage certification scheme, with wine professionals from all over the world.

- ***Profits tax exemption for offshore funds in 2006, and extension of the exemption to offshore private equity funds in 2015***

  The asset and wealth management business is a fast-growing area of financial services industry. Hong Kong is among the top asset management hubs in Asia.

  By providing clear tax exemption to transactions conducted by offshore private equity funds in respect of eligible overseas portfolio companies, Hong Kong has attracted more private equity fund managers to set up or expand their businesses in Hong Kong, hire local asset management, investment and advisory services, which is conducive to the further development of the asset management industry in Hong Kong. This has also driven demand for other relevant professional services, such as business consulting, tax, accounting and legal services.

These are remarkable "less is more" showcases of Hong Kong.

RSM Hong Kong's Suggestions

We welcome our Government's new tax measures of two-tier profits tax rates regime, and the super-deduction for R&D expenditure.

We are also very pleased to see our Government's initiative and open communication with various stakeholders in collating different views for formulating forward-looking tax policies and measures for fostering economic development.

In addition to suggestions mentioned above, our Government may also wish to consider the following financial and tax ideas:

- Attracting more companies

  At present, there are about 1.4 million registered businesses in Hong Kong. With the new tax measures, and in light of the Belt and Road Initiative and Greater Bay Area development, we hope our Government could promote Hong Kong further, and attract more enterprises to be set up in Hong Kong by local, the Mainland and international investors.

For a long-term planning purpose, we need to enlarge the number and size of taxpayers for all types of taxes and duties to avoid overly reliance on thousands of key taxpayers contributed to more than 70% of the total profits tax paid.

- Direct subsidies to start-up companies

It may not be easy for green-field enterprises to make profits during their infancy period. They may more keen to have upfront cash rather than future saving of profits tax. Rentals and payroll costs are usually key operating expenses of the new companies. Our Government may consider providing suitable amounts to qualified enterprises in encouraged industries to subsidise part of their actual rental expenses for office premises and staff quarters in the initial few years of operations.

Rental-low/free office premises and staff quarters are quite common in the incubation hubs in our neighbourhood cities in the Greater Bay Area.

Our Government may also consider allowing qualified enterprises to apply for cashing their tax losses (i.e. to forego the use of tax losses to set off against future profits by receiving equivalent amount of cash in current tax year).

- Indirect financing SMEs

The Mainland has just implemented new tax incentives to encourage financial institutions to provide financing to certain SMEs, with the Value-Added Tax on the interest income exempted and the Stamp Duty on the related loan documents exempted.

We may also consider along the tracks to provide profits tax and stamp duty incentives to relevant vendors (e.g. landlords of office premises and staff quarters, lessors of prescribed fixed assets, licensors of prescribed IPs, lenders to SMEs, consulting and professional service providers to SMEs) to encourage them to support focused groups of SMEs together with the Government.

- Attracting more talents

High-calibre people are vital to the success of innovation and technology businesses. Our Government may consider extending their salaries tax payment schedules or provide tax incentives to tax loan providers.

- Fiscal and tax measures to facilitate Greater Bay Area economic development

Cross-border investment and operations with Mainland are becoming indispensable and more extensive. Our Government may liaise with the finance and tax authorities in the Mainland to see how we could cooperate to make Hong Kong residents to serve the Mainland market easier from a tax perspective to avoid double taxation or sharp increase in tax costs better.

We will discuss in the coming Tax Flash our views and suggestions about the Greater Bay Area development plans from the southern China. Please stay tuned in RSM Tax Flash.

Appendix 1

Tax Rates for Dividends, Interest, Royalties and Technical Fees

The following table shows the maximum rates of tax those countries/territories with a Comprehensive Double Taxation Agreement/Arrangement with Hong Kong can charge a Hong Kong resident on payments of dividends, interest, royalties and technical fees. This high-level summary is for general information only. Please refer to the latest version of the relevant Agreements/Arrangements for specific criteria and applications.

Country / Territory	Effective from Year of Assessment	Dividends		Interest (%)	Royalties (%)	Technical Fees (%)
		Qualifying Companies (%)	Others (%)			
Austria	2012/2013	0	10	-	3	NA
Belarus	Pending	0	5	5	3/5	NA
Belgium	2004/2005	0/5	15	10	5	NA
Brunei	2011/2012	-		5/10	5	15
Canada	2014/2015	5	15	10	10	NA
Czech	2013/2014	5		-	10	NA
France	2012/2013	10		10	10	NA
Guernsey	2014/2015	-		-	4	NA
Hungary	2012/2013	5	10	5	5	NA
Indonesia	2013/2014	5	10	10	5	NA
Ireland	2012/2013	-		10	3	NA
Italy	2016/2017	10		12.5	15	NA
Japan	2012/2013	5	10	10	5	NA
Jersey	2014/2015	-		-	4	NA
Korea	2017/2018	10	15	10	10	NA
Kuwait	2014/2015	0	5	5	5	NA
Latvia	Pending	0	10	0/10	0/3	NA
Liechtenstein	2012/2013	-		-	3	NA
Luxembourg	2008/2009	0	10	-	3	NA
Mainland of China	2007/2008	5	10	7	5/7	NA
Malaysia	2013/2014	5	10	10	8	5
Malta	2013/2014	-		-	3	NA

Country / Territory	Effective from Year of Assessment	Dividends: Qualifying Companies (%)	Dividends: Others (%)	Interest (%)	Royalties (%)	Technical Fees (%)
Mexico	2014/2015	-		4.9/10	10	NA
Netherlands	2012/2013	0	10	-	3	NA
New Zealand	2012/2013	0/5	15	10	5	NA
Pakistan	Pending	10		10	10	12.5
Portugal	2013/2014	5	10	10	5	NA
Qatar	2014/2015	-		-	5	NA
Romania	Income derived on or after 01.01.2017	3	5	3	3	NA
Russia	2017/2018	0/5	10	-	3	NA
Saudi Arabia	Pending	5		-	5/8	NA
South Africa	2016/2017	5	10	10	5	NA
Spain	2013/2014	0	10	5	5	NA
Switzerland	2013/2014	0	10	-	3	NA
Thailand	2006/2007	10		10/15	5/10/15	NA
United Arab Emirates	2016/2017	0	5	5	5	NA
United Kingdom	2011/2012	0/15		Domestic rate	3	NA
Vietnam	2010/2011	10		10	7/10	NA

Source: Hong Kong Inland Revenue Department website as of 13 November 2017

RSM Tax Advisory (Hong Kong) Limited

RSM Hong Kong's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalization schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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