

Mr Paul Chan, GBS, MH, JP
Financial Secretary
25/F, Central Government Offices
2 Tim Mei Avenue
Tamar
Hong Kong

4 May 2017

Dear *Paul*

We welcome the proposals set forth in the 2017/18 HKSAR Budget to foster the development of pillar business sectors in Hong Kong, over which we have advantages, as well as reindustrialisation of our manufacturing sector focusing on the emerging high-value industries to ensure that Hong Kong remains competitive and to secure long-term development of our economy. Following the brain storming session held on 3 April 2017, we would like to present the below for your further consideration.

We understand it may take time for the setting up of the proposed Tax Policy Unit (Unit) in the Financial Services and Treasure Bureau (FSTB) to comprehensively review various tax issues from a macro perspective, however, the setting up of such Unit is essential for Hong Kong to remain competitive in terms of fiscal policy in view of the fast-progressing international tax environment and changing business practices. As an interim arrangement to upskill our labour workforce and speed up the reindustrialisation of Hong Kong manufacturing sector, we have the following suggested tax and non-tax measures for your consideration.

1. Research and Development (R&D) Expenditure Deduction under existing Section 16B

Under the current provisions of the Inland Revenue Ordinance, R&D is specifically defined as any activities in the fields of natural or applied science for the extension of knowledge, or any activities carried on for the purposes of any feasibility study, gaining new scientific or technical knowledge and understanding; or application of research findings or other knowledge to a plan or design for the production or introduction of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of their commercial production or use. On the other hand to support the development of

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high-value industries, the various funding schemes managed by the Innovation and Technology Commission do not use a concrete definition for R&D, instead it contains descriptions for the assessment frameworks of each individual funding scheme.

To ensure high-value industrial businesses, especially those start-up businesses, can be enjoyed by the tax deductions of R&D expenditure, we suggest that the Inland Revenue Ordinance (IRO) can be amended to add a reference to those R&D expenditures in projects supported by the Innovation and Technology Commission funding programmes.

In addition, according to the Inland Revenue Department's (IRD) interpretation of the current tax legislation, an item of R&D expenditure is only deductible if the R&D activities are conducted in-house by the taxpayer or a payment is made to an approved research institute. In situations where the R&D work is outsourced or the expenditure is not paid to an approved research institute, the expenditure is not eligible for any tax deduction, even though the R&D activities may be conducted by other companies within the same group. This does not appear to fit the rationale of encouraging R&D as well as the commercial practices. We therefore reiterate our suggestion in ACCA Hong Kong's Budget Submission that any expenditure of qualifying nature should be allowed as a tax deduction no matter whether it is conducted in-house by the taxpayer or outsourced to a third party.

2. Super tax deduction for R&D investment

New R&D projects usually entail significant investments at their early stages while return on investment would only materialise gradually, resulting in significant losses in early years. To encourage large corporations to undertake expenditures on R&D projects, we suggest reducing their tax burden through allowing a 300% tax deduction for R&D expenditure, similar to tax measures taken by our neighbours such as the Mainland China, Singapore and Australia.

The R&D expenditure for the purposes of super deduction includes tax depreciation on manufacturing equipment. Such super deduction should provide an incentive for businesses to develop of high-value and high-end industries and to participate in the re-industrialisation process.

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3. Quasi tax consolidation (Pseudo Group Loss Relief)

Businesses have to take risk in R&D projects and not every R&D projects will turn into profitable. Hence it is a common commercial practice that businesses to use a separate company for each R&D project within a group. As such, these R&D expenditures may not be fully tax deductible especially where these subsidiaries do not generate sufficient revenue to cover costs and/or do not generate taxable profits at the end. Group loss relief is a possible solution. We understand that group tax loss relief has been debated for long and there are issues that may not be able to be resolved in the short term. As an interim measure, we suggest to offer tax incentives to large corporations for them to continue their investment in their R&D work by granting "quasi tax consolidation", that is R&D expenditure incurred by a group company can be claimed for tax deduction by another group company(ies) when certain conditions are met. This helps enhancing Hong Kong's tax competitiveness especially when many other major jurisdictions around the region, such as Australia, Japan, Korea, Malaysia, Singapore and Taiwan, have already implemented group tax loss relief.

4. Direct land and Government Funding for start-ups and small and medium entities (SMEs)

Any tax deduction on R&D expenditures would be less relevant to SMEs involving in innovative production as it usually take a few years before they are profitable. Land and financial supports are the keys for development of high-end productions for SMEs, especially those start-ups. As such, we suggest the following:

- To provide start-ups and SMEs a stable location to run their businesses, at an affordable and reasonable rental with longer lease periods, with conditions that the entities can demonstrate certain hi-tech or R&D progress or final deliverables within a specified period. This can help motivate the start-ups and SMEs and at the same time to minimise the risk of abuse.
- To provide subsidised buildings in different locations in Hong Kong. Similar hi-tech projects or industries can be grouped in one zone to allow the players to build the "innovative networks". This can also ensure the players compete

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with each other and only the genuine hi-tech and R&D players can get in and build up the reputation of these zones.

- To provide direct cash low-cost long-term funding to qualified projects or specific industries that are covered by the regime of Information and Technology Commission, such as midstream / downstream R&D projects undertaken by universities, R&D Centres, industry support organisations, professional bodies and trade and industry associations.
- To set up sovereign venture capitals or angel funds with an initial funding of HK\$10 billion, being approximately 10% of 2016/17 fiscal surplus. Any gains generated can be reinvested into further R&D projects making the fund self-financing. To encourage participation by businesses in these venture capital funds / angel funds, we also suggest allowing tax deduction for any investment loss in recognised venture capital or angel fund investment, capped at 10% of their assessable profits.

5. Tax incentives for HK-based hi-tech investment funds

Investment funds can play a critical role to help the flourishing of R&D projects. To encourage more investment funds or fund managers to “reside” in Hong Kong, we suggest providing attractive and competitive tax incentives when they invest in HK-based hi-tech projects exceeding a certain percentage of the value of their annual total investment portfolio. One of the incentives may be reduced tax rate for a specified period after their initial set up.

6. Attracting / retaining talents and industries from overseas

Having a pool of talents is critical to the success of innovation. The attracting of talents to Hong Kong and the retention of local and overseas talents is hence essential for the development of high-value industries, ranging from advanced manufacturing to urban solutions to digital economy. A reduced tax rate of 8.25% can be introduced for selected industries over a period of time so as to give room for these industries to allocate more resources to attraction and retention of talents.

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Apart from corporate tax incentives, access to talents will be another important consideration for businesses. Government may consider offering low rent or even rent free accommodation for employees in selected industries satisfying certain conditions, such as scientists, technicians, researchers with certain qualifications. This may also encourage the younger generation to study relevant subjects and help cultivate innovations further.

7. Developing Hong Kong as the intellectual properties (IP) hub of the region

Commercialization of R&D results is the final step for the reindustrialization. Land supply is a scarce resource in Hong Kong. Oftentimes it is necessary to move the production of the high-end products to nearby cities. To protect the fruit of innovation and R&D, the registration and management of intellectual properties becomes utmost important. To encourage companies register and manage their IP in Hong Kong, we suggest the qualifying income generated from the licensing, exploitation or renting of IP used in Hong Kong be taxed at a reduced rate of 8.5%. As the offshore royalty income is usually subject to withholding tax in the source countries, the Government should consider providing exemption to offshore royalty income to avoid double taxation.

We believe this should be anti-Base Erosion and Profit Shifting (BEPS) compliant and should not be labelled as a harming tax practice.

8. Cultivating innovation mindset

Having the right culture in Hong Kong is important to foster the innovation in long-term. To groom the innovative mind-set amongst the younger generation, Government may set up a fund to encourage schools or universities or enterprises to participate in international technology-related events, such as conference, competition and exhibition.

While the above measures aim at facilitating the development of innovative business activities and encouraging investments, the effectiveness of these measures would depend on implementations of the measures. In this regard, drafting of the legislation needs to be clear and commercially friendly in order to facilitate implementation and

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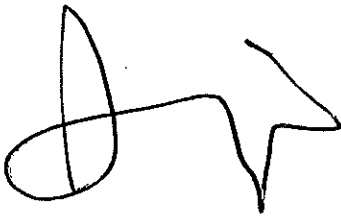
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administration. Given the international tax environment, any tax policies proposed should be anti-BEPS compliant to ensure they can be long-term sustainable.

In view of the fast-progressing international tax environment and the need to accelerate the reindustrialisation process, the setting up of the Tax Policy Unit would be a long-term priority to take the lead in the initiation of the relevant policy, to solicit opinions from the relevant sectors and to co-ordinate various departments of the Hong Kong Government, including the IRD and the Innovation and Technology Commission, to design business-friendly environments in the process of reindustrialisation, which we always believe a potential area of economic growth for the future of Hong Kong.

Should there be any question, please do not hesitate to contact the undersigned at 2973-1108.

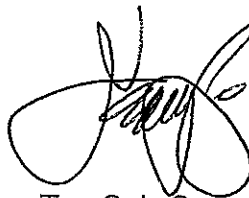
For and on behalf of
ACCA Hong Kong



Chairman
Alice Yip



Tax Sub-Committee Co-Chairman
Kenneth Wong



Tax Sub-Committee Co-Chairman
Danny Po

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