



China promulgated the 12th Five-Year Plan (the Plan) in March 2011. The Plan is the blueprint and action agenda for the economic and social development of the Mainland over the next five years. It has a special significance to Hong Kong as it is the first time that it has incorporated a chapter on Hong Kong (the Hong Kong Chapter). This paper outlines the proposals for Hong Kong under the Plan and discusses how Hong Kong should consider modifying its tax regime to complement the Plan and to consolidate its position as an international financial, trade and shipping centre.

The Hong Kong Chapter

The Hong Kong Chapter emphasises the Central Authorities' support for the future development of Hong Kong in the following three major areas:

- 1. Consolidating and enhancing Hong Kong's competitive advantages.** This includes consolidating and enhancing Hong Kong's position as an international financial, trade and shipping centre, and support for Hong Kong's development into an offshore renminbi (RMB) centre and an international asset management centre.
- 2. Support for Hong Kong in nurturing emerging industries and developing the six industries where Hong Kong enjoys clear advantages.** The six industries are Cultural and Creative, Innovation and Technology, Environmental, Testing and Certification, Education and Medical. The relevant statements will assist the six industries extend the fields of co-operation and scope of services on the Mainland.
- 3. Deepening economic co-operation between the Mainland and Hong Kong.** This includes continuing the implementation of the Closer Economic Partnership Arrangement (CEPA) and confirming the Hong Kong-Guangdong co-operation. The core functions and positioning of Hong Kong in the development of the Pearl River Delta region are clearly defined and provide a clear direction and basis for Hong Kong in taking forward further regional co-operation with other provinces.

These can be summarised as follows:

Hong Kong's competitive advantages	The six industries	Economic co-operation between Hong Kong and the Mainland
<ul style="list-style-type: none">• Financial, trade and shipping centre• Offshore RMB centre• Asset management centre	<ul style="list-style-type: none">• Medical• Education• Testing & Certification• Innovation & Technology• Cultural & Creative• Environmental	<ul style="list-style-type: none">• CEPA• Financial co-operation zone• World-class metropolitan cluster• Opening up the Guangdong service industries

The Hong Kong Government has indicated that all relevant policy bureaux would be responsible for formulating policies and measures according to the substantive contents of the Plan. These include, for example:

- a) The development of offshore RMB business by further enhancement of the RMB settlement platform, encouraging overseas enterprises and Mainland enterprises to issue RMB bonds in Hong Kong and reinforcing Hong Kong's status as an offshore RMB centre. The Government will also look to establish channels to allow enterprises to invest in the Mainland the RMB funds raised in Hong Kong and promote the diversification of RMB financial products and services.
- b) Facilitating the development of asset management businesses by seeking to enter into more agreements for the avoidance of double taxation, continuing to develop an Islamic financial platform, providing fiscal incentives and stepping up overseas promotion. The Government will also continue to strengthen the competitiveness of our asset management industry.
- c) In developing the six industries, the Government will be proactive in strengthening the co-operation with the Mainland to explore and serve the domestic market in the Mainland making use of CEPA and existing regional co-operation platforms.
- d) To support Hong Kong's development into a high-value goods inventory management and regional distribution centre, the Government will gradually make available long-term sites in Kwai Tsing to attract third-party logistics services providers to operate in Hong Kong. The Government will also promote the wider use of e-logistics services, and continue to promote to the Mainland and overseas markets the professional logistics services which Hong Kong can offer. The Airport Authority is actively increasing the handling capacity of the airport to meet future demand, including the midfield expansion project and construction of a new air cargo terminal.
- e) On regional co-operation, the Government will co-operate further with Mainland provinces and municipalities in taking forward the relevant measures. The focus will be on forging ahead with advanced manufacturing industry and modern services industries, Qianhai development, the opening up of the Guangdong market to Hong Kong service industries, cross-boundary infrastructure development and the building of the Guangdong-Hong Kong-Macao Quality Living Area.
- f) With the Central Authorities' support of the continuing implementation of CEPA, the Government will continue its dialogue with the relevant Central Government ministries in taking forward the related work.



Recommendations on Hong Kong tax changes

To allow Hong Kong to take full advantage of the macroeconomic opportunities envisaged in the Plan, it is important that Hong Kong adapts its tax system. It is recommended that Hong Kong should consider modifying its tax laws in the following areas:

- Further expanding the network of comprehensive double taxation agreements (DTAs)
- Loss relief
- Providing a level playing field for Islamic finance
- Tax incentives for asset management
- Tax incentives for research & development
- Tax deduction for intellectual property rights
- Depreciation allowances for manufacturing plant and machinery utilised in certain cross-border activities
- Principles for determining the source of profits
- Facilitating the maintenance of substance in investment holding companies.

These will be considered in the context of the three major areas of support outlined in the Plan for Hong Kong's future development.

Tax proposals in support of Hong Kong's competitive advantages

Comprehensive double taxation agreements

As an international financial, trade and shipping centre and asset management centre, Hong Kong should have a broad network of DTAs with its major trading partners. The existence of such a network will provide Hong Kong companies conducting business overseas with a number of tax benefits. It will also facilitate Mainland investors in structuring their overseas investments through Hong Kong and for overseas businesses investing in the Mainland using Hong Kong as a spring-board.

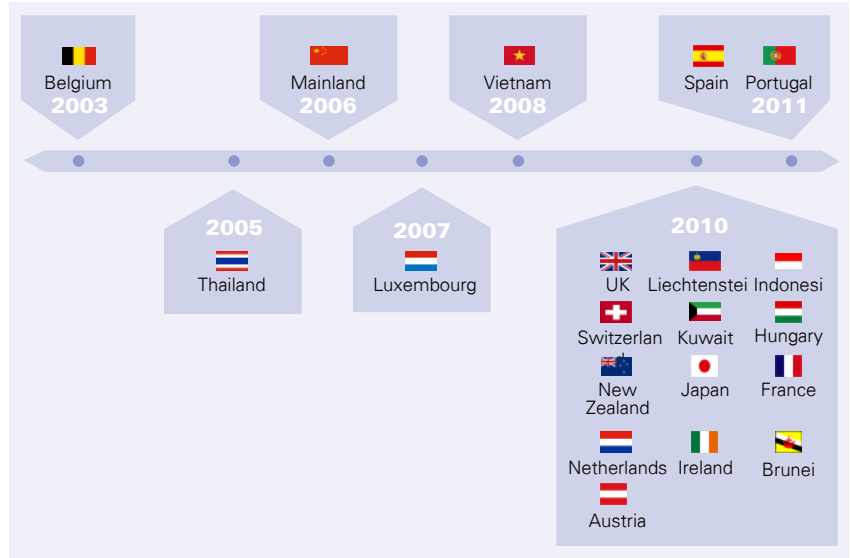
Overseas jurisdictions typically impose withholding taxes on various forms of income, such as dividends, interest, royalties and capital gains, derived from the jurisdiction. Where a DTA has been concluded, withholding taxes on payments made to a Hong Kong enterprise are usually substantially reduced or in some instances eliminated.

DTAs typically contain rules that prevent an agreement country from imposing tax on the business profits of a Hong Kong enterprise unless the enterprise maintains a "permanent establishment" (PE) in that country and the business profits are attributable to that PE. The DTA defines what constitutes a PE and whilst the definition varies from country to country, certain activities are commonly excluded from the definition. For instance, facilities maintained only for the purpose of storage, display or delivery of stock do not normally constitute a PE. Therefore, a well negotiated DTA can, through its definition of a PE, provide significant savings for Hong Kong enterprises operating overseas.

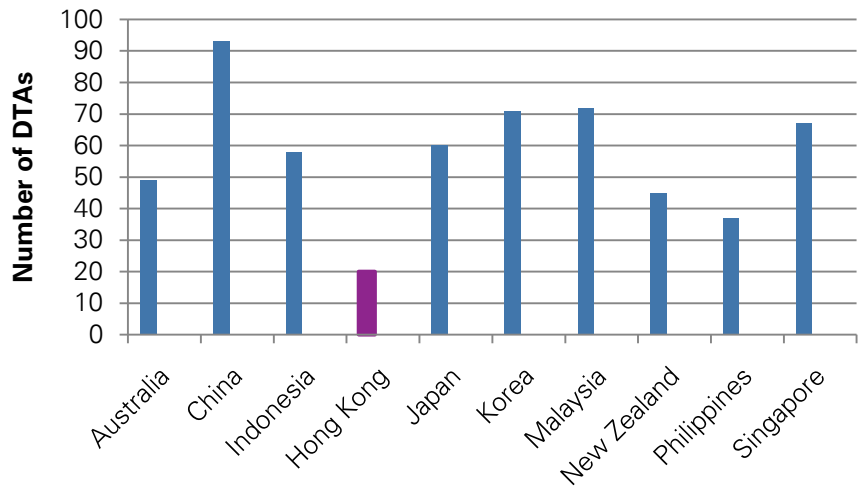
For individuals, a DTA normally allows a Hong Kong resident to perform employment services in the agreement country without being subject to tax in that country (normally where they are present in that country for less than 183 days in the year of income).

Moreover, a DTA provides investors with certainty. This is achieved firstly, by placing a ceiling on withholding tax rates and secondly, by providing investors with procedures to settle disputes that may arise from time to time.

Prior to 2010, when Hong Kong amended its legislation to allow it to incorporate in its DTAs the latest international standard on exchange of information of the Organisation of Economic Co-operation and Development (OECD), Hong Kong had only concluded five DTAs. In order to be deemed to have substantially implemented the internationally agreed standard by the OECD, Hong Kong needed to conclude 12 DTAs containing the latest exchange of information article. Currently, Hong Kong has concluded twenty DTAs and negotiations are under way with a number of other jurisdictions. The current situation is set out below:



Compared to other jurisdictions in the region, and despite the commendable steps taken to conclude negotiations in 2010 and 2011, Hong Kong cannot be regarded as having an extensive network of DTAs. The following table highlights Hong Kong's relative position vis-à-vis its regional counterparts:



The twenty DTAs concluded to date by Hong Kong, whilst positive, does not compare favourably with our competitors in the region. Singapore has over sixty DTAs, the Mainland over ninety and Korea and Malaysia over seventy. Accordingly, to enhance its position, Hong Kong should give priority to expanding its network of DTAs with particular emphasis being given to concluding DTAs with Hong Kong's major trading partners, such as the USA, Australia, India and Taiwan and countries in South America and Africa where Chinese outbound investments are heading.

Islamic finance

To complement Hong Kong's position as an international financial centre and asset management centre, it is important that the Government supports alternative financing arrangements such as Islamic finance. In this regard, the Financial Secretary announced in the 2009/10 Budget, that the Government would further develop and increase financial co-operation with emerging markets and improve Hong Kong as a platform for the growing area of Islamic finance.

Islamic finance considers money to have no intrinsic value in itself – it is merely a store of wealth and medium of exchange and as such it is unjust to increase its value merely by lending it to another person. Therefore, financial instruments such as bonds, debt securities and deposits involving the receipt and payment of interest are not acceptable to Islamic communities.

However, Islamic law promotes the notion of risk sharing and hence Islamic financial instruments are structured as risk-sharing arrangements. Islamic law requires that financing should only be raised for trading in, or construction of, specific and identifiable assets; trading in 'indebtedness' is prohibited and conventional bonds (which are interest based) do not comply with Islamic law. Modern Islamic banking has developed mechanisms that allow interest income to be replaced by payments flowing from productive sources, for example, returns from trading in assets and rental income. A sophisticated Islamic financial system has developed which seeks to reward investors for the actual risks undertaken. Investors are deemed to acquire a share of the underlying business from which profits are generated.

The key tax issue with Islamic finance is that the arrangements operate in the form of equity finance but, in substance, are similar to debt finance. Tax law has always treated debt and equity differently. The interest income and interest expenses arising from a debt finance arrangement may be taxable and deductible subject to certain conditions. In contrast, dividend income and distributions arising from an equity finance arrangement are generally not taxable or deductible. Moreover, the sale and repurchase of certain assets such as property under Islamic finance arrangements can be subject to Stamp Duty in Hong Kong and the periodic rental payments can be subject to Profits Tax or to Property Tax. Consequently, Islamic finance can be exposed to a heavier tax burden when compared to conventional finance, which places it at a competitive disadvantage in the market place.

To address this issue, the Government initially planned to submit a proposal in 2009-10 to create a level playing field for Islamic financial products vis-à-vis conventional ones. This proposal would include making changes to or clarifications of the arrangements for stamp duty, profits tax and property tax. A similar announcement was made by the Financial Secretary in the 2011/12 Budget; however unfortunately, the necessary legislative amendments have still not been introduced. The only development, to date, has been the issue of guidelines to the finance industry towards the end of November 2009 to facilitate applications for tax exemption in relation to the launch of and transactions in Islamic bonds. However, these procedures are time consuming and complicated and do not represent an appropriate mechanism to facilitate the development of Islamic finance.



Without the relevant legislative amendments, Hong Kong will continue to lag behind regional competitors such as Singapore and Malaysia, which have already introduced measures to address the tax issues associated with Islamic financial products. Indeed, the Malaysian Government is determined to make Malaysia the hub of Islamic financial services and has gone further and introduced not only measures to eliminate inequitable tax results, but provided additional tax incentives to the Islamic financial sector. Accordingly, the Hong Kong Government should take immediate steps to introduce the relevant legislative amendments to place Islamic finance on a level playing field, thereby enhancing Hong Kong's competitive advantage.

Tax incentives for asset management

There are currently no incentives provided for either onshore or offshore asset management business carried out in Hong Kong. However, regional competitors, such as Singapore, promote fund management activities in Singapore by offering a concessionary tax rate of 10 percent for fund management and investment advisory activities, subject to certain conditions. It is recommended that Hong Kong consider offering similar incentives to attract fund management businesses to Hong Kong.

Loss relief

Currently Hong Kong only allows tax losses to be carried forward indefinitely for set-off against future profits. By contrast, many other jurisdictions allow tax losses to be carried back to offset against taxable profits in earlier years or to be transferred between group companies (group relief).

Hong Kong's loss rules work well when companies operate separate businesses under the same legal entity. However, enterprises no longer commonly organise their businesses under a single entity. Rather, companies are usually organised along lines of business operating through separate legal entities notwithstanding that the group is managed and controlled as a single economic unit. This structure may be utilised to limit the liability and risk of their investments or to reflect the structure of their businesses.

To reflect Hong Kong's status as an international financial centre, the Government should take positive steps to update the current tax loss provisions. Taxpayers in similar situations conducting similar transactions should be subject to similar levels of taxation. But the current tax loss regime in Hong Kong can result in inequitable tax results. For example, a loss making enterprise which derived profits and paid tax in earlier years can never obtain a tax refund and will remain in a tax paying position overall, despite it being in an overall loss position during its lifetime. Further, a corporate group with both profit-making and loss-making companies may suffer a higher overall tax burden and higher effective tax rate than would be the case had the business been carried out by a single company.

To address these issues, countries around the world have progressively introduced group relief and similar measures to reflect this economic reality. Under group relief, the losses of one company can be utilised to offset the profits of another company within the same group. Taxing group companies as a single unit would provide investors with greater flexibility to engage in new activities through separate business vehicles.

There is also a need to allow the carry back of losses to be set-off against the assessable profits of a preceding year. For instance, a company engaged in securities trading is assessed or allowed a deduction for unrealised gains or losses when they are taken to the profit and loss account and this can result in an inequitable result. For example, an unrealised gain is assessed in a year due to a rise in market value. Subsequently, when the security is disposed an actual loss may eventuate. This loss may not be able to be utilised if the taxpayer does not have any other business profits. Allowing companies to carry losses back for three years, for example, would help to address this issue.

The following table sets out examples of countries that have group loss relief and loss carry-back provisions.

Jurisdiction	Group relief	Loss carry back
Australia	✓	✗
France	✓	✓
Germany	✓	✓
Malaysia	✓	✓
Singapore	✓	✓
United Kingdom	✓	✓
United States	✓	✓

Tax proposals in support of the six industries

The six industries include cultural and creative and innovation and technology industries. These particular industries are heavily knowledge based and dependent upon research and development (R&D) and the creation of intellectual property. Currently, Hong Kong's expenditure on R&D represents less than one percent of its GDP. It is essential that Hong Kong's tax policy should encourage businesses to invest into these industries, particularly as these industries typically incur initial high expenditures when they are being established. The Hong Kong tax regime needs to ensure that Hong Kong can attract such businesses to establish.

Tax incentives for research & development

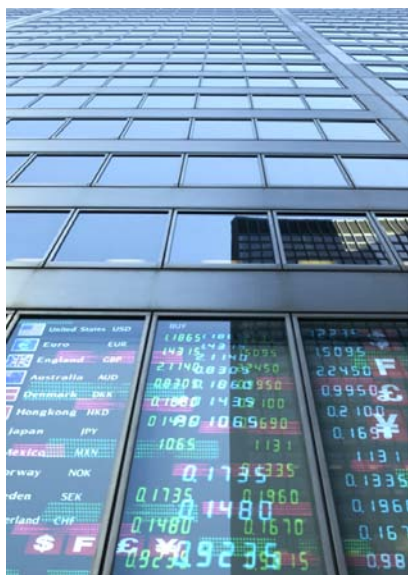
Hong Kong currently provides tax relief for R&D expenditure as follows:

- Outright deductions for payments made to approved research institutes for R&D
- Outright deductions for expenditure on R&D other than expenditure on the acquisition of land or buildings or on alterations, additions or extensions to buildings
- Where any rights arising out of R&D, for which a deduction has been given, is resold, the sale proceeds are deemed to be an assessable trading receipt (limited to the amount of the original deduction in respect of the expenditure which gave rise to the rights sold).

However, these reliefs are not as generous as Hong Kong's regional competitors (see table below) which provide bonus R&D tax deductions.

Country	Bonus deduction
Australia	125 – 175 %
China	150 %
Singapore	Up to 400 %
United Kingdom	130 % (175 % for SMEs)

Thus, Singapore, for example, provides a tax deduction of up to 400 percent. Other relief measures provided by other countries include accelerated depreciation for expenditure on plant and machinery, providing a tax credit/rebate, a partial tax exemption, or some combination thereof. In order to encourage investment in R&D, Hong Kong needs to introduce tax incentives in line with those offered by its competitors.



Intellectual property (IP)

Hong Kong currently allows a deduction for expenditure on the registration of trademarks, patents or designs used for the purposes of earning assessable profits. However, only expenses “for the registration” of a trademark or design are allowable, although a deduction is allowed for either the registration or grant of a patent. In addition, a deduction is allowed for the cost of purchasing patent rights or rights to any know-how, provided that the rights are to be used in Hong Kong in producing profits chargeable to Profits Tax. Where the rights are to be used partly in Hong Kong and partly elsewhere, only that part of the cost which is attributable to the use in Hong Kong is deductible.

If the rights are subsequently sold, the proceeds of sale are to be brought in as a trading receipt and charged to Profits Tax. However, the taxable amount is not limited to the original cost and there is the potential for what is a capital gain to be taxed.

The categories of intellectual property rights that qualify for deduction is to be extended to copyrights, registered designs and registered trademarks. The requirement that the patent rights or rights to any know-how must be used in Hong Kong will also be removed. The deduction will be available over five succeeding years of assessment or a lesser number of years of assessment in the case of a copyright or registered design whose maximum period of protection is due to expire earlier than the five year limit. The provisions only apply to expenditure on the acquisition of copyrights, registered designs and registered trademarks, as opposed to ‘in-house’ expenditure on the development of such intangibles.

Whilst this widening of the categories of intangibles that qualify for deduction is welcome, it does not extend to all types of intangible assets. Deductions are not available for such intangible items as brand names and purchased goodwill. Expenditure on “excluded” intangible items are effectively treated as non-deductible capital expenditure. An anomaly results in that profits produced from the use of these intangible items are assessable, but no deduction is available for the corresponding costs. These costs represent real economic costs to the enterprise that should be deductible in ascertaining its assessable profits. This is a strong disincentive to enterprises performing IP enhancement activities in Hong Kong. As can be seen from the table below, Hong Kong is not an attractive jurisdiction to hold IP and the Government should introduce suitable incentives to enhance Hong Kong’s position.

Tax deductions for purchased intellectual property in Hong Kong

Deductible	Non-deductible
Patents	Brand names
Industrial know-how	Licensing rights
Registered trademarks	Customer lists
Copyrights	Indefeasible rights of use
Registered designs	



Tax proposals in support of economic co-operation between Hong Kong and the Mainland

Tax deduction for expenditure on manufacturing plant and machinery utilised in certain cross-border activities

Among the priority industries listed in the Plan is high-end manufacturing, which is an area where Hong Kong can directly assist the Mainland. However, the current tax system in Hong Kong does not currently assist this process. It is a common arrangement for a Hong Kong manufacturer to provide plant and machinery to a Mainland enterprise, which manufactures goods on its behalf. However, the Inland Revenue Department (IRD) considers that such arrangements amounts to a lease of the plant and machinery and denies a deduction for depreciation allowances on the basis that their use is wholly or principally outside Hong Kong. Despite repeated calls to the Government to amend the relevant legislation, this has not been forthcoming. The Government should re-visit this matter to allow tax relief to Hong Kong manufacturers providing plant and machinery to Mainland enterprises.

Principles for determining the source of profits

Previously, Hong Kong manufacturers were able to enter into contract processing arrangements with Mainland enterprises. Under such contract processing arrangements, the IRD accepted that only 50 percent of the profits were assessable on the basis that they arise from manufacturing activities undertaken partly in Hong Kong and partly in the Mainland. However, the Mainland has been phasing out contract processing arrangements in favor of import processing and other arrangements.

Essentially, whilst the import and contract processing arrangements are similar, the IRD considers that they are different and does not accept that import processing arrangements can be assessed on a 50:50 basis. The Department considers that import processing arrangements are taxable as a trading arrangement, and that the profits are taxable if sourced in Hong Kong. This situation is clearly anomalous and unfairly discriminates against Hong Kong manufacturers engaged in import processing. As the arrangements are in substance identical they should be placed on an equal footing.

Facilitating the maintenance of substance in investment holding companies

Under the circular of the State Administration of Taxation (SAT), Guo Shui Han [2009] No. 601 (Circular 601), a non-Chinese resident enterprise in a treaty country or territory, such as a Hong Kong company, deriving dividends, interest or royalties from the Mainland will not be able to enjoy the treaty benefit unless it can show that it has economic substance in that treaty country or territory. This is a beneficial ownership test.

If the Hong Kong Government provided tax incentives to corporate groups to use Hong Kong to hold investments in overseas subsidiaries, including Chinese subsidiaries, then more foreign investors will be motivated to establish such operations in Hong Kong and in turn to maintain a sufficient level of economic substance in Hong Kong. Such incentives could apply to regional headquarter functions, regional trading activities, shared services, R&D etc. The incentives could take the form of a reduced tax rate, tax deductions and / or credits that are linked to the amount of investments held outside Hong Kong.

Similar requirements on economic substance in the territory of offshore investment holding companies also exist in another circular issued by the SAT, Guo Shui Han [2009] No. 698 (Circular 698), which deals with indirect disposals of equity interests in Chinese resident enterprises by foreign investors. To a certain extent, the abovementioned tax incentives may encourage foreign companies to set up offshore holding companies in Hong Kong to deal with the issues arising from Circular 698.

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Conclusion

The Plan presents an opportunity for Hong Kong to enhance its position as an international financial, trade and shipping centre and as an international asset management centre. However, to fully capitalise on these opportunities the Government needs to make policy decisions and amend current tax legislation to ensure that it is compatible with both the Plan and the Mainland's support for Hong Kong.

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