With an eye on Hong Kong’s fiscal health, the Financial Secretary’s 2019-20 budget included significantly less of the sweeteners that have become an expected ingredient of any budget recipe. However, the fact that the annual budget surplus has reduced by two thirds, but the ceiling of the salaries and profits rebates has only reduced by one-third, might make it easier for taxpayers to swallow this medicine.

In tandem with Hong Kong’s fiscal health, the Financial Secretary has clearly diagnosed that Hong Kong’s public health is in need of attention. The 10.9% increase in recurrent government expenditure on public healthcare to HK$80.6 billion, the HK$700 million additional recurrent funding to increase the allowances for medical staff and allied health professional posts, and the encouragement given to health sector employment generally are welcomed. Equally welcome is the additional HK$5 billion earmarked for the Hospital Authority to acquire and upgrade medical equipment and the creation of a public healthcare stabilization fund in the sum of HK$10 billion to fund the Hospital Authority in case of unexpected circumstances. All these actions lend credence to the importance which the HKSAR Government places on Hong Kong’s public healthcare system, a system which has been hard pressed by the recent influenza outbreak.

The creation of a stabilization fund for health issues, whilst justifiable and a due reflection of the HKSAR Government’s concern on matters of public health, may cause commentators to compare the same with today’s decision by the Financial Secretary to transfer the Housing Reserve back to the overall fiscal reserves. Some may query whether it is the view of the HKSAR Government that taking back part of the Fanling golf course, coupled with its Lantau Tomorrow Vision, is a sufficient demonstration of its commitment of resources towards public housing such that there is no longer a need for a dedicated fund account. Any such view however, may not be shared by all.

Also perhaps unclear is how the recent instances affecting the reputation of the construction industry in Hong Kong will be addressed by way of the somewhat ad hoc items announced by the Financial Secretary in today’s budget. It is perhaps unclear how the re-naming of the Project Cost Management Office as the Project Strategy and Governance Office, and the creation of courses aimed at equipping public officers with more innovative minds and enhanced leadership skills, will fix such instances. Whilst a budget speech is perhaps not a vehicle in which to announce specific steps as regards corporate governance, an announcement of an amount specifically assigned to a taskforce charged with improving corporate governance of the construction industry would have been welcomed by a public badly rattled by the recent instances in this area.
A further area where the Financial Secretary could have provided additional comment is the large amount of funds earmarked to promote research and development, technology and innovation. Whilst it is laudable for the HKSAR Government to have already incurred considerable expense in this area, and to have earmarked the further expenditure announced by the Financial Secretary in today’s budget speech, some commentators may have hoped for guidance on the internal performance measures the HKSAR Government will apply in assessing whether taxpayers are receiving the best bang for their buck.

More clear in today’s budget was the Financial Secretary’s desire to diversify Hong Kong’s economy away from the so-called “four pillar” service industries of financial services, tourism, logistics and professional business services. In addition to today’s announcement of increased expenditure on research and development, the Financial Secretary’s commitment to diversify through developing technology infrastructure, smart production activities and high-end manufacturing industries, together with increased spending on creative industries, is welcomed.

Also welcome is today’s announcement that the Financial Secretary will move the Tax Policy Unit, currently under the Financial Services and Treasury Bureau, to directly under his office, and that additional resources will be made available to the Unit as necessary. It is hoped that this move will herald a more proactive and timely assessment of tax policy and the implementation of changes where necessary.

In conclusion, the Financial Secretary’s health-conscious budget, with less sweeteners and increased expenditure on public health, together with a greater diversification of Hong Kong’s economy, may be good medicine for Hong Kong.

Further strengthening the asset management industry of Hong Kong

To facilitate Hong Kong’s development into a full-fledged fund service center, the Financial Secretary noted today that, effective from 1 April this year, the profits tax exemption for funds in Hong Kong will cover all privately-offered funds.

Under the new law passed by the Legislative Council last Wednesday, funds in the form of a collective investment scheme, regardless of their residence, size and type, will be exempt from profits tax in Hong Kong in respect of their usual investment and securities trading income (i.e., qualifying transactions).

The tax exemption will be conditional on the qualifying transactions being carried out by persons who are either licensed by the Securities and Futures Commission, or exempt from such licensing, or the fund itself is a qualified investment fund. These conditions are to ensure that the Hong Kong economy derives the maximum benefit from the new law together with the underlying employment benefits.

While we welcome the passage of this new law, we hope the Financial Secretary will at an appropriate time consider one specific request made by the fund industry which has not been reflected in the new law.

Under the new law, the list of qualifying transactions does not include “the holding of debentures, loan stocks, bonds or notes to earn interest income”. As such, interest income derived by funds from the holding of such debt instruments would only be regarded as income incidental to the qualifying transactions of buying and selling of the instruments concerned.

Tax exemption of such incidental interest income under the new law will however be subject to the 5% threshold. That means, if the interest income exceeds 5% of the total trading receipts of the fund for a year, the interest income, if on-sourced in nature, will be fully taxable in Hong Kong.

As such, bond funds may not benefit from the new law given that their principal income is frequently interest which could easily exceed 5% of their total trading receipts for a year.

Given the increasing popularity of many bond funds among investors, the Financial Secretary may need to review whether it is desirable from a policy perspective to include “the holding of debentures, loan stocks, bonds or notes to earn interest income” as qualifying transactions as requested by many in the fund industry.

Possible introduction of tax incentives for regional headquarters based in Hong Kong

While Hong Kong is valued as a portal to mainland China, Singapore is perceived as a gateway to a broader portion of the Asian region. In 2016, the number of multinational corporations (MNCs) that had set up regional headquarters (RHQs) in Singapore was 4,200 as compared with 1,379 in Hong Kong\(^1\).

Apart from the aforesaid geographical advantage of Singapore that may partly explain why there were more RHQs in Singapore than in Hong Kong, the fact that Singapore has long offered tax incentives to RHQs could be another reason.

Currently, Singapore operates a Headquarters Program under the Development and Expansion Incentive (HQ-DEI). Under the HQ-DEI, qualifying RHQs enjoy a 5% or 10% concessional tax rate on qualifying income derived from qualifying activities and operations carried out in Singapore during an incentive period.

By comparison, in terms of taxation, Hong Kong has sought to attract RHQs by merely relying on its simple, low-rate and territorial-based tax regime and the fact that dividend income is generally not taxed in Hong Kong.

However, on-shore management fees derived by RHQs, if not qualifying for the existing tax incentives for corporate treasury centers (CTCs), continue to be taxable at the normal rate of 16.5% in Hong Kong.

The Financial Secretary indicated today that given that many MNCs co-locate their CTCs with their RHQs, the HKSAR Government will continue to enhance the relevant tax measures to strengthen Hong Kong’s competitiveness. This message appears to foretell that Hong Kong will soon introduce tax incentives for RHQs.

We hope the HKSAR Government is close to completing its study of the idea of granting tax incentives to attract more MNCs to establish their RHQs in Hong Kong and will announce the result of any such study at an appropriate time.

Such tax incentives can be in the form of a concessional tax rate of 8.25% for qualifying income derived by qualifying RHQs, and should preferably not be confined to the MNCs of particular sectors.

In addition to complementing the tax incentives currently offered by Hong Kong as regards corporate treasury activities, tax incentives for RHQs will also increase the demand for expertise, goods and services in Hong Kong. Such increased demand would also greatly benefit the development of Hong Kong’s economy.

\(^1\) APAC Regional Headquarters, Cushman & Wakefield Research, 2016.
Proposed tax incentives for high value-added maritime services

As indicated by the Chief Executive in her 2018 Policy Address delivered last October, the Financial Secretary announced today that a dedicated task force has been set up to study tax and other measures with a view to developing Hong Kong as a ship leasing center in the Asia-Paciﬁc region. In addition, Hong Kong will offer a 50% profits tax concession to eligible insurance businesses including the marine insurance industry.

The drive for such a move is to enable Hong Kong to build on its existing strength as a major container port in the region and capitalize on the immense opportunities brought about by the Belt and Road (B&R) and Greater Bay Area (GBA) initiatives.

Whilst Hong Kong overtook London as the world’s second-best shipping center in the 2018 global shipping center index published by the Baltic Exchange and Xinhua, Singapore maintained its dominance retaining the top spot for the ﬁfth consecutive year2.

In his speech today, the Financial Secretary however only appeared to focus on granting tax incentives to lessors of ships and entities undertaking certain types of marine insurance in Hong Kong. In contrast, Singapore’s Marine Sector Incentive (MSI) scheme covers a wider range of marine businesses, including ship management, brokerage and ﬁnancing.

Given the success of the MSI scheme in Singapore, the Financial Secretary may need to consider the desirability of widening the coverage of the proposed tax measures being considered such that a larger swathe of shipping-related businesses can be attracted to Hong Kong to complement the services of each other. Tax incentives for research and development (R&D) expenditure can be further enhanced

The Financial Secretary noted in his speech today that a new law was passed last year to grant enhanced tax deductions for qualifying R&D expenditure. The move was aimed at attracting more R&D activities and investment to Hong Kong, thereby encouraging the development of the innovation and technology industries, and enhancing the drive to re-industrialize Hong Kong.

Under the new law, qualifying R&D expenditure incurred on or after 1 April 2018 on a qualifying R&D activity (i.e., Type B expenditure) will be eligible for enhanced tax deduction: the ﬁrst HK$2 million being eligible for a 300% deduction with the remainder at 200%.

The move was aimed at attracting more R&D activities and investment to Hong Kong, thereby encouraging the development of the innovation and technology industries, and enhancing the drive to re-industrialize Hong Kong.

Other R&D expenditure, including that related to the acquisition of relevant ﬁxed assets, other than land and buildings, would qualify for the normal 100% deduction.

There are, however, restrictions on both the enhanced and normal deductions where the R&D activities are not undertaken in-house by the taxpayers themselves but are instead subcontracted out to be performed by other service providers or by separate group companies under a cost sharing arrangement. Where the service provider or the separate group company is not a university, a college or a designated local research institution, such payments would be ineligible for the normal or enhanced tax deductions. This would be the case regardless of whether the R&D activities are undertaken in Hong Kong or overseas.

Such restrictions may cause the new law to be less effective in achieving its aims given that Hong Kong may currently lack sufﬁcient talent with the necessary skills and expertise to conduct certain types of R&D activities. As a result, enterprises may often ﬁnd it necessary to subcontract out their R&D activities to be undertaken by a service provider or another group company inside or outside Hong Kong. Due to the above restrictions, such enterprises will not be incentivized to conduct more R&D activities inside or outside Hong Kong.

We hope that the Financial Secretary will give further thought to whether the above restrictions can be relaxed when he reviews the effectiveness of the new law.

Key budget assumptions, budgetary criteria and projections

Assumptions used for the medium range forecast (MRF) for the period from 2019-20 to 2023-24

► Real GDP growth rate for the forecast period is 2% to 3% for 2019 and the trend rate for 2020 to 2023 is 3%.
► Investment return is estimated to be 2.9% in 2019 and in the range of 2.8% to 4.6% per annum thereafter.
► Land premium is estimated to be 3.9% of GDP for 2020.
► The ﬁscal reserves balance as at 31 March 2023, previously estimated at HK$1,222.6 billion is now revised to HK$1,216.4 billion, representing about 35.2% of GDP for that year. By 31 March 2024, the estimated ﬁscal reserves balance is estimated at HK$1,224.6 billion, representing 33.7% of GDP for that year.

Budgetary criteria
► Budget surplus/deficit
To sustain balance in the consolidated account in the longer term
► Expenditure policy
To commensurate public expenditure with the growth rate of the economy in the longer term
► Fiscal reserves
To maintain adequate reserves in the long run

Medium range forecast and ﬁscal reserves (in HK$ billion)

<table>
<thead>
<tr>
<th>Year</th>
<th>2018-19 (Revised)</th>
<th>2019-20</th>
<th>2020-21</th>
<th>2021-22</th>
<th>2022-23</th>
<th>2023-24</th>
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<tbody>
<tr>
<td>Operating revenue</td>
<td>452.1</td>
<td>467.0</td>
<td>528.5</td>
<td>547.8</td>
<td>577.6</td>
<td>598.2</td>
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<tr>
<td>Operating expenditure</td>
<td>(434.6)</td>
<td>(501.5)</td>
<td>(510.9)</td>
<td>(540.2)</td>
<td>(568.9)</td>
<td>(595.0)</td>
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<tr>
<td>Operating surplus/(deficit)</td>
<td>17.5</td>
<td>(34.5)</td>
<td>17.6</td>
<td>7.6</td>
<td>8.7</td>
<td>3.2</td>
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<tr>
<td>Capital revenue</td>
<td>144.3</td>
<td>159.1</td>
<td>139.7</td>
<td>152.3</td>
<td>167.8</td>
<td>165.3</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>(103.1)</td>
<td>(106.3)</td>
<td>(129.7)</td>
<td>(155.0)</td>
<td>(170.9)</td>
<td>(160.4)</td>
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<tr>
<td>Repayment of bonds and notes</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(2.7)</td>
<td>(3.1)</td>
<td>4.9</td>
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<tr>
<td>Capital surplus/(deficit) after repayment of bonds and notes</td>
<td>41.2</td>
<td>51.3</td>
<td>10.0</td>
<td>(2.7)</td>
<td>5.6</td>
<td>8.1</td>
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<tr>
<td>Consolidated surplus</td>
<td>58.7</td>
<td>16.8</td>
<td>27.6</td>
<td>4.9</td>
<td>5.6</td>
<td>8.1</td>
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<tr>
<td>Fiscal reserves as at 31 March</td>
<td>1,161.6</td>
<td>1,178.4</td>
<td>1,206.0</td>
<td>1,210.9</td>
<td>1,216.5</td>
<td>1,224.6</td>
</tr>
</tbody>
</table>

Source: Budget 2019-20
Hong Kong 2019-20
Budget Insights

2 http://thebalticbriefing.com/member-news/14883/
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