

**For information
on 24 April 2003**

**Paper for Bills Committee on the
Revenue Bill 2003**

Purpose

This paper provides information on the Revenue Bill 2003, which implements the proposals on motor vehicles first registration tax (FRT) in the 2003-04 Budget, to facilitate Members' deliberations.

Background

2. The Financial Secretary proposed in the Budget for 2003-04 to amend the motor vehicles first registration tax (FRT) system by (a) removing the tax exemption for vehicle accessories and distributor's warranties; (b) introducing a marginal tax system for private cars; and (c) raising the tax rates for private cars, especially for the more expensive ones.

3. For revenue protection purposes, the proposals were effected on Budget Day (5 March) under the Public Revenue Protection (Revenue) Order 2003. The Order will have provisional legal effect lasting for four months. The Revenue Bill 2003, which is scheduled to the Order, was introduced into the Legislative Council on 9 April. If the Revenue Bill was not passed by the Legislative Council by 5 July, the Order will lapse on that day.

4. The House Committee decided on 21 March to form a subcommittee to study the Order. The Subcommittee has held three meetings with the Administration, including one with deputations to hear their views on FRT proposals and the Order. The Subcommittee considered it inappropriate to repeal the Order, and recommended that a Bills Committee should be formed, commencing work in scrutinizing the Revenue Bill 2003 as soon as possible to enable early discussions on the Bill.

Abolishing Exemptions

5. In the 2000-01 Budget, the Government announced our intention to review the scope of exemptions from FRT with a view to updating the tax system. A review was conducted during the course of 2001 and 2002. When the current FRT system was first designed, the three exempted vehicle accessories namely air-conditioners, audio equipment and anti-theft devices, and the exempted distributors' warranties were either fitted to vehicles locally after the vehicles had arrived, or did not form part of the sales contracts of vehicles. The review found that these exemptions had become largely outdated, because the trade practice had changed over the years whereby the vast majority of exempted accessories were now in-built items of imported vehicles and the majority of the warranties today formed part of the sales contracts of the vehicles. The exemptions for the vehicle accessories and the distributors' warranties posed an unnecessary cost of compliance on the part of the trade (as vehicle distributors are required to apportion the values of the three exempted accessories even though the prices of such individual items are not separately provided by the manufacturers) and gave rise to tax evasion problems (through over-declaring the value of the tax-exempted items).

6. In order to prevent abuse, we propose to include a requirement for registered vehicle owners to declare to the Transport Department (TD) the purchasing of warranties (in addition to accessories) from any person (in addition to registered distributors and associated persons); and extend the requirement for payment of additional FRT for the accessories and warranties from three months after registration to six months thereafter. If registered distributors or associated persons offer the warranties, the registered distributors should also make the declaration to TD. These requirements, building on the existing anti-avoidance measures, are necessary to prevent tax avoidance through the purchase of previously-exempted accessories/warranties after first registration. It helps to level the playing field for all providers of accessories and warranties. The registered distributors, associated persons and registered owners would be required to keep the records of the distribution, sale and purchase of vehicles, and the accessories and warranties as applicable for thirty months from first registration for

inspection when required.

7. The Government has consulted the trade on the proposal to remove the exemptions and the proposed anti-avoidance measures (but not the tax increase proposed in the 2003-04 Budget) in the latter part of 2001. The trade did not express in-principle objection to the removal of exemptions and the enhanced anti-avoidance measures per se. Some of them suggested that the Government should widen the bands, reduce the rates and change to a marginal tax system for private cars. Some of them remarked that the anti-avoidance period for accessories and warranties and the proposed record-keeping period should be lengthened, while others opposed the requirement for registered owners and distributors to declare fitting of accessories and warranties on grounds of administrative complexity. When the Subcommittee deliberated on the Order, the Motor Traders Association of Hong Kong (MTA) expressed strong support for the proposal to remove exemptions. The Hong Kong Right Hand Drive Motors Association (RHDMA), the Motor Alliance, the Hong Kong Motorcycle Association, the Hong Kong Motorcycle of Commerce and the Motorcycle Alliance have expressed in-principle support.

Adjustments to Bandwidths and Tax Rates

Private cars

8. As mentioned above, we propose to abolish the exemptions for vehicle accessories and distributors' warranties. Private cars are usually fitted with three to four exempted items. The value of the exempted items constitutes a larger percentage of the taxable value of the vehicle for lower-priced private cars (e.g. 68% for private cars with taxable value, i.e. published retail price of the motor vehicle excluding the value of exempted items, below \$100,000). We therefore propose to widen the tax bandwidths for private cars from \$100,000 for the first three steps to \$150,000 for the first two steps and \$200,000 for the third step, and to decrease the effective tax rate for these cars to mitigate the impact of abolishing the exemptions. Besides, we also propose to switch to a marginal tax system which is more equitable. These were in response to the requests of some trade associations expressed during the consultation in 2001.

9. In order to raise additional revenue, we also propose to increase the tax rates for more expensive private cars with taxable value over \$150,000, and make the tax more progressive. The proposed marginal rates are 35%, 75%, 105% and 150% for the four bands respectively. These are marginal tax rates which cannot be compared directly with the tax rates under the pre-Budget system. The new effective tax rates for private cars with taxable value below \$150,000, between \$150,001 and \$300,000, between \$300,001 and \$500,000 and above \$500,000 would be 35%, 46%, 65% and 95% respectively on average. The pre-Budget system and the new system proposed for all types of vehicles are set out in **Annex A**.

10. While the above proposed changes will bring about an increase in tax liability for the majority of private cars, the increase is merely due to the abolition of exemptions rather than any increase in the tax rate for the bulk of private cars. We have looked at the impact of the adjustments on 12 representative car models, details of which are set out in **Annex B**. The share of these 12 models as a percentage of the total number of first registrations in 2001-02 and 2002-03 (up to 5 March 2003) is 17% and 15% respectively. Assuming no change in pricing strategies, the new tax rates would lead to an increase in retail price inclusive of the tax component in a range between 5% and 27% for these 12 models.

11. The impact of the proposed adjustments will be uneven. It will be higher for more expensive private cars and lower for less expensive cars, because the tax rates for the latter group have been reduced or adjusted less progressively. Nevertheless, expensive cars only represent a small portion of the private car markets in Hong Kong. In 2002-03 (up to 5 March 2003), there were 28,962 first registrations of private cars. As shown in **Annex C**, only about 6% or 1,803 of the private cars first registered had a taxable value (after including the formerly tax-exempted items) in excess of \$500,000 (examples of such car models include Lexus - LS430, Mercedes - S350L, BMW - 735I and Porsche - 911 Carrera 4 Coupe). Private cars with taxable value below \$500,000 accounted for 94% of the market. The impact of the proposed adjustments on these 94% of private cars ranged between 5% - 12%, applying the representative model analysis.

12. Those private cars with taxable value below \$300,000 accounted for 82% of the market in 2002-03. The impact of the proposed adjustments on these 82% of private cars ranged between 5% - 11%, applying the representative model analysis.

13. Some distributors may choose not to pass the full tax burden on to consumers and may change their pricing strategies. If so, the increase in retail price because of the abolition of exemptions and tax changes would be smaller. The Customs and Excise Department conducted a survey in March 2003. It is found that for five out of the 12 representative models we have sampled, the retail prices had not increased by the full amount of the increase in tax liability. This was more common with higher-priced private cars. Vehicle dealers have absorbed 0.1% - 19% of the tax increase for four of the models, and 74% for the remaining one. The vehicle dealers might have lowered their profit margin or shortened the warranty period.

14. According to TD's statistics, there were 1,636 private car first registrations in the week before the Budget this year, as compared with the weekly average of 571 for 2002-03 (detailed figures are set out in **Annex D**). This represents 287% of the weekly average number of registrations in 2002-03. As the market would need some time to digest this surge in volume, the number of private car registrations has dropped to 59 during the week after Budget announcement (i.e. from 6 March to 12 March). However, while the number of first registrations immediately after the Budget announcement slowed down, this has started to pick up again. The numbers of private car registrations for the three weeks beginning 24 March, 31 March, and 7 April respectively were 328, 317 and 325. These represent 56% to 57% of the 2002-03 weekly average. For the month following the Budget announcement there have been 898 first registrations for private cars. This represents 36% of the monthly average of 2474 for 2002-03.

Motorcycles

15. Motorcycles normally do not have air-conditioners and audio-equipment. According to a survey we conducted, motorcycles are usually provided with one or two of the items exempted under the old

taxation regime. Compared with private cars which are usually fitted with three to four such items, the impact of abolishing exemptions is significantly higher on private cars than on motorcycles. We therefore propose not to make any adjustment to the tax rates on motorcycles.

16. Based on the published retail prices of the motorcycles registered in 2002-03, their price inclusive of the tax component should rise by 8% on average after the abolition of the exempted items, assuming no change in pricing strategies. This is smaller than the projected increase in retail price of 11% for the representative models of lower-priced private cars with taxable value below \$150,000.

17. There were 105 motorcycle first registrations in the week before the Budget this year, as compared with the weekly average of 92 for 2002-03. The number dropped to 61 for the week from 6 to 12 March. However, this has also started to pick up again and has risen back to its normal level. The numbers of motorcycle registrations for the three weeks beginning 24 March, 31 March, and 7 April respectively were 91, 54 and 81. These represent 59% to 99% of the 2002-03 weekly average. For the month following the Budget announcement there have been 316 first registrations for motorcycles. This represents 86% of the monthly average of 368 for 2002-03.

Commercial vehicles

18. For commercial vehicles such as buses, light buses, taxis, and goods and special purpose vehicles, we propose to lower their tax rates to mitigate the impact of abolition of exemptions. The proposals are not expected to affect the transport trade's livelihood.

Effects on the Economy

19. We expect the proposed adjustments would have some initial psychological impact on consumers but this impact will gradually fade over time.

20. As can be seen from above, there were 3,026 registrations in private cars in the month before the Budget. The figure for the month before and the month after the Budget combined was 3,924, 159% of the

2002-03 monthly average. With the effect of the Budget rush, some time will be needed for the market to digest the surge in volume.

21. Secondly, we understand from the trade that some prospective car buyers are adopting a wait-and-see approach. As the adjustment proposals are being considered by the Legislative Council, such buyers wish to await a decision on the tax rates before making purchase decisions. This could have contributed partly to the reduced number of first registrations after the Budget announcement.

22. Third, as can be seen from the above analysis, the impact on retail prices of less expensive cars both in money or percentage terms is not significant. Since less expensive cars account for the bulk of Hong Kong's private car market, we do not expect the tax adjustment proposals would have major impact on such vehicles and hence the overall sales and employment situation for the private car market should not be unduly affected by the adjustment proposals.

23. Before the present proposal, the Government last raised FRT in the 1991-92 Budget and the 1990-01 Budget respectively, when the FRT rates for private cars were raised in ranges of 12.5% to 20% and 11% to 14%. Both tax increase exercises yielded significant revenues from FRT. For these two exercises, FRT revenues increased by 67% (for 1991-92) and 18% (for 1990-91) over the previous year as a result. For this year, the estimated FRT receipts in 2003-04 are projected to be about 30%, or \$700 million higher than without the Budget measure, which is only half of the amount under the scenario of an unconstrained market. This additional revenue represents about 22% of the 2003-04 estimate of \$3,182 million. We consider this estimate appropriate as we have already factored in a 15% drop in the total number of private cars to be registered, and a 10% drop in the average tax payable for private cars (due to possible changes in the pricing strategy of vehicle dealers pursuant to the inclusion of the formerly-exempted items in the calculation of taxable value). These forecasted drops are on top of a projected decline in the overall sale of cars in 2003-04 compared with the previous year.

24. According to a study carried out by the Government

Economist, the Budget proposals on FRT would not have a significant effect on the economy as a whole. The effect of the increases on GDP growth is estimated to be very insignificant, amounting to less than a hundredth of a percentage point. According to the Census and Statistics Department, the number of persons engaged in the wholesale, retail (including fitting of accessories) and import and export trade of motor vehicles, motorcycles and bicycles was about 12,330 persons in 2002 (630 persons in wholesale, 5,900 persons in retail and 5,800 persons in import and export trade). This number includes employees engaged by authorised dealers, parallel importers as well as shops selling and fitting accessories. Except those dealing only in bicycles, they represent the group whose business might be affected most by the Budget proposals on FRT. The Labour Department advises that, as of 12 April 2003, there was no report of labour disputes handled by the Department involving major vehicle distributor or accessories businesses closing down after the Budget proposals took effect on 5 March. Separately, there were about 10,000 persons who were engaged in the servicing and repairing of motor vehicles and motorcycles as at March 2002. This group might benefit if people tend to hold on to their existing vehicles for a longer period.

Conclusion

25. As highlighted in the 2003-04 Budget Speech, the budget deficit problem has become very serious. There is a need to devise relevant revenue-raising measures to tackle the problem. We believe that increasing the tax rates on private cars is a proposal which does not affect people's livelihood. We expect the slow-down in car sales would be only a temporary phenomenon, that car sales should pick up after the initial psychological impact of the tax increase on consumers has faded, and that this should have a limited impact on the motor trade or the economy. We urge Members to support the Government's proposal to adjust FRT rates and the related proposals as contained in Revenue Bill 2003.

Treasury Branch
Financial Services and the Treasury Bureau
April 2003

First Registration Tax on Motor Vehicles

Vehicle type	Present tax bands and rates	Proposed tax bands and rates #
Private cars	(a) taxable value does not exceed \$100,000 40% (b) taxable value exceeds \$100,000 but does not exceed \$200,000 45% (c) taxable value exceeds \$200,000 but does not exceed \$300,000 50% (d) taxable value exceeds \$300,000 60%	(a) for first \$150,000 of taxable value 35% @ (b) for next \$150,000 75% @ (c) for next \$200,000 105% @ (d) for the balance (i.e. for taxable value over \$500,000) 150% @
Motor cycles	40%	40%
Motor tricycles	40%	40%
Goods vehicles		
Van-type light goods vehicles not exceeding 1.9 tonnes permitted gross vehicle weight	(a) taxable value does not exceed \$100,000 40% (b) taxable value exceeds \$100,000 but does not exceed \$200,000 45% (c) taxable value exceeds \$200,000 50%	(a) for first \$150,000 of taxable value 35% @ (b) for next \$150,000 of taxable value 75% @ (c) for the balance (i.e. for taxable value over \$300,000) 105% @
Van-type light goods vehicles exceeding 1.9 tonnes permitted gross vehicle weight	20%	17%
Goods vehicles, other than van-type light goods vehicles	18%	15%
Taxis	4%	3.7%
Public and private light buses		
Public and private buses (except those exempted from the Motor Vehicle First Registration Tax as specified in the relevant Ordinance)		
Special purpose vehicles		

Under the proposed tax system, no exemption will be given to air-conditioners, audio equipment, anti-theft devices or distributors' warranties. Also, the marginal tax system will be adopted for private cars and van-type light goods vehicles not exceeding 1.9 tonnes.

@ These are marginal tax rates.

Impact analysis of 2003-04 Budget proposals on individual private car models

Vehicle Model	Old tax system #						New tax system @					
	(I) Taxable value under old FRT regime	(II) Value of exempted items	(III) Tax under old FRT regime (<=\$100,000@40% \$100,001-\$200,000@45% \$200,001-\$300,000@50% >\$300,000@60%)	(IV) Old tax as % of old taxable value	(V) Retail price (including the old taxable value) under old FRT regime	(VI) Old tax as % of old retail price (including the old taxable value)	(VII) New taxable value after including exempted items	(VIII) Tax under new FRT regime (First \$150,000@35% Next \$150,000@75% Next \$200,000@105% Value>\$500,000@150%)	(IX) New retail price (including the new taxable value)	(X) New tax as % of new taxable value	(XI) New tax as % of new retail price (including the new taxable value)	(XII) % difference in retail price (including the taxable value) after tax increase
Toyota Picnic	88,700	63,820	35,480	40%	188,000	19%	152,520	53,382	205,902	35%	26%	10%
Toyota Corolla	61,300	54,080	24,520	40%	139,900	18%	115,380	40,383	155,763	35%	26%	11%
Toyota Echo	34,700	30,420	13,880	40%	79,000	18%	65,120	22,792	87,912	35%	26%	11%
Toyota Camry	106,500	63,500	47,925	45%	217,925	22%	170,000	67,500	237,500	40%	28%	9%
Mercedes C200k - Classic	157,000	35,700	70,650	45%	263,350	27%	192,700	84,525	277,225	44%	30%	5%
Mercedes E240V6 - Avantgarde	250,000	61,000	125,000	50%	436,000	29%	311,000	176,550	487,550	57%	36%	12%
Mercedes ML320	217,000	61,000	108,500	50%	386,500	28%	278,000	148,500	426,500	53%	35%	10%
Lexus - LS430	415,300	125,520	249,180	60%	790,000	32%	540,820	436,230	977,050	81%	45%	24%
Mercedes S320L	366,000	53,000	219,600	60%	638,600	34%	419,000	289,950	708,950	69%	41%	11%
Mercedes S350L	480,000	70,700	288,000	60%	838,700	34%	550,700	451,050	1,001,750	82%	45%	19%
BMW - 735I	530,000	106,400	318,000	60%	954,400	33%	636,400	579,600	1,216,000	91%	48%	27%
Porsche - 911 Carrera 4 Coupe	654,625	52,600	392,775	60%	1,100,000	36%	707,225	685,838	1,393,063	97%	49%	27%

Old tax system refers to the system which was in place before 2:30 p.m. on 5 March 2003 when the Public Revenue Protection Order took effect.

@ New tax system refers to the system which is in effect since 2:30 p.m. on 5 March 2003 after the Public Revenue Protection Order took effect.

Annex C

Private cars first registered in 2002-03 (up to 5 March 2003)

Taxable value (including formerly tax-exempt items)	No. of cars liable to FRT	% of the total no. of first registrations
Below \$150,000	13,369	46%
\$150,001 - \$300,000	10,427	36%
\$300,001 - \$500,000	3,363	12%
Over \$500,000	1,803	6%
Total:	28,962	100%

	Total FRT revenue for all vehicles types (\$million)	Date of Budget / Change in tax system or rates	No. of private cars first registration						
			One week before Budget Day or date of change of tax system / rates	One week after Budget Day or date of change of tax system / rates	One month before Budget Day or date of change of tax system / rates	One month after Budget Day or date of change of tax system / rates	Total number of first registration	Monthly Average	Weekly Average
1981-82	484	25.2.1981 (Budget Day)	2,227	167	4,455	1,427	32,978	2,748	634
1982-83	384	24.2.1982 (Budget Day)	1,665	232	3,283	2,408	12,009	1,001	231
		5.5.1982 *	494	177	2,196	941			
1983-84	316	23.2.1983 (Budget Day)	71	128	876	521	6,319	527	122
1984-85	350	29.2.1984 (Budget Day)	239	54	571	329	7,336	611	141
1985-86	634	27.2.1985 (Budget Day)	59	169	924	656	12,074	1,006	232
1986-87	964	26.2.1986 (Budget Day)	402	218	1,288	786	14,965	1,247	288
1987-88	1,447	25.2.1987 (Budget Day)	381	410	1,388	1,385	21,177	1,765	407
1988-89	1,922	2.3.1988 (Budget Day)	613	153	2,086	1,159	27,303	2,275	525
1989-90	1,735	1.3.1989 (Budget Day)	1,505	82	3,314	1,072	27,318	2,277	525
1990-91	2,054	7.3.1990 * (Budget Day)	1,484	71	4,247	1,131	26,934	2,245	518
1991-92	3,437	6.3.1991 * (Budget Day)	1,131	119	2,214	1,401	36,842	3,070	709
1992-93	4,940	4.3.1992 (Budget Day)	3,071	193	5,471	1,749	41,421	3,452	797
1993-94	4,192	3.3.1993 (Budget Day)	3,287	57	6,583	1,393	41,482	3,457	798
1994-95	4,662	2.3.1994 (Budget Day)	2,955	208	4,986	1,859	34,158	2,847	657
		1.8.1994 #	2,015	54	4,732	1,920			
1995-96	2,880	1.3.1995 (Budget Day)	3,716	55	5,214	1,126	20,174	1,681	388
1996-97	3,249	6.3.1996 (Budget Day)	496	374	1,605	1,877	26,820	2,235	516
1997-98	4,246	12.3.1997 (Budget Day)	651	772	2,551	3,301	44,056	3,671	847
1998-99	2,237	18.2.1998 (Budget Day)	522	507	3,167	3,021	29,641	2,470	570
1999-2000	2,613	3.3.1999 (Budget Day)	324	483	1,306	2,157	32,231	2,686	620
2000-01	3,025	8.3.2000 (Budget Day)	2,030	200	3,780	1,877	34,346	2,862	661
2001-02	2,676	7.3.2001 (Budget Day)	1,701	343	3,789	2,217	33,274	2,773	640
2002-03	2,605 α	6.3.2002 (Budget Day)	673	415	1,760	2,042	29,687	2,474	571
2003-04		5.3.2003 @ (Budget Day)	1,636	59	3,026	898			

* Change of tax rates

Change of tax system w.e.f. 1.8.1994

@ Change of tax system and rates w.e.f. 5.3.2003

α 2002-03 Revised Estimate