Bills Committee on Revenue (No. 2) Bill 2003

The Administration's response to the issues raised by Members during the meeting of the Bills Committee on 13 May 2003 are set out below:-

<u>Impact of the outbreak of the Severe Acute Respiratory Syndrome (including the proposed relief measures) on revenue estimates</u>

2. Due to the impact of the Severe Acute Respiratory Syndrome (SARS) outbreak, the forecast of 3% GDP growth in real terms for this year as put out in the Budget is unlikely to be attainable. An updated forecast on GDP and prices, incorporating the impact of SARS, will be put out on 30 May.

3. Given that government revenue has a close relationship with economic performance, we expect the revenue outturn to be lower than the revenue estimates in the 2003-04 Budget. In addition, the relief package announced on 23 April 2003 includes government revenue concessions and rebate amounting to $5.3 billion ($2.1 billion for rates concessions, $0.5 billion on waiver of charges on water, sewage and trade effluent surcharges, $0.3 billion on waiver of licencing fees, $2.3 billion on salaries tax rebate, and $0.1 billion on rent concessions for tenants of government properties). However it is too early to make any meaningful forecast of the likely shortfall in revenue, particularly as our major revenue items such as profits and salaries tax are mostly received towards the end of our financial year. We will closely monitor the situation.

<u>Adding analysis and information about level of salaries tax before 1998-99 concessions to the table "Effect of the revision of the first $120,000 chargeable income"</u>

4. The table has been revised to include information before the 1998-99 concessions. Revised table is at ***Appendix A***.

<u>Committee Stage Amendments relating to holiday warrant and passage and impact of the removal of the exemption on airline/travel industry</u>

5. At present, holiday warrant/passage is excluded from a person’s income for the purpose of salaries tax assessment. This is the only type of employment benefit which is specifically exempt from salaries tax. To make the system more equitable, we propose to remove the exemption for holiday warrant/passage.

6. In other jurisdictions, including Australia, New Zealand, Canada, Singapore and the UK, holiday warrant/passage is taxable.

7. In Revenue (No. 2) Bill 2003, it is proposed (in Clause 3) that the existing exemption provisions under section 9(1)(a) of the Inland Revenue Ordinance (Cap. 112) be deleted with effect from the 2003-04 year of assessment. The implications of this proposal are that holiday warrant/passage will be assessed according to the general taxing principles on benefits-in-kind, i.e. it will be assessed and subject to tax if it is capable of being converted into money, or it is a discharge of the employee's personal liability to pay for the passage. On the other hand, a holiday warrant/passage not convertible into money and which is not a discharge of the employee's personal liability will continue to be exempt.

8. Following the introduction of the Bill, there have been suggestions that it may be more equitable also to subject also holiday warrants/passages not convertible into money to tax to discourage abuse. An example of avoidance would be an employer converting a holiday warrant/passage allowance into an air-ticket or a holiday tour and giving it to his employee (and/or the employee’s family members).

9. Upon careful review, the Inland Revenue Department (IRD) has reached a view that such avoidance is possible and should be prevented. As mentioned at the last Bills Committee meeting, we propose to add a specific provision to subject all holiday warrants/passages, irrespective of whether they are convertible to cash, to tax. This amendment will bring our proposed arrangements more into line with international practice.

10. Again, as mentioned at the last meeting, there are two principal approaches in determining the taxable value of holiday warrant/passage, which is by market value, or by cost incurred by the employer. Most of the other jurisdictions we have looked at, including the United Kingdom, Canada, Australia and New Zealand, adopt the latter. We propose to follow the practice to tax on the cost incurred by the employer. For example, airline staff who benefit from discounted or free air-tickets from their employer will not be taxed on the benefit if their employer does not incur cost on the

air-tickets.

11. Under our proposal, expenses for business trips in the performance of a taxpayer's duty as an employee are not regarded as employment income and hence not assessable. In cases where a holiday trip is combined with a duty visit, IRD will look at the immediate purpose of the trip; if a holiday is merely incidental to a business trip, IRD would refrain from taxing the benefit. Where the situation is not as clear-cut, an apportionment according to circumstances will arise. IRD will consider issuing a Departmental Interpretation and Practice Note to explain the basis of apportionment in practice.

Proposal on Increasing the Rate of Deeming Profits for Certain Intellectual Property–Related Payments [By Non-residents]

12. We have set out in detail our proposal on increasing the deeming rate for certain intellectual property-related payments by non-residents for Members' reference. The requested paper is at ***Appendix B***.

Response to Issues raised by Senior Assistant Legal Adviser

13. We have responded separately to the Senior Assistant Legal Adviser regarding the issues raised in his letter of 12 May 2003.

Financial Services and the Treasury Bureau
May 2003

Effect of the revision of the marginal tax bands and rates on tax payable for the first $120,000 chargeable income

			Before 1998-99 concessions			Present			2003-04			2004-05		
Chargeable income ($)		**Cumulative income ($)**	**Rate**	**Tax ($)**	**Cumulative tax ($)**	**Rate**	**Tax ($)**	**Cumulative tax ($)**	**Rate**	**Tax ($)**	**Cumulative tax ($)**	**Rate**	**Tax ($)**	**Cumulative tax ($)**
First	10,000	10,000	2.0%	200	200	2.0%	200	200	2.0%	200	200	2.0%	200	200
Next	10,000	20,000	2.0%	200	400	2.0%	200	400	2.0%	200	400	2.0%	200	400
Next	10,000	30,000	2.0%	200	600	2.0%	200	600	2.0%	200	600	2.0%	200	600
Next	2,500	32,500	8.0%	200	800	2.0%	50	650	2.0%	50	650	8.0%	200	800
Next	2,500	35,000	8.0%	200	1,000	2.0%	50	700	7.5%	187	837	8.0%	200	1,000
Next	2,500	37,500	8.0%	200	1,200	7.0%	175	875	7.5%	188	1,025	8.0%	200	1,200
Next	2,500	40,000	8.0%	200	1,400	7.0%	175	1,050	7.5%	187	1,212	8.0%	200	1,400
Next	10,000	50,000	8.0%	800	2,200	7.0%	700	1,750	7.5%	750	1,962	8.0%	800	2,200
Next	10,000	60,000	8.0%	800	3,000	7.0%	700	2,450	7.5%	750	2,712	8.0%	800	3,000
Next	2,500	62,500	14.0%	350	3,350	7.0%	175	2,625	7.5%	188	2,900	14.0%	350	3,350
Next	2,500	65,000	14.0%	350	3,700	7.0%	175	2,800	7.5%	187	3,087	14.0%	350	3,700
Next	2,500	67,500	14.0%	350	4,050	7.0%	175	2,975	13.0%	325	3,412	14.0%	350	4,050
Next	2,500	70,000	14.0%	350	4,400	7.0%	175	3,150	13.0%	325	3,737	14.0%	350	4,400
Next	10,000	80,000	14.0%	1,400	5,800	12.0%	1,200	4,350	13.0%	1,300	5,037	14.0%	1,400	5,800
Next	10,000	90,000	14.0%	1,400	7,200	12.0%	1,200	5,550	13.0%	1,300	6,337	14.0%	1,400	7,200
Next	2,500	92,500	20.0%	500	7,700	12.0%	300	5,850	13.0%	325	6,662	20.0%	500	7,700
Next	2,500	95,000	20.0%	500	8,200	12.0%	300	6,150	13.0%	325	6,987	20.0%	500	8,200
Next	2,500	97,500	20.0%	500	8,700	12.0%	300	6,450	13.0%	325	7,312	20.0%	500	8,700
Next	2,500	100,000	20.0%	500	9,200	12.0%	300	6,750	18.5%	463	7,775	20.0%	500	9,200
Next	2,500	102,500	20.0%	500	9,700	12.0%	300	7,050	18.5%	462	8,237	20.0%	500	9,700
Next	2,500	105,000	20.0%	500	10,200	12.0%	300	7,350	18.5%	463	8,700	20.0%	500	10,200
Next	2,500	107,500	20.0%	500	10,700	17.0%	425	7,775	18.5%	462	9,162	20.0%	500	10,700
Next	2,500	110,000	20.0%	500	11,200	17.0%	425	8,200	18.5%	463	9,625	20.0%	500	11,200
Next	10,000	120,000	20.0%	2,000	13,200	17.0%	1,700	9,900	18.5%	1,850	11,475	20.0%	2,000	13,200

Appendix B

Revenue (No. 2) Bill 2003

Clause 5 - profits from cinematograph films, patents, trademarks, etc.

Under our profits tax regime, a non-resident who does not carry on business in Hong Kong and who may not have any physical presence here is still liable to profits tax if he receives payments in the form of royalties or licence fees for the use of or right to use in Hong Kong certain intellectual properties.

2. Currently, under section 21A(1)(b) of the Inland Revenue Ordinance (Cap. 112) (IRO), 10% of such receipts by non-residents are deemed to be the recipient's assessable profit. This deemed profit is subject to profits tax (at 16% at present). The effective tax rate is therefore 1.6% (i.e. 10% x 16%) at present. Clause 5 of the Bill seeks to increase the rate of deeming such receipts as profits from 10% to 30%. The Bill also proposes to increase the corporation profits tax rate from 16% to 17.5%. Therefore, the effective tax rate after the amendment will be 5.25% (i.e. 30% x 17.5%). The change is illustrated in the following example in which a Hong Kong company pays an overseas company $10,000 as royalty for patent.

Under existing legislation:

Assessable profits of overseas company	=	$10,000 x 10%	
	=	$1,000	
Tax payable	=	$1,000 x 16%	
	=	$160	
Effective tax rate	=	$160 / $10,000	x 100% = 1.6%

After amendment:

Assessable profits of overseas company	=	$10,000 x **30%**	
	=	$3,000	
Tax payable	=	$3,000 x **17.5%**	
		$525	
Effective tax rate	=	$525 / $10,000	x 100% = 5.25%

3. After the proposed increase in deeming rate for assessable profits, the effective tax rate in Hong Kong for such payments (at 5.25%) should still be the lowest in comparison with neighbouring jurisdictions. The effective tax rates for royalty paid to non-residents in some neighbouring jurisdictions are set out in the following table.

Jurisdictions	Effective tax rate for royalty paid to non-residents
Indonesia	20%
Japan	20%
Mainland China	10%
Malaysia	10%
Singapore	15%
South Korea	25%

Financial Services and the Treasury Bureau
May 2003