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Report of the Bills Committee on
Revenue (No. 2) Bill 2003

Purpose

This paper reports on the deliberations of the Bills Committee on Revenue (No.2) Bill 2003 (the Bill).

Background

2. In the 2003-04 Budget, the Financial Secretary (FS) has pointed out that although the economy has shown signs of improvement in real terms, the Government's huge fiscal deficit, if not resolved early, will dampen investors' confidence and stifle economic recovery. FS has forecast a consolidated deficit of $70 billion for 2002-03, $24.8 billion higher than the original estimate. Meanwhile, the Government's Consolidated Account has registered a deficit in four of the past five years while its Operating Account, which reflects government day-to-day revenue and expenditure, has been in deficit for five years in a row.

3. FS has stated that the Administration will seek to eliminate the problem of fiscal deficit through a three-pronged approach, namely, to boost the economy, cut expenditure and raise revenue. To achieve the target of attaining fiscal balance by 2006-07, the Administration aims to generate $20 billion through raising revenue and another $20 billion through reducing operating expenditure in the next four years. Against this background, FS has proposed in the 2003-04 Budget a number of tax increases. If fully implemented, these proposals will raise revenue by $14 billion.

The Bill

4. The Bill seeks to implement the revenue proposals relating to salaries tax, profits tax and property tax announced in the 2003-04 Budget. The major proposed adjustments are as follows:

Salaries tax

(a) to revert the marginal salaries tax rates and bands, as well as the Basic Allowance, Married Person's Allowance and Single Parent Allowance to their levels before the concessions made in 1998-99, to be implemented over the 2003-04 and 2004-05 years of assessment;

(b) to increase the standard rate of salaries tax from 15% to 16% in two phases over two years of assessment;

(c) to remove the exemption for holiday warrants and passage;

(d) to increase the allowance for the third to ninth child from $15,000 to $30,000; and

(e) to raise the ceiling for tax deductible charitable donations from 10% to 25% of assessable income.

Profits tax

(f) to increase the tax rate for corporations from 16% to 17.5% effective from 2003-04 year of assessment;

(g) to increase the tax rate for unincorporated businesses from 15% to 16% in two phases over two years of assessment;

(h) to increase the rate of deeming assessable profits for certain payments, such as royalties and licence fees, from 10% to 30% and

(i) to raise the ceiling for tax deductible charitable donations from 10% to 25% of assessable profits.

Property tax

(j) to increase the property tax rate from 15% to 16% in two phases over two years of assessment.

The Bills Committee

5. At the House Committee held on 25 April 2003, members agreed that a Bills Committee should be formed to study the Bill. Hon Eric LI Ka-cheung was elected Chairman of the Bills Committee and the membership list of the Committee is at **Appendix I.** The Bills Committee has held three meetings to examine the Bill. The organizations which have submitted views to the Bills Committee is at **Appendix II**.

Deliberations of the Bills Committee

<u>Overall views on the Bill</u>

6. The Bills Committee is fully aware that the main objective of the Bill is to help tackle the fiscal deficit by raising revenue through adjustments to salaries tax, profits tax and property tax. Some members of the Bills Committee have expressed concern about certain proposals relating to salaries tax and profits tax. Members note the proposed increase in property tax and have not raised any queries.

7. Some members of the Bills Committee have stated their position on the Bill. Hon CHAN Kam-lam reckons that any proposal to increase taxes is unlikely to be welcomed. However, as most of the proposed tax increases will be implemented in phases over two years and a one-off salaries tax rebate for the 2001-02 year of assessment has been proposed, Members of the Democratic Alliance for Betterment of Hong Kong consider that the tax burden on taxpayers can be alleviated to a certain extent. In the absence of other viable alternatives to cut expenditure and raise revenue significantly, they are prepared to support the Bill on account of the need to resolve the deficit problem.

8. Hon Selina CHOW appreciates the serious deficits faced by the Government and agrees that certain revenue-raising measures are necessary to help restore fiscal balance. Having regard that many of the tax proposals in the Bill are to be implemented over two years, Members of the Liberal Party consider the Bill by and large acceptable as it will not impose an immediate and heavy financial burden on the community.

9. On behalf of Members of the Democratic Party, Hon SIN Chung-kai has stated that they will object to certain provisions of the Bill relating to proposed adjustments in salaries tax but will support the other proposals in the Bill.

10. Hon Emily LAU states the objection of Members of the Frontier to the Bill as they are of the view that it is inappropriate to introduce tax increases

at this point of time when the economy is still in the doldrums and the various sectors are yet to recover from the impact of the Severe Acute Respiratory Syndrome (SARS).

<u>Impact of the outbreak of SARS on revenue estimates</u>

11. The Bills Committee notes that according to the Administration's original estimate, if the proposals in the Bill are implemented, a total of $10.37 billion will be raised (namely, $6.8 billion from salaries tax, $3.5 billion from profits tax and $70 million from property tax) in a full year, less a cost to revenue of about $100 million due to the concession on charitable donation deductions. Nevertheless, following the outbreak of SARS in late March 2003 which has dealt a heavy blow on Hong Kong's economy, members have expressed grave concern about the impact of SARS on the Administration's revenue estimates.

12. In this regard, the Bills Committee notes that the Administration is not in a position to make a meaningful forecast of the revenue outturn for 2003-04 at this stage. Nevertheless, the Administration has explained that due to the outbreak of SARS, the forecast 3% growth in GDP in real terms for this year cannot be attained. According to the latest economic forecast released on 30 May 2003, the forecast growth of GDP in real terms has been lowered to 1.5%. Given the downward revision of economic growth for 2003 and the financial implications of the SARS relief and support package announced on 23 April 2003, the Government expects a lower revenue outturn for 2003-04 than the original estimate of $193.5 billion. For example, the drop in profits and income levels will likely lead to more applications for holding over of the 2003-04 provisional tax charged and a higher arrears rate by the year end than originally estimated. The receipts from betting duty, stamp duty and hotel accommodation tax are expected to drop in view of the falling attendance at horse racing meetings, the sluggish property market and low hotel occupancy rates.

<u>Salaries tax</u>

Adjustments to salaries tax

13. The Bills Committee notes from the Final Report by the Advisory Committee on New Broad-based Taxes that out of a working population of some 3.2 million, only 1.2 million are paying salaries tax. Statistics also show that the top 100 000 taxpayers account for 61.4% of all salaries tax. Some members consider that under the existing salaries tax regime, middle-class professionals still bear the brunt of the tax burden. There are also comments that for professionals with higher income, the proposed one-off salaries tax rebate (capped at $3,000 per case) cannot offset the tax implications of reverting the marginal tax rates and tax bands to their levels before the

concessions made in 1998-99.

14. On the proposed adjustments to salaries tax, Hon SIN Chung-kai has stated that Members of the Democratic Party disagree with the proposals in the Bill to revert the tax bands and marginal rates, as well as various Personal Allowances (namely, Basic, Married Person and Single Parent Allowances) to their levels before the 1998-99 concessions, as provided in clause 10 and clause 11 respectively. He has indicated that he will move the necessary Committee Stage Amendments (CSAs) to retain their existing levels.

Exemption of holiday warrants/passage for the purpose of salaries tax assessment

15. At present, holiday warrants/passage are 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, the Administration has proposed to remove this exemption such that the value of, as well as the allowance for the purchase of, any holiday warrant or passage payable by the employer will be assessed according to the general taxing principles on benefits-in-kind. Members note that under this arrangement, the holiday warrant/passage will be assessed and subject to salaries tax if it is capable of being converted into money, or if it is a discharge of the employee's personal liability to pay for the passage.

16. The Administration has reported to the Bills Committee that following the introduction of the Bill, it has received suggestions that holiday warrants/passage not convertible into money should also be subject to tax so as to prevent possible abuse. An example would be an employer converting a holiday warrant/passage allowance into an air ticket or a holiday tour and giving it to his employee. After careful review, the Administration has come to the view that such abuse is possible and should be avoided. As such, it has proposed a CSA to the effect that all holiday warrants/passage paid by the employer, irrespective of whether they are capable of being converted into money, will be included as assessable income for the purpose of salaries tax. The Administration has also advised that similar arrangements are adopted in other jurisdictions such as Australia, New Zealand, Canada, Singapore and the United Kingdom. The Administration has also clarified that the holiday warrants/passage paid by the employer to the employee will be subject to salaries tax assessment irrespective of whether such warrants/passage are used by the employee himself, or his family members or other parties.

17. Hon Howard YOUNG has informed the Bills Committee that the travel industry does not consider the removal of the exemption entirely satisfactory, although there is also a view that people who intend to travel usually are not too concerned about whether the expenses incurred are subject to tax exemption or not. In the course of deliberation, some members have

questioned the implications of clause 3 and the Administration's proposed CSA on the benefit currently enjoyed by some employees (such as airline staff) on discounted or free air tickets provided by their employers. They are concerned that if the value of such air tickets is subject to salaries tax, a major fringe benefit of airline employees will be affected.

18. In response to members' concerns, the Administration refers to the two principal approaches in determining the taxable value of holiday warrants/passage, namely, by referring to market value or to the cost incurred by the employer. Having studied overseas practice, the Administration has decided to adopt the latter approach in determining the taxable value by making reference to the cost incurred by the employer. As such, the Administration has advised that in the case of airline staff who benefit from discounted or free air tickets from their employer, these employees will not be taxed on the benefit if their employer has not incurred cost on the air tickets.

19. Given the prevalence of business trips nowadays, some members of the Bills Committee have also enquired about the implications of the proposed amendments on such trips. In response, the Administration has confirmed that expenses for business trips in the performance of a taxpayer's duty as an employee are not regarded as employment income for the purpose of salaries tax assessment. Regarding concerns about a business trip combined with a holiday journey, the Administration has advised that if the holiday trip is merely incidental to the business trip, the Inland Revenue Department (IRD) will not tax the holiday benefit. Where the situation is not as clear-cut, an apportionment of the holiday and non-holiday portions according to circumstances may be required. IRD has confirmed that after passage of the Bill, it will issue a Departmental Interpretation and Practice Note (DIPN) to provide guidance on the basis for such apportionment. The Administration will give an undertaking to this effect at the Second Reading debate on the Bill.

20. Referring to the Administration's proposed CSA to the definition of "holiday journey" under section 9(6) of the Inland Revenue Ordinance (Cap.112) (IRO), which provides for the apportionment of a journey for holiday and other purposes, some members are concerned whether the definition should explicitly exclude a journey the predominant part or purpose of which is for non-holiday purposes. They are concerned that the amount paid by the employer in connection with such a journey will also be subject to apportionment for the purpose of salaries tax assessment.

21. To address members' concern, the Administration has confirmed that where a journey undertaken by the employee is predominantly for non-holiday purposes, the amount paid by the employer in connection with the journey will not be regarded as income for the purpose of salaries tax. As to whether the wording of the proposed definition of "holiday journey" under section 9(6) of IRO should be further revised to remove doubt, the Administration has advised

that explicitly excluding a journey predominantly for non-holiday purposes may have implications on other provisions in IRO. Moreover, it may not be practicable to specify all scenarios in the legislation. Instead, a more preferable approach is to provide for clear guidance in the DIPN. The Administration will confirm at the Second Reading debate that a DIPN on this subject will be issued.

22. Members note that if the Administration's proposed CSAs to clause 3 are enacted, then, the cost paid by an employer for any holiday warrant or passage to an employee will form part of the employee's income from employment and subject to salaries tax assessment. They share the view that employers and human resources personnel should be given adequate guidance and advice in the computation of employees' income, in particular for the purpose of filing tax returns. In this regard, the Administration has advised that IRD has been in close liaison with employer and business groups and no major problems are currently envisaged over the new arrangements. The Administration has also informed the Bills Committee that travel-related benefits only account for a very small part of the employee's employment income.

23. A member has commented that as most holiday warrants/passage usually cover overseas trips and tours, removing their exemption from the assessable income for the purpose of salaries tax may have the effect of encouraging more people to join local tours instead, and hence boosting domestic consumption.

<u>Profits tax</u>

Proposed increase in the rate of deeming assessable profits for certain intellectual property-related payments

24. At present, 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 payment in the form of royalties or licence fees for the use of, or right to use, certain intellectual properties in Hong Kong. The tax is on the recipient of the royalty payment and collected in the form of a withholding tax. Under existing section 21A(1)(b) of IRO, 10% of such payment received by the non-resident concerned are deemed to be his assessable profits subject to profits tax at the current rate of 16%. As such, the effective rate of the withholding tax is 1.6% (i.e. 10% x 16%) at present.

25. Clause 5 of the Bill seeks to amend section 21A(1)(b) of IRO to increase the deeming rate of assessable profits from 10% to 30% of the payments received by non-residents in the form of royalties or licence fees. As the Bill also seeks to increase the profits tax rate for corporations from 16% to 17.5%, therefore, the effective rate of the withholding tax after amendment

will become 5.25% (i.e. 30% x 17.5%).

26. The Bills Committee has noted the objection of the film and music record industries to clause 5 of the Bill. In presenting views to the Bills Committee, the relevant industry bodies have stressed that the proposed increase in effective tax rate, which is more than three-fold, will send a very bad signal to overseas trading partners, in particular for the film and music industries which often need to purchase the rights from overseas companies to release films or use certain intellectual properties (IPs) in Hong Kong. They have also submitted to the Bills Committee that under the existing trade practice of the film industry, local companies usually pay overseas IP owners the royalties/licence fees net of the withholding tax. Any shortfall in royalties/licence fees received by the overseas IP owner as a result of the increase in withholding tax will usually be borne by the local companies purchasing the IP rights. This will impose an additional burden on local companies and hit their net profits. The three major television broadcasters in Hong Kong have also submitted to the Bills Committee that the proposed increase in deeming rate will increase their operating costs. They urge that the deeming rate be maintained at the existing level.

27. In this connection, the Administration has pointed out that the proposed increase in deeming rate on assessable profits is not confined to royalty income from exhibition of foreign films in Hong Kong, but applies also to cases where other types of IP, such as design, trade marks, patents etc. are used in Hong Kong and fees for such usage are paid to the overseas IP owners. The Administration has estimated that the proposed increase in deeming rate, if enacted, will bring about an additional $90 million in revenue. According to the Administration's statistics, the royalties from foreign films constituted only around 3% (about $100 million) of all royalty payment made to non-residents. The amount of withholding tax from the film industry only accounted for less than 1% (about $1.65 million) of the total withholding tax collected.

28. As regards the extent of the proposed increase, the Administration has advised that even if the proposed increase in deeming rate is enacted, the effective tax rate of 5.25% on royalties paid to non-residents still compares much lower than the effective rates for comparable tax currently in force in neighbouring jurisdictions, which range from 10% in the Mainland and Malaysia to 20% in Japan and 25% in South Korea. On concerns that the increase in the deeming rate will result in a corresponding rise in royalty payment which will ultimately be borne by Hong Kong film distributors, the Administration considers that whether the increase in deeming rate will be factored into the bidding price for foreign films or result in higher royalty charged is a matter of commercial decision and is to be determined by the market.

29. On the Bills Committee's enquiry about the business outlook of the film and music-related industries, the deputations have informed members that a number of listed companies engaged in film and video businesses have incurred losses. While appreciating that the industries are operating in a very challenging environment, some members of the Bills Committee have put forward the view that the proposed tax increase should also be considered in the light of the Government's resources and active efforts in recent years to combat piracy and set up schemes such as the Film Development Fund and the Film Guarantee Fund to foster the growth of the industries.

30. Hon MA Fung-kwok does not object in principle to the proposed increase in profits tax rate in the face of fiscal deficits. However, he considers it unfair to target tax increases at particular industries, such as increasing the deeming rate for assessable profits which will affect local film and music-related industries in their purchase of IP rights from overseas IP owners. On the impact of the proposed increase, Mr MA has drawn the attention of the Administration to the market conditions of the film industry. The Bills Committee notes that the majority of Hollywood films are distributed in Hong Kong by the local agents/distributors of major film companies in the United States which own the IPs. As such, these local distributors may only need to pay a modest amount of royalty to the IP-owning companies in the United States and the proposed increase in the deeming rate on assessable profits (based on the amount of royalties received by the non-resident IP owners) may not adversely affect these distributors. However, local independent film distributors will be hard hit by the proposed increase as they do not benefit from any concessions in the amount of royalties.

31. On the arrangements for computing assessable profits for the purpose of profits tax, the Administration has clarified to the Bills Committee that under the existing requirements, 100% of the royalty paid by the non-resident's associate in Hong Kong (e.g. the Hong Kong subsidiary of a foreign film company) is already subject to profits tax. The proposed deeming rate of assessable profits at 30% of the royalty payment will only apply to royalties paid by local independent film distributors to foreign film companies.

32. Some members are concerned that local film distributors may be subject to double taxation in connection with their purchase of the rights to distribute films in Hong Kong and in neighbouring territories such as the Mainland and Southeast Asia. In response, the Administration has stressed that Hong Kong adopts a territorial source principle of taxation. Only profits which are derived from Hong Kong will be subject to profits tax. In other words, the royalty payment derived from the use of the IP in places outside Hong Kong will not be considered as assessable profits for the purpose of charging profits tax in Hong Kong. In this regard, the Bills Committee has been informed that in actual practice, there are some agreements signed between local film distributors and foreign film companies which apportion the

royalty payment from different territories, such that only the royalty payment derived from Hong Kong will be subject to local profits tax. The Administration also recognizes the merits in concluding double taxation agreements with Hong Kong's trading partners so as to provide local and overseas investors with greater certainty over their tax obligations and rights.

33. On the wordings of proposed section 21A(1)(b)(i) and (ii), the Administration has taken on board the concern of the Association of Chartered Certified Accountants (ACCA) and has confirmed that the new deeming rate of 30% will only apply to sums received by or accrued to the non-resident persons on or after 1 April 2003. The Administration will re-affirm this arrangement during the resumption of the Second Reading debate of the Bill. Apart from putting up the information on the Website of IRD on the Internet, IRD has confirmed this arrangement in writing with the Joint Liaison Committee on Taxation, ACCA and other professional bodies.

Committee Stage Amendments

34. Apart from the proposed CSAs relating to the exemption of holiday warrants/passage for the purpose of salaries tax assessment, the Administration will also move a number of amendments to improve textual clarity. Hon SIN Chung-kai will move CSAs to clauses 10 and 11 of the Bill. The Bills Committee will not move any CSAs in its name.

Consultation with the House Committee

35 The House Committee was consulted on 13 June 2003 and supported the resumption of the Second Reading debate of the Bill on 25 June 2003.

Council Business Division 1
Legislative Council Secretariat
20 June 2003

Appendix I

Bills Committee on Revenue (No. 2) Bill 2003

Membership list

Chairman	Hon Eric LI Ka-cheung, JP
Members	Dr Hon David CHU Yu-lin, JP Hon Albert HO Chun-yan Hon Mrs Selina CHOW LIANG Shuk-yee, GBS, JP Hon CHAN Yuen-han, JP Hon CHAN Kam-lam, JP Hon SIN Chung-kai Hon Howard YOUNG, JP Hon Emily LAU Wai-hing, JP Hon Henry WU King-cheong, BBS, JP Hon Frederick FUNG Kin-kee Hon LAU Ping-cheung Hon Audrey EU Yuet-mee, SC, JP Hon MA Fung-kwok, JP
	(Total : 14 Members)
Clerk	Miss Polly YEUNG
Legal Adviser	Mr Arthur CHEUNG
Date	12 May 2003

Appendix II

Organizations which have submitted views to the Bills Committee on Revenue (No. 2) Bill 2003

Copyright and Trade Mark-related organizations

1. Hong Kong Kowloon & New Territories Movie Picture Industry Association

2. International Federation of the Phonographic Industry (Hong Kong Group) Limited

3. Movie Producers and Distributors Association of Hong Kong Limited

Television broadcasters

4. Television Broadcasts Limited

5. Asia Television Limited

6. Hong Kong Cable Television Limited

Chambers of commerce

7. The Chinese General Chamber of Commerce

Professional association

8. The Association of Chartered Certified Accountants Hong Kong