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Paper for the House Committee meeting on 13 June 2008

Report of the Bills Committee on Revenue Bill 2008

Purpose

This paper reports on the deliberations of the Bills Committee on Revenue Bill 2008 (the Bill).

Background

2. In the 2008-09 Budget, the Financial Secretary (FS) proposed a number of concessionary revenue measures. The purpose of the Bill is to implement some of these proposals.

The Bill

3. The Bill proposes to amend the Inland Revenue Ordinance (Cap. 112) (IRO) to :

(a) increase the deduction ceiling for approved charitable donations;

(b) allow more concessionary profits tax deduction for capital expenditure on environment-friendly facilities;

(c) lower the standard rate of salaries tax and tax under personal assessment and the corporate profits tax rate;

(d) provide for one-off tax reduction for 2007-08; and

(e) increase the amounts of personal allowances and widen the tax bands.

4. The Bill also proposes to amend the Hotel Accommodation Tax Ordinance (Cap. 348) (HATO) to waive the tax levied on hotel accommodation charges.

The Bills Committee

5. At the House Committee meeting on 9 May 2008, Members agreed to form a Bills Committee to study the Bill. Under the chairmanship of Hon Andrew LEUNG Kwan-yuen, the Bills Committee has held four meetings and considered the views submitted by five organizations. The membership list of the Bills Committee and the organizations that have submitted views to the Bills Committee is at **Appendix I** and **Appendix II** respectively.

Deliberations of the Bills Committee

6. In principle, the Bills Committee agrees that given the large surplus in 2007-08, the Government should make good use of the surplus for the well-being of the community. It also notes that the various proposals in the Bill have the support of organizations which have submitted views to the Bills Committee. In the course of scrutiny, members have expressed different views on some of the proposed concessions. Their major concerns are summarized in the ensuing paragraphs.

<u>Increasing the deduction ceiling for approved charitable donations</u>
(Clauses 3 and 5 of the Bill)

7. To encourage more generous charitable donations from the business community and the public, FS has proposed in the 2008-09 Budget to raise the ceiling for tax deductible donations under profits tax, salaries tax and tax under personal assessment from the present 25% to 35% of a person's assessable profits or income. According to the Administration, this proposal will cost the Government about $80 million a year. The Bill proposes to amend sections 16D and 26C of IRO to give effect to this proposal.

8. While members have not raised any objection to this proposal, they have sought information on the amount of tax deductible donations under assessable profits/income in the past years. Members note from the Administration's information that in the 2002-03 year of assessment when the deduction ceiling was at 10% of assessable profits/income, the amount of charitable donations deducted under profits tax and salaries tax (including tax under personal assessment) were $640 million and $2,380 million respectively. Since the increase of the deduction ceiling to 25% in the 2003-04 year of assessment, the amount of charitable donations deducted under profits tax rose from $1,280 million in 2003-04 to $2,150 million in 2006-07; while that under salaries tax and tax under personal assessment rose from $2,940 million to $3,820 million. The Administration believes that raising the deduction ceiling should be able to encourage taxpayers to make more charitable donations. However, it is unable to quantify the increase because there are other factors which may affect the decision of an individual or a corporation to make charitable donations.

9. Consequential upon a possible increase in charitable donations, some members have enquired on the Administration's stance on strengthening regulatory

oversight on charitable organizations over their use of donations. The Administration has advised that the Inland Revenue Department (IRD) conducts regular reviews to ensure that the objects of institutions are exclusively charitable in nature and that their activities are compatible with their objects. The Social Welfare Department has since 1998 published a set of Guidance Notes on Internal Financial Controls for Charitable Fund-raising Activities for charitable organizations' reference. With the assistance of the Hong Kong Institute of Certified Public Accountants and the Independent Commission Against Corruption, the Guidance Notes include advice on basic controls to ensure that income and expenditure generated from charitable fund-raising activities are properly documented and that such income is spent for designated purposes. Noting that the Law Reform Commission has formed a subcommittee to review the legal and regulatory framework relating to charities in Hong Kong, the Bills Committee agrees that the relevant Panel(s) should be invited to follow up the development in due course.

<u>More concessionary profits tax deduction for capital expenditure on environment-friendly facilities</u>
(Clauses 4 and 11 of the Bill)

10. To encourage the business sector to use environment-friendly facilities, the 2008-09 Budget proposes a 100% profits tax deduction for capital expenditure on environment-friendly machinery in the first year of purchase. For environment-friendly installations mainly ancillary to buildings, the Budget proposes that the depreciation period be shortened from the usual 25 years to five years.

11. To implement the above proposal, the Bill has proposed to add new sections 16H to 16K and Schedule 17 to IRO. Under the proposed section 16I, capital expenditure incurred by a person during the basis period for any year of assessment on the provision of any environmental protection machinery or on the construction of any environmental protection installation is eligible for profits tax deduction. The proposed tax deduction for the five-year depreciation period in respect of an environmental protection installation is as follows:

(a) for the year of assessment in which capital expenditure is incurred on the provision of the installation, 20% of the capital expenditure involved is to be deducted ; and

(b) the remaining part to be deducted by four equal amounts, one for each of the next succeeding four years of assessment, so long as the installation has not been sold at the end of the basis period for the year of assessment concerned.

12. Under the proposed section 16H(3), the Secretary for Financial Services and the Treasury (SFST) may, after consultation with the Director of Environmental Protection, amend Schedule 17 by notice published in the Gazette to specify the environmental protection facilities that would qualify for the tax concessions. Regarding members' concern about the consultation to be conducted by SFST, the Administration has advised that the views and suggestions of the relevant industries

will also be taken into account. The Bills Committee also notes that the notice in question is subsidiary legislation subject to negative vetting by the Legislative Council.

13. The Bills Committee notes the support expressed by the Hong Kong Institution of Engineers and the Taxation Institute of Hong Kong for the proposed tax deduction. Members also note that according to the information provided by the Administration, about 16 000 businesses are claiming the existing 60% profits tax deduction in respect of environmental protection machinery. Regarding some members' enquiry on the increase in such deduction claims after the implementation of the proposal, the Administration has indicated that it is unable to provide such an estimate as whether a business would use environmental protection machinery may be affected by other factors.

14. When considering item 2 of Part 2 in the new Schedule 17[1] proposed to be added to the IRO, the Bills Committee notes the view of its legal adviser on whether the item should be suitably revised to take into account that it is the "buildings", not the "installations", that are registered under the Hong Kong Energy Efficiency Registration Scheme for Buildings (HKEERSB) administered by the Electrical and Mechanical Services Department (EMSD). Question has also been raised on the need or otherwise to align the term "building installations" in the proposed Schedule 17 with the term "building services installations" used in the Building Energy Codes of Practice issued by EMSD for energy efficiency of lighting, electrical, air-conditioning and lift and escalator installations in buildings.

15. As informed by the Administration, EMSD maintains a register of building venues that have been registered under the HKEERSB. The registration certificate issued to a building under the HKEERSB also contains information on the type of installation in the building which complies with any of the above Codes published by EMSD. As such, the Administration considers that broadly speaking, the installation concerned can be regarded as being registered under the HKEERSB. It also considers that the scope of the term "building installations" can cover "building services installations". Accordingly, the Administration is of the view that item 2 of Part 2 in the proposed Schedule 17 is sufficiently clear and would unlikely give rise to any operational difficulties.

<u>Lowering the standard rate of salaries tax and tax under personal assessment and the corporate profits tax rate</u>
(Clauses 7 and 10 of the Bill)

Financial implications of the proposed reduction

16. To implement the measures announced by the Chief Executive (CE) in the 2007 Policy Address, the 2008-09 Budget proposes to reduce the standard rate from 16% to 15%; and the profits tax rate, from 17.5% to 16.5%. The Bill seeks to amend

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[1] Item 2 of Part 2 of Schedule 17 reads : "Energy efficient building installations registered under the Hong Kong Energy Efficiency Registration Scheme for Buildings administered by the Electrical and Mechanical Services Department."

Schedule 1 and Schedule 8 to IRO to give effect to the proposed reductions which will apply in relation to the 2008-09 year of assessment and subsequent years of assessment.

17. The Bills Committee notes that as a result of the proposed reduction in the standard rate from 16% to 15% of salaries tax, tax under personal assessment, profits tax of unincorporated businesses and property tax, the standard rate (and also all of the personal allowances) will revert to the level in 2002-03. According to the Administration, this proposal will cost the Government $960 million a year. As regards corporate profits tax, lowering the tax rate to 16.5% will cost the Government $4.4 billion a year.

18. As the proposed reduction, if enacted, is not a one-off measure but will remain in force in the years to come, there is concern about the financial implications and the revenue foregone in the longer run. The Administration has responded that it is unable to provide details on the financial implications in the next 10 years or so as it cannot forecast how the current tax base, individuals'/companies' income/profits level and all other relevant factors which affect tax revenue will change during this period. Nevertheless, the Administration has advised that the prevailing tax rates are taken into review each year when FS prepares the Budget. They may be revised in the light of the latest economic and fiscal conditions.

Justifications for lowering the tax rates

19. Hon Mrs Selina CHOW highlights that Members of the Liberal Party support the proposed reductions as a move to return wealth to the community in the light of the Government's fiscal surplus. However, some members including Hon LEE Cheuk-yan, Hon Albert HO, Hon Frederick FUNG and Hon Emily LAU have stated their objection to the proposed reduction in standard rate and corporate profits tax rate. They consider that persons who are required to pay the standard rate of tax are better-off and highly paid employees[2] who can well afford the existing level of tax. Lowering the tax payable by them may widen the wealth gap and further narrow the tax base. Regarding the proposed reduction in corporate profits tax rate, these members stress that the corporate profits tax rate in Hong Kong is already very low and query the need for the proposed reduction. According to them, there has not been a strong demand from the business sector for a reduction in corporate profits tax rate. They do not consider the proposed reduction in tax rates justified. Hon TAM Heung-man shares similar concern and indicates that the proposed reduction is not supported by the entire accountancy profession, especially those operating under sole proprietorship.

20. Some members have queried the fairness of the Government's decision to provide tax relief to the well-off while ignoring the plight of disadvantaged groups and some 1.3 million people living in poverty, especially when public expenditure is badly needed in other policy areas ranging from education, health reforms to social

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[2] IRD has informed the Bills Committee that under the existing requirement, in 2007-2008, a single person with an annual income of $2.75 million or more would be subject to the standard rate of salaries tax or tax under personal assessment.

welfare. In this regard, the Administration has highlighted that the 2008-09 Budget has proposed other initiatives such as the one-month rental waiver for public housing tenants, an additional month of welfare payment and the electricity charge subsidy which serve to alleviate the financial burden on the grassroot population. The Administration and some other members are of the view that the revenue concessions will not necessarily result in reduced spending on other policy initiatives or relief measures.

21. In this connection, the Administration has also informed the Bills Committee that the total number of taxpayers who would benefit from the proposed lowering of standard rate is about 144 000, among whom 24 600 are unincorporated profits taxpayers, 19 000 are salaries tax and personal assessment taxpayers and the rest are property taxpayers. Some members however maintain their view that the proposal would not benefit the majority of lower/middle income group and small and medium enterprises under sole proprietorship.

22. On the proposal to lower the corporate profits tax rate to 16.5%, the Administration points out that in the course of Budget consultation, there has been clear support from the business sector. One of the main reasons advanced by the Administration is that the move will enhance Hong Kong's competitive edge in the face of stiff competition from neighbouring territories, many of which also offer other forms of tax incentives or concessions. Some members including Hon Mrs Selina CHOW agree that a reduction in corporate profits tax rate may boost investment in Hong Kong and increase taxable profits in the longer run. Some other members however are concerned that as the prevailing corporate profits tax rate of 17.5% is already low, the 1% point reduction is hardly a key factor for enhancing Hong Kong's competitiveness and attracting foreign investments. With a view to ascertaining how Hong Kong's corporate tax regime compares with those in other jurisdictions, the Bills Committee has examined information provided by the Administration on the corporate profits tax rates of neighbouring economies.

23. The Administration has highlighted that the global trend for corporate profits tax rate is a downward one and Hong Kong was an exception when it increased the corporate profits tax rate in 2003-04, given the prevailing weak economy and fiscal deficit. Following improvement in the economy and the Government's fiscal position, the Administration considers it appropriate to lower the corporate profits tax rate to 16.5%, which is still higher than the level back in 2002-03. As regards how Hong Kong compares with other economies, the Administration stresses that while some overseas governments offer tax incentives in the form of tax exemption and reduced tax rates to attract foreign investment[3], Hong Kong's competitiveness is mainly founded on its low and simple tax regime. According to the Administration's statistics, out of the 74 200 corporations paying profits tax in the 2006-07 year of assessment, about 52 100 (i.e. 70%) had annual assessable profits below $1 million. The Administration has therefore come to the view that the reduction in corporate profits tax rate will benefit many small and medium enterprises.

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3 According to information provided by the Administration, a range of tax incentives in the form of tax exemption and reduced tax rates are available in Singapore, South Korea and Taiwan.

24. Noting from the Administration's information that the number of offices set up in Hong Kong by non-local corporations has increased from 5 414 in 2003 to 6 440 in 2007 despite the increase in corporate profits tax rate with effect from 2003-04, some members remain unconvinced that it is necessary to reduce the corporate profits tax rate in order to attract overseas corporations to Hong Kong. Some members including Hon Albert HO and Hon TAM Heung-man are of the view that instead of lowering the corporate profits tax rate across the board, the Administration should actively explore the introduction of well-conceived tax incentives to enhance Hong Kong's competitiveness. Some examples cited are group tax relief and tax concession for corporations setting up regional headquarters in Hong Kong.

Proposed amendments

25. The Bills Committee has discussed the existing regime under which profits tax is charged on the assessable profits of corporations at a fixed rate. Some members including Hon LEE Cheuk-yan, Hon Albert HO and Hon CHAN Yuen-han have urged the Administration to seriously consider the feasibility of charging profits tax at different rates based on the amount of the corporations' assessable profits. They share the view that small and medium enterprises making modest profits should be subject to a lower rate of profits tax than large corporations making huge profits. Hon CHAN Kam-lam has expressed his disagreement because all enterprises, whether big or small, have likewise made tremendous effort to maintain their viability and profitability. A progressive profits tax may have the unintended consequence of discouraging corporations from maximizing their profitability. The Administration's stance is that a progressive profits tax system runs counter to Hong Kong's well-established simple taxation regime. It also cautions that this approach may give rise to opportunities for abuse, such as corporations splitting up into smaller businesses so that each will benefit from a lower profits tax rate. The change may also undermine Hong Kong's competitive edge and result in the payment of profits tax being further concentrated on a small number of large corporations.

26. In this regard, the Bills Committee has passed a motion to move a Committee Stage amendment (CSA) to the Bill in its name to the effect that the proposed corporate profits tax rate of 16.5% would only apply to corporations with an annual assessable profits not exceeding $10 million. Pursuant to the motion passed and after further discussion by the Bills Committee, members have considered and agreed to the CSAs as per **Appendix III**. The purpose of the proposed CSA to clause 10(2) is to amend Schedule 8 to IRO to the effect that the first $10 million of a corporation's assessable profits will be subject to the proposed reduced tax rate of 16.5%, while the remainder of the assessable profits will be subject to the existing tax rate of 17.5%. The other proposed amendments are mainly technical and consequential amendments to existing provisions of IRO to provide, among other things, for the interpretation of the reference to the rate specified in Schedule 8 in those provisions to avoid ambiguity.

27. The Administration's initial view is that the proposed CSAs may have the effect of changing the existing profits tax regime and may fall outside the scope of the

Bill. Moreover, the other proposed CSAs to IRO will result in operational difficulties in tax assessment by IRD. The Administration has also expressed concern that no public consultation has been carried out on the proposed amendments. Hon Mrs Selina CHOW has stated that Members of the Liberal Party do not support the proposed CSAs.

One-off tax reduction for 2007-08
(Clauses 6 and 11 of the Bill)

28. To implement FS's proposals in the Budget for a one-off reduction of salaries tax, tax under personal assessment, profits tax and property tax for 2007-08 by 75%, subject to a ceiling of $25,000, the Bill adds to IRO the proposed section 90 and Schedule 18 to give effect to these proposals. Under section 1 of the proposed Schedule 18, where a person owns two or more properties, the proposed reduction of property tax will apply to each of those properties. The Bills Committee has no objection to the proposal.

Increasing personal allowances and widening tax bands
(Clauses 8 and 9 of the Bill)

29. The FS has also proposed to raise the basic allowance and the single parent allowance from $100,000 to $108,000, and to increase the married person's allowance from $200,000 to $216,000. Furthermore, each tax band is proposed to be widened from $35,000 to $40,000. Clause 8 of the Bill seeks to amend Schedule 2 to IRO to widen the tax bands while clause 9 seeks to amend Schedule 4 to increase the aforesaid allowances. The proposed changes will apply in relation to the 2008-09 year of assessment and subsequent years of assessment.

30. On the impact, if any, of the proposal on the tax base, the Administration has advised that the proposal to raise the personal allowances will result in about 7% of the current taxpayers falling outside the tax net in 2008-09. However, such an impact will likely be short-term as the number of taxpayers will increase as a result of wage rise during a period of strong economy.

Waiving the hotel accommodation tax
(Part 3 of the Bill - clauses 12 to 14)

31. To promote inbound tourism and enhance the competitiveness of Hong Kong's hotel industry, the 2008-09 Budget has proposed to waive the hotel accommodation tax. Under section 3 of the Hotel Accommodation Tax Ordinance (Cap. 348) (HATO), the current rate of tax levied on all hotel accommodation charges is 3%. Part 3 of the Bill seeks to amend section 3 of HATO by repealing the current tax rate and providing that the rate of hotel accommodation tax is to be specified in the proposed Schedule to the Ordinance. Under the proposed Schedule, the specified rate is 0%.

32. Hon LEE Cheuk-yan considers that waiving the hotel accommodation tax would unlikely benefit hotel guests as hotel operators are still at liberty to raise room

tariffs, in particular during high seasons. Hence, the benefit of the waiver will not be passed onto the customers. He therefore does not support the proposed waiver. The Administration nevertheless points out that at present, the 3% tax is levied on top of the room tariff as a separate charge listed on the bill. Since the hotel business is highly competitive, the Administration is of the view that hotel operators may not be able to increase room tariff and pocket the benefit of the waiver.

Commencement
(Clause 2 of the Bill)

33. The Bills Committee notes that while the proposed one-off tax reduction applies in relation to the year of assessment 2007-08, the other proposed concessionary revenue measures under IRO apply in relation to the year of assessment 2008-09 and subsequent years of assessment. According to the Administration, the proposed waiver of the hotel accommodation tax is intended to take effect on 1 July 2008 in order to allow adequate advance notice for hotel operators to adjust their billing system. It has further advised that the hotel accommodation tax is collected on a quarterly basis. For the proposed waiver to be implemented with effect from 1 July 2008, the Bill would have to be enacted before that date. In principle, members have no objection to the proposed commencement arrangement.

Consultation exercise for the 2008-09 Budget

34. Noting that the Administration has referred to the consultation conducted by FS prior to finalizing the proposals in the 2008-09 Budget, some members have raised concern about the lack of transparency on the details of the consultation, notably the parties consulted and the views expressed by them. The Administration has confirmed that LegCo Members, various bodies and the general public have been consulted during the formulation of the 2008-09 Budget. At the request of members, the Administration has provided, on a non-attributed basis, a summary of the views received and general reasons given in support of or objecting to the proposed lowering of the standard rate and the corporate profits tax rate. Some members including Hon Emily LAU maintain the view that more information on the views collected during each year's Budget consultation exercise should be made available to the public.

Committee Stage Amendments

35. The Administration has not proposed any CSA to the Bill. The CSA proposed to be moved to the Bill by Hon LEE Cheuk-yan on behalf of the Bills Committee is at **Appendix III**.

Recommendation

36. The Bills Committee supports the resumption of the Second Reading debate on the Bill on 25 June 2008.

Advice sought

37. Members are invited to note the Bills Committee's recommendation in the preceding paragraph.

Council Business Division 1
Legislative Council Secretariat
12 June 2008

Appendix I

Bills Committee on Revenue Bill 2008

Membership list

Chairman	Hon Andrew LEUNG Kwan-yuen, SBS, JP
Members	Hon Albert HO Chun-yan Hon LEE Cheuk-yan Hon Mrs Selina CHOW LIANG Shuk-yee, GBS, JP Hon CHAN Yuen-han, SBS, JP Hon CHAN Kam-lam, SBS, JP Hon SIN Chung-kai, SBS, JP Hon Howard YOUNG, SBS, JP Hon Emily LAU Wai-hing, JP Hon Tommy CHEUNG Yu-yan, SBS, JP Hon Frederick FUNG Kin-kee, SBS, JP Hon LEUNG Kwok-hung Hon WONG Ting-kwong, BBS Hon TAM Heung-man
	(Total : 14 Members)
Clerk	Miss Polly YEUNG
Legal Adviser	Ms Connie FUNG
Date	16 May 2008

Appendix II

Bills Committee on Revenue Bill 2008

Organizations which have submitted views on the Revenue Bill 2008 to the Bills Committee

1. Federation of Hong Kong Industries
2. Hong Kong General Chamber of Commerce
3. The Hong Kong Institution of Engineers
4. The Society of Chinese Accountants & Auditors
5. The Taxation Institute of Hong Kong

Appendix III

REVENUE BILL 2008

COMMITTEE STAGE

Amendments to be moved by the Honourable LEE Cheuk-yan

Clause	Amendment Proposed
New	By adding in Part 2—
	"**2A. Charge of profits tax** Section 14(2) of the Inland Revenue Ordinance (Cap. 112) is amended, in the English text, by repealing "rate" and substituting "rates".".
New	By adding—
	"**2B. Qualifying debt instruments** Section 14A is amended by adding— "(1A) In subsection (1), the reference to the rate specified in Schedule 8, in relation to the year of assessment commencing on 1 April 2008 and to subsequent years of assessment, is a reference to 16½%.".".
New	By adding—
	"**2C. Qualifying reinsurance business** Section 14B is amended by adding— "(1A) In subsection (1), the reference to the rate specified in Schedule 8, in relation to the year of assessment commencing on 1 April 2008 and to subsequent years of assessment, is a reference to 16½%.".".
3(1)	By deleting "of the Inland Revenue Ordinance (Cap. 112)".

New	By adding—
	"**4A. Treatment of losses: concessionary trading receipts** Section 19CA is amended by adding— "(4A) In subsection (4), the reference to the rate specified in Schedule 8, in relation to the year of assessment commencing on 1 April 2008 and to subsequent years of assessment, is a reference to 16½%."".
New	By adding—
	"**5A. Amount of provisional profits tax** Section 63H(1A) is amended, in the English text, by repealing "rate" and substituting "rates".".
10	(a) By adding before subclause (1)— "(1A) Schedule 8 is amended, in the English text, by repealing "RATE" and substituting "RATES".". (b) By deleting subclause (2) and substituting— "(2) Schedule 8 is amended by adding at the end— "For the year of assessment 2008/09 and for each year after that year— (*a*) upon the first $10,000,000 16½% (*b*) upon the remainder 17½%".".