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FINANCIAL SERVICES AND THE TREASURY BUREAU
24/F, Central Government Offices,
2 Tim Mei Avenue, Tamar
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By email (cwcho@legco.gov.hk)

31 January 2018

Clerk to Bills Committee
(Attn: Miss Cindy HO)
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Miss HO,

Bills Committee on Inland Revenue (Amendment) (No. 7) Bill 2017

Thank you for your letter of 24 January 2018 and the list of follow-up actions sent to us via email on 25 January 2018. Our response is set out in the attached note.

Yours sincerely,

(Ms Pecvin Yong)
for Secretary for Financial Services and the Treasury

c.c.
Commissioner of Inland Revenue (Attn: Mr KK Chiu)
Department of Justice (Attn: Mr Manuel Ng)

Inland Revenue (Amendment) (No. 7) Bill 2017

Government's response to members' enquiries at the meeting on 24 January 2018

At the first meeting of the Bills Committee on Inland Revenue (Amendment) (No. 7) Bill (the Bill) held on 24 January 2018, the Administration is requested to provide –

(a) information on the corporate tax/profits tax rates of other jurisdictions, including those which have their corporate tax rates reduced recently;

(b) the rationale for setting the proposed threshold (i.e. the first $2 million of assessable profits) for the lower tax rates under the two-tiered profits tax rates regime; and

(c) written response to Assistant Legal Adviser (ALA)'s letter to the Administration dated 23 January 2018 (LC Paper No. CB(1)513/17-18(01)).

Information on corporate tax/profits tax rates of other jurisdictions

2. In recent years, there is a global trend of reducing corporate income tax (CIT) rates. The combined CIT rates (taking into account the average state/provincial/local corporate tax rates where appropriate) of selected jurisdictions are set out in the table below –

Jurisdictions	Combined CIT Rates
Hungary*	9%
Hong Kong	16.5%
Singapore	17%
United Kingdom*	19%
United States	25.75%
Canada*	26.7%
Korea	27.5%
Japan*	29.97%
Australia*	30%

* Source: OECD Statistics (2017)

Rationale for setting the proposed threshold (i.e. the first $2 million of assessable profits) for the lower tax rates

3. The two-tiered profits tax rates regime was first proposed in the Chief Executive's Election Manifesto with the objective of reducing the tax burden on enterprises, especially small, medium and startup businesses. A concrete proposal was announced in the 2017 Policy Address delivered by the Chief Executive in October 2017.

4. In 2015-16, about 111 900 enterprises in Hong Kong (comprising 82 500 corporations and 29 400 unincorporated businesses (UBs)) had assessable profits of $2 million or below, and they contributed about 4% of the total profits tax of $140 billion. 96% of the profits tax was contributed by some 23 900 enterprises (comprising 21 300 corporations and 2 600 UBs) with assessable profits above $2 million.

5. As it can be seen from above, 82.4% (or 111 900) enterprises among all taxpaying enterprises (135 800) had assessable profits of $2 million or below, and many of these enterprises are believed to be small, medium and startup businesses. It is therefore reasonable to set the threshold for the lower tax rates at $2 million in order to focus the tax benefits of the two-tiered profits tax rates regime on the intended targets.

Written response to ALA's letter

6. Our response to ALA's letter dated 23 January 2018 is set out in the ensuing paragraphs.

<u>Qualifying debt instruments – avoidance of double benefits</u>

(1)(a) Section 14A of the Inland Revenue Ordinance (IRO) provides that interest, gains or profits derived from qualifying debt instruments are chargeable to profits tax at one-half of the rate specified in Schedule 1 (15%) or Schedule 8 (16.5%), as the case may be. The Bill has not amended the existing section 14A. Thus, such interest, gains or profits would continue to be taxed at 7.5% or 8.25% rather than at one half of the two-tiered rates (3.75% or 4.125% for profits

up to $2 million and 7.5% or 8.25% for profits beyond $2 million). Assessable profits from businesses unrelating to qualifying debt instruments would be chargeable to profits tax at the two-tiered rates under the proposed section 14(2), (3) or (4).

(1)(b) Section 14A would continue to apply to the assessable profits of $3 million derived from qualifying debt instruments. The remaining assessable profits of $1 million from operating a business but not from qualifying debt instruments would be taxed at the lower rate of 8.25% under the two-tiered profits tax rates regime.

Clause 4 – connected entities

(2)(a) Yes, A and B are considered as connected entities under the proposed section 14AAB(1)(a).

(2)(b) B would not benefit from the two-tiered profits tax rates regime unless it elects the two-tiered rates in writing under the proposed section 14AAC(4). In practice, B could make an election in annual profits tax returns.

(3) Yes, the policy intent is to allow only one of the connected entities to benefit from the two-tiered profits tax rates regime even if the aggregated profits of the connected entities are less than $2 million.

(4)(a) Either corporation F or corporation N can benefit from the two-tiered profits tax rates regime by electing the two-tiered rates in writing under the proposed section 14AAC(4).

(4)(b) In the given scenario, the profits tax liabilities of corporation F and corporation N in aggregate would be greater than the profits tax liability of corporation T.

The proposed section 14AAC provides that if two or more entities are connected, the two-tiered profits tax rates may only apply to one of them. This serves to help focus the tax benefits on small and medium enterprises (SMEs). It should be noted that profits tax is assessed on corporations F, N and T, which are separate taxable

persons, rather than on X and Y who are their respective shareholders. Since connected entities can have diverse ownership (including different shareholders at different times during the same accounting period), different accounting periods and different deadlines for filing tax returns, aggregating their profits for taxation purposes might not be feasible from the tax administration angle.

(5) Corporation N would be taxed in respect of its profits up to 1 March 2019 when it ceases business. If corporation F is taxed at the two-tiered rates for the year of assessment 2018/19, corporation N cannot benefit from the two-tiered profits tax rates regime for that year under the proposed section 14AAC(6) since corporation N is a connected entity of corporation F at the end of the basis period of corporation N (i.e. 1 March 2019). For subsequent years of assessment, corporation F would be entitled to the proposed lower profits tax rate for the first $2 million of its aggregated assessable profits from selling flowers and noodles.

Business restructuring is a normal commercial activity. Different business set-ups can have divergent risk profiles, return on assets and cost structures. Costs and benefits have to be carefully considered prior to an amalgamation of businesses and that is a business decision. Generally, such commercial activities would not be treated as tax avoidance transactions.

(6) When defining the term "associate" in other anti-abuse provisions of the IRO, the concept of "relative" is usually adopted so as to prevent profits from shifting to companies controlled by relatives, like spouse and children. For the two-tiered profits tax rates regime, the policy intent is to reduce the tax burden of all enterprises, especially SMEs. Given members of the same family may run different businesses independently (e.g. a father runs a vegetable store while his son operates a hair salon business), it is reasonable to apply the proposed lower rate to each of them.

Financial Services and the Treasury Bureau
January 2018