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Legislative Council

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**Report of the Bills Committee on Inland Revenue
(Amendment) (No. 7) Bill 2017**

Purpose

This paper reports on the deliberations of the Bills Committee on Inland Revenue (Amendment) (No. 7) Bill 2017 ("the Bills Committee").

Background

2. According to the Administration, profits tax is the largest revenue source in Hong Kong. In 2016-2017, it stood at HK\$139 billion, accounting for 24% of total government revenue. The existing Inland Revenue Ordinance (Cap. 112) ("IRO") sets the profits tax rates at 16.5% for corporations (section 14(2) of and Schedule 8 to IRO refer) and 15% for unincorporated businesses (sections 2(1) and 14(1) of and Schedule 1 to IRO refer). The Chief Executive ("CE")'s 2017 Policy Address published in October 2017 stated that the Financial Services and the Treasury Bureau ("FSTB") would implement a two-tiered profits tax rates regime put forward by CE in her Election Manifesto with a view to enhancing the competitiveness of Hong Kong.¹

The Bill

3. The Inland Revenue (Amendment) (No. 7) Bill 2017 ("the Bill") was published in the Gazette on 29 December 2017 and received its First Reading at the Legislative Council ("LegCo") meeting of 10 January 2018. The Bill seeks to amend IRO to introduce the two-tiered profits tax rates for corporations and unincorporated businesses ("UBs") for the years of assessment commencing on or after 1 April 2018 as follows:

¹ See paragraphs 65 and 66 of the CE's 2017 Policy Address. According to paragraph 66, the profits tax rate for the first HK\$2 million of profits of enterprises would be lowered from the current 16.5% to 8.25% instead of 10% as proposed in the Election Manifesto.

Assessable profits	Tax rates	
	Corporations	UBs
First HK\$2 million	8.25%	7.5%
Beyond the first HK\$2 million	16.5%	15%

Under the proposed regime, the profits tax rate for the first HK\$2 million of profits of corporations would be lowered to 8.25%. Profits above that amount would continue to be subject to the tax rate of 16.5%. For UBs, the two-tiered tax rates would correspondingly be set at 7.5% and 15%. A tax-paying corporation or unincorporated business may save up to \$165,000 and \$150,000 each year respectively.

4. The main provisions of the Bill are as follows:

- (a) Clause 3 – to amend section 14 of IRO (charge of profits tax) to provide that for any year of assessment commencing on or after 1 April 2018, profits tax would be charged in accordance with the new Schedule 8A or 8B (depending on whether the person is a corporation); and
- (b) Clause 4 – to add the new sections 14AA, 14AAB and 14AAC to IRO to define "entity" and "connected entities" etc.; and to provide that if two or more entities are connected, the proposed two-tiered profits tax rates would only apply to one of them;
- (c) Clause 11 – to add the new Schedules 8A and 8B to IRO to provide for the charging of profits tax under the proposed two-tiered profits tax rates system. The new Schedule 8A would apply to a person other than a corporation, while the new Schedule 8B would apply to a corporation; and
- (d) Clause 12 – to add the new Schedule 43 to IRO to provide for the transitional arrangements in relation to the charging of provisional profits tax for the year of assessment commencing on 1 April 2018.

5. The Bill contains no commencement provision. By virtue of section 20(2)(a) of the Interpretation and General Clauses Ordinance (Cap. 1), the Bill, if passed, would come into operation on the day the enacted ordinance is published in the Gazette.

The Bills Committee

6. At the House Committee meeting on 12 January 2018, members agreed to form a Bills Committee to study the Bill. The membership list of the Bills Committee is in **Appendix I**. Under the chairmanship of Hon Holden CHOW Ho-ding, the Bills Committee has held two meetings to discuss the Bill with the Administration. The Bills Committee has also invited written views from the related organizations and the public. A list of organizations which have provided written submissions to the Bills Committee is at **Appendix II**.

Deliberations of the Bills Committee

7. The Bills Committee supports the Bill in general. Members have noted that the organizations which have submitted written views to the Bills Committee are generally supportive of the proposed two-tiered profits tax rates regime. The deliberations of the Bills Committee are set out in the ensuing paragraphs.

Impact on tax revenue and economy

8. Hon Starry LEE, Hon KWOK Wai-keung, Hon YIU Si-wing, Hon CHUNG Kwok-pan and Hon Jimmy NG have expressed support for reducing the profits tax rates for the first HK\$2 million of assessable profits as the initiative would help relieve the financial burden on small and medium enterprises ("SMEs"). Hon CHAN Chi-chuen has, however, expressed the view that it is the People Power's position that a progressive profits tax rates regime should be adopted instead and, in this respect, he is not inclined to support proposals on reducing the profits tax rates. The Bills Committee has enquired about the financial implications of implementing the proposed two-tiered profits tax rates regime, including whether it would in effect narrow Hong Kong's tax base.

9. The Administration has advised that, on the assumption that 20% of the tax-paying enterprises are connected enterprises, the tax revenue forgone under the regime would be about \$5.8 billion per year, or around 4% of the total profits tax received in 2016-2017. The Administration has pointed out that as the proposal only reduces the rates of charging assessable profits, it would not change or narrow the tax base.

10. The Administration has further advised that introducing a two-tiered profits tax rates regime can bring about the following positive impacts:

- (a) The lower tax rates would reduce the tax burden on enterprises, especially SMEs and startup enterprises. This would help foster a favourable business environment, drive economic growth and enhance Hong Kong's competitiveness.
- (b) The tax savings by enterprises can be reinvested in upgrading their hardware or software, thereby boosting their overall operation and efficiency which in turn could bring in additional tax revenue in future.
- (c) The lower tax rates would also benefit the more successful social enterprises by alleviating their tax burden. The tax saved would enable these enterprises to pursue their social objectives, e.g. enhancing the services they provide and creating more employment and training opportunities for the socially disadvantaged.
- (d) The two-tiered regime would gain international publicity mileage in promoting Hong Kong as a preferred investment destination.

Rationale for setting the upper limit of assessable profits for the lower tax rates at HK\$2 million

11. The Bills Committee has enquired about the rationale for proposing an upper limit and setting it at the first HK\$2 million of assessable profits for the lower tax rates under the proposed two-tiered profits tax rates regime.

12. The Administration's explanation is that the two-tiered profits tax rates regime was first proposed in CE's Election Manifesto with the objective of reducing the tax burden on enterprises, especially SMEs and startup businesses. In 2015-2016, about 111 900 enterprises in Hong Kong (comprising 82 500 corporations and 29 400 UBs) had assessable profits of HK\$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 HK\$2 million. In light of the above, 82.4% (or 111 900) enterprises among all taxpaying enterprises (135 800) had assessable profits of HK\$2 million or below, and many of these enterprises are believed to be SMEs and startup businesses. On that basis, the Administration has therefore considered it reasonable to set the upper limit for the lower tax rates at HK\$2 million of assessable profits in order to focus the tax benefits of the proposed two-tiered profits tax rates regime on the intended targets.

13. The Bills Committee has taken note of a deputation's² suggestion in its written submission that the Administration should reduce the upper corporate profits tax rate from 16.5% to 15% and correspondingly adjust the tax rate at the lower tier. In response to the enquiry of the Bills Committee, the Administration has advised that Hong Kong's corporate tax rate of 16.5% is amongst the lowest in the world. While it has no plan at present to reduce the upper corporate profits tax rate across the board, it will continue to monitor the evolution of tax policy of other developed economies. At the Bills Committee's request, the Administration has provided information on the combined corporate income tax ("CIT") rates (taking into account the average state/provincial/local corporate tax rates where appropriate) of selected jurisdictions as illustrated 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: The Organisation for Economic Co-operation and Development Statistics (2017)

Policy objectives of the Bill and eligibility for the proposed two-tiered profits tax rates

14. Some members consider that the policy intent of introducing the two-tiered profits tax rates regime is unclear. While the proposal is meant to target SMEs, it is designed to benefit all eligible enterprises with assessable profits irrespective of their size. Some members have queried whether the proposal is sufficient to bring about the intended positive impacts. In particular, it may not be appealing enough to attract multinational enterprises ("MNEs") by reducing the profits tax rate only for the first HK\$2 million of assessable profits. Some members have enquired whether it is possible to simplify the operation of the proposed regime by imposing restrictions on the size of enterprises, thereby excluding MNEs and the larger enterprises from being eligible for the proposed two-tiered profits tax rates. There is also a view that enterprises with assessable profits in the range of HK\$2 million to HK\$5 million should be eligible for less tax reduction and those with assessable profits above

² Liberal Party

HK\$5 million should not be eligible for the proposed two-tiered profits tax rates.

15. The Bills Committee has enquired whether the proposed two-tiered profits tax rates should be applicable to entities which profit from purchase and sale of properties as their sole or primary business. Some members have also pointed out that MNEs may exploit the gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity (i.e. base erosion and profit shifting ("BEPS")). The Bills Committee has raised concerns about possible abuse of the two-tiered profits tax rates regime through tactics such as –

- (a) artificial shift of profits/losses of an enterprise across different years of assessment;
- (b) segregation(s) of business(es), transfer of shares or re-distribution of profits to alter the control, or conceal the genuine control, of an entity in a group such that the entity will no longer be considered as "connected" with another entity or other entities in the group for the purpose of the said regime; and
- (c) carrying on businesses through natural persons and sole proprietorships, instead of through a group of connected entities, in order to maximize the benefits yieldable from the proposed reduced profits tax rates for the first HK\$2 million of assessable profits of each entity.

16. The Administration stresses that while Hong Kong's corporate tax rate of 16.5% is amongst the lowest in the world, it is appropriate to introduce the two-tiered profits tax rates regime in order to remain competitive and attract foreign investment into Hong Kong as global tax rates continue to fall. For instance, the United States has recently announced that it would cut down its corporate tax rates to 21% while the United Kingdom would lower the same to 17% in 2020. Japan has also lowered its corporate tax rate from 23.4% in 2016 to 23.2% in 2018. That said, the Administration reckons that foreign investment in Hong Kong is influenced by a number of factors, and tax concessions including lowering the profits tax rates form only part of the government measures to promote Hong Kong as a preferred investment destination.

17. The Administration stresses that its objective is to adopt a competitive taxation system to promote economic development, while maintaining a simple tax regime and low tax rates. Striking this balance, the proposed two-tiered profits tax rates regime is designed to benefit all eligible enterprises with assessable profits irrespective of their size and number of employees, and target SMEs in particular.

18. In response to some members' concerns on possible abuse of the two-tiered profits tax rates regime, the Administration has explained that 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. In response to Hon Kenneth LEUNG's enquiry, the Administration has pointed out that as loss carried forward from the previous year of assessment has to be set off against the profits in the immediate year that follows, it is not possible to artificially shift the loss across subsequent years of assessment with a view to lowering the assessable profits to HK\$2 million or less and hence qualifying for the proposed lower profits tax rates. The Chairman and Hon WU Chi-wai have called on the Administration to keep the situation under review to ensure compliance with the requirements of the Bill and consider legislative amendments to combat abusive practices regarding corporate restructuring where necessary.

19. As regards whether it is appropriate that the proposed two-tiered profits tax rates be applicable to entities engaging in purchase and sale of properties, the Administration has pointed out that how an entity carries on its business or makes investment is essentially a commercial decision of the entity concerned. Besides, measures such as the Buyer's Stamp Duty and Special Stamp Duty are in place to cool down investment and speculative activities in the property market, regardless of whether the entities involved in the property transactions are natural persons or companies. The Administration has further advised that issues relating to BEPS are dealt with in the context of the Inland Revenue (Amendment) (No. 6) Bill 2017, which was introduced to LegCo in January 2018 for implementing a package of measures to counter BEPS and enhance tax transparency.

Rationale for the restrictions on the application of the proposed tax regime

20. The Administration has explained that under the proposed regime, certain restrictions on connected entities have been introduced such that each group of connected entities may only nominate one entity in the group to benefit from the proposed lower tax rates. According to the Bill, an entity³ is a connected entity of another entity if (a) one of them has control over the other; (b) both of them are under the control of the same entity; or (c) in the case of the first entity being a natural person carrying on a sole proprietorship business, the

³ Under the proposed new section 14AA(1), "entity" means (a) a natural person; (b) a body of persons; or (c) a legal arrangement, including (i) a corporation; (ii) a partnership; and (iii) a trust.

other entity is the same person carrying on another sole proprietorship business. The same principle applies whether the entity in question is a natural person, a body of persons or a legal arrangement (including a corporation, a partnership and a trust), and basically, two entities are generally regarded as "connected entities" if one of them has control over the other or both of them are under control of the same entity. "Control" generally refers to holding directly or indirectly more than 50% of the issued share capital, voting rights, capital or profits in another entity.⁴ The Bills Committee also notes that according to the proposed section 14AAC(1), the "connected" relationship of the entities in question is determined by their status at the end of the basis period for a particular year of assessment.

21. Some members are of the view that the restrictions imposed in relation to "connected entities" under the proposed two-tiered profits tax rates regime may complicate the profits tax system and undermine Hong Kong's competitive edge of having a simple tax regime.

22. The Administration stresses that it is necessary to restrict the application of the two-tiered rates to only one enterprise nominated among connected entities to ensure that the tax benefits would target SMEs. If the proposed restriction were removed, a vast number of entities within a multinational group or listed company would be able to benefit from the proposed regime, given that conglomerates usually carry on different businesses via different vehicles. This would undermine the Administration's policy objective of targeting the tax benefits at SMEs. Indeed, the proposed eligibility criteria, based on amount of assessable profits and a simple definition of "connected entity" prescribed by the Bill, are meant to simplify the operation of the proposed regime and minimize both administrative/compliance burden.

23. The Bills Committee has sought explanation for adopting the "50%" dividing line. The Administration has explained that there must be a clear dividing line for defining which entities are connected. To this end, the Administration proposes to adopt 50% as the dividing line. An entity would have control over the other if it controls more than 50% of the other's interest or profits. Thus, a clear boundary can be drawn for each group of connected

⁴ The proposed new section 14AAB(2), (3) and (4) explains what constitutes "control". An entity (entity A) has control over another entity (entity B) if entity A, whether directly or indirectly through one or more than one other entity: (a) owns or controls more than 50% in aggregate of the issued share capital of entity B; (b) is entitled to exercise or control the exercise of more than 50% in aggregate of the voting rights in entity B; (c) is entitled to more than 50% in aggregate of the capital or profits of entity B; or (d) in the case of entity B being a trust, entity A is entitled to (other than in the capacity of a trustee) a vested interest in more than 50% of the capital of the property of the trust (whether the interest is in possession or in remainder or reversion; and whether the interest is defeasible or not).

entities. The majority shareholder or partner who has the dominant control of his or her connected entities can determine which of them can elect the proposed two-tiered rates. According to the Administration, as the proposed threshold is clear and objective, disputes among shareholders or partners would be minimized.

24. Members have sought clarification from the Administration on the scope of "connected entities" under different scenarios. Hon Jimmy NG and Hon WU Chi-wai have enquired whether a group of companies jointly owned by relatives, like brother, sister, spouse and children, are regarded as "connected entities" if each person owns or controls no more than 50% of the interest or profits in each of the companies in question. The legal adviser to the Bills Committee ("Legal Adviser") has also pointed out that as the concept of "relative" is not used in the proposed definition of "connected entity" in the Bill, and this is in contrast with the use of the term in other parts of the existing IRO (e.g. sections 14A(4) and 14G(1) in relation to the definition of "associate").

25. The Administration has advised that when defining the term "associate" in other anti-abuse provisions of 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 proposed two-tiered profits tax rates regime, the policy intent is to reduce the tax burden of all enterprises, especially SMEs. Given that members of the same family may run different businesses independently (e.g. a father operates a vegetable store while his son operates a hair salon business), it is reasonable to apply the proposed lower tax rate to each of them. In response to the Legal Adviser's enquiry, the Administration has advised in writing the tax treatments in a number of scenarios. The information is reproduced in **Appendix III**.

26. Hon Jimmy NG has further sought clarification that if a person, via his shareholding in a British Virgin Island company, is the ultimate owner of a group of companies, whether the companies in question would each benefit from the proposed lower profits tax rate. The Administration has confirmed that the Inland Revenue Department ("IRD") would trace the ultimate owner through successive layers of companies in a chain of ownership and there are specific provisions in the Bill to address this point. Under the proposed new section 14AAB(4), entity A has a specified interest in entity B if entity A, whether directly or indirectly through one or more than one other entity (interposed entity), owns or controls more than 50% in aggregate of the issued share capital, voting rights, capital or profits of entity B.

27. Regarding the provisions on charge of profits tax for connected entities, the Bills Committee notes the suggestion of a deputation⁵ in its written

⁵ Hong Kong Institute of Certified Public Accountants

submission on whether there is scope to adopt a more straightforward drafting approach for the proposed new section 14AAC.

28. The Administration has explained that from a policy perspective, it may be reasonable to take the straightforward view that, under IRO as amended by the Bill, an enterprise would not enjoy the proposed two-tiered profits tax treatment if two conditions are met, namely, (a) that the enterprise is connected to another entity; and (b) that the enterprise has not elected the proposed two-tiered profits tax treatment. However, from a legislative drafting perspective, one must note the fact that under the to-be-amended section 14 of IRO, the starting position is that an enterprise would enjoy the proposed two-tiered profits tax treatment. It would be conceptually problematic to refer to the "election of two-tiered profits tax rates" at the outset of the proposed new section 14AAC. It is therefore necessary to first provide that, for a connected enterprise, the proposed section 14 of IRO as amended by the Bill would disapply to a certain extent. In this regard, it should be noted that the tax rate is only one of the aspects that the proposed section 14 of IRO would cover. That section would also provide for the basic principle that profits tax is to be charged in respect of a person's assessable profits arising in or derived from Hong Kong from the trade, profession or business carried on by that person, which would continue to apply to an enterprise even if it is connected to another entity. In other words, in so far as the connected enterprise is concerned, the proposed section 14 of IRO would apply except only for the proposed two-tiered rates of profits tax treatment. To accurately reflect that policy intent, the proposed new section 14AAC(3) provides for the modifications of section 14 of IRO for a connected enterprise. Accordingly, the election of proposed two-tiered profits tax treatment by a connected enterprise is treated as an exemption in the ensuing provision (i.e. proposed new section 14AAC(4)). The current drafting approach thus ensures that the level of precision and logical clarity required for legislation is achieved.

Avoidance of double benefits

29. The Bills Committee notes that in order to avoid double benefits, the Administration has proposed that the following would be excluded from the proposed two-tiered profits tax rates regime:

- (a) enterprises electing the existing preferential half-rate tax regimes (e.g. professional reinsurance companies, captive insurance companies, corporate treasury centres and aircraft leasing companies); and
- (b) the assessable profits for sums received by or accrued to holders of qualifying debt instruments ("QDI") as interest, gain or profit for

which are already taxed at half-rate (i.e. 7.5% or 8.25%, as the case may be).

Tax treatment on income from businesses under preferential half-rate tax regimes

30. Hon Kenneth LEUNG has enquired in the scenario where a corporation chooses to benefit from the existing preferential half-rate tax regimes, be it an aircraft leasing company or a corporate treasury centre, how its assessable profits derived from other sources would be taxed.

31. The Administration has advised that the proposed new section 14(5) makes express reference to the existing sections 14B(2)(a), 14D(5)(b), 14H(4)(b) and 14J(5)(b) of IRO in respect of certain existing preferential half-rate tax regimes (relating to professional reinsurance business/captive insurance business, qualifying corporate treasury centres and aircraft leasing companies).⁶ The Administration has added that a corporation electing for a preferential regime should be a standalone corporate entity engaging predominately in relevant businesses. Under the safe harbour rules for those preferential regimes, the standalone entity might be allowed to engage in other profit-generating activities subject to specified limits (e.g. the percentage of profits from those activities should be less than 25%).

Tax treatment on income from qualifying debt instruments

32. The Bills Committee has noted that the Legal Adviser has raised concern about the assessment of profits arising from QDI and assessable profits other than arising from QDI. In particular, the Legal Adviser has sought clarification on the following: in the case of a corporation having HK\$3 million assessable profits from its QDI as well as HK\$1 million assessable profits from operating a business in Hong Kong in the same year of assessment commencing on 1 April 2018, how the existing section 14A of IRO and the proposed two-tiered profits tax rates regime under the Bill would apply to that corporation.

33. The Administration has explained that a corporation could have assessable profits from QDI and other sources. Section 14A of IRO provides that interest, gains or profits derived from QDI 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 present Bill has not amended the existing section 14A of

⁶ The proposed new section 14(5) provides that if a corporation has made an election under section 14B(2)(a), 14D(5)(b), 14H(4)(b) or 14J(5)(b) of IRO in respect of a portion of its assessable profits, then, in relation to the rest of its assessable profits, the tax is to be charged at the rate specified in Schedule 8. The rate of profits tax in respect of a corporation as currently specified in Schedule 8 is 16.5%.

IRO. Thus, such interest, gains or profits would continue to be taxed at 7.5% or 8.25% after the implementation of the proposed two-tiered profits tax rates regime. Assessable profits from businesses unrelated to QDI would be chargeable to profits tax at the two-tiered rates under the proposed new section 14(2), (3) or (4). In the aforementioned scenario, according to the Administration, section 14A would continue to apply to the assessable profits of HK\$3 million derived from QDI. The remaining assessable profits of HK\$1 million from operating a business but not from QDI would be taxed at the lower rate of 8.25% under the proposed two-tiered profits tax rates regime.

34. The Legal Adviser has further enquired how section 14 of IRO (as amended by the Bill) and the proposed new Schedule 8A and Schedule 8B, as presently drafted, could sufficiently reflect the Administration's policy intent that QDI-related profits would not be counted towards the "cap" of HK\$2 million of assessable profits under the two proposed new Schedules.

35. In response to the Legal Adviser's enquiry, the Administration has confirmed that it is in fact the policy intent that profits relating to QDI would not be counted towards the "cap" of HK\$2 million of assessable profits under the new Schedule 8A or 8B. The Administration agrees that the Bill may be fine-tuned to reflect this policy intent more clearly. Accordingly, the Administration would propose amendments to the Bill to change the references to "assessable profits" in the proposed new Schedules 8A and 8B to "assessable profits to which section 14 [of IRO] applies".

36. Notwithstanding the Administration's explanation above, the Legal Adviser has requested the Administration to further consider whether an explicit provision similar to the proposed new section 14(5) would be necessary in respect of QDI in order to clarify beyond doubt the relationship between the existing section 14A, the proposed section 14 and the proposed new Schedule 8A and Schedule 8B in respect of assessable profits arising from QDI and the rest of the assessable profits for easy reference of the public and for avoiding possible legal dispute in the future.

37. The Administration has advised that the drafting of the proposed new section 14(5) is to provide for exceptions to the application of the proposed two-tiered profits tax rates regime for an entity electing for a preferential regime. In respect of QDI, however, the existing provision under section 14A of IRO has already made it clear that such interest, gains or profits derived from QDI are chargeable to profits tax at one-half of the rate specified in Schedule 1 (15%) or Schedule 8 (16.5%). As the relevant provision (section 14A of IRO) which is not amended would continue to be in force, the Administration considers that providing an express provision would deviate from the existing drafting practice. As regards the rest of its assessable profits of an enterprise derived from non-QDI sources, as explained in paragraph 35 above, the

Administration has agreed to propose amendments to clause 11 of the Bill to change the references to "assessable profits" in the proposed new Schedules 8A and 8B to "assessable profits to which section 14 [of IRO] applies". At the request of the Chairman, the Administration has agreed to explain the aforementioned policy intent and considerations in the speech of the Secretary for Financial Services and the Treasury to be made during the resumption of the Second Reading debate on the Bill.

38. The Administration has stressed that the proposed approach of tax treatment would serve the best interests of taxpayers. It is therefore envisaged that it would not lead to disputes from relevant taxpayers. Nevertheless, in administering the proposed two-tiered profits tax rates regime, IRD has undertaken to provide relevant guidance through its webpage and explanatory guidelines to facilitate taxpayers in completing their tax returns.

Enforcement

39. The Bills Committee has sought information on enforcement of the proposed two-tiered profits tax rates regime and whether IRD would seek additional manpower resources in this regard. The Administration has explained that taxpayers concerned would be required to indicate in their tax returns whether they elect the proposed two-tiered profits tax rates regime, and if so, declare that their connected entities, if any, have not elected the same. IRD would conduct desk audits and risk-based thematic reviews to ensure tax compliance, and penal provisions like section 82A of IRO would be invoked for incorrect returns. If the tax returns filed by taxpayers contain errors or omissions, IRD would seek additional information from the taxpayers concerned, and take appropriate measures, including raising additional tax and instituting legal actions, to rectify the errors and to enforce compliance.

40. The Administration has further advised that while it is necessary to enhance the relevant computer system of IRD, it is envisaged that the existing manpower resources can cope with the additional administrative and enforcement workload arising from the operation of the proposed two-tiered profits tax rates regime. The Administration has taken note of members' suggestion that IRD should seek additional manpower resources as appropriate and necessary to ensure compliance and combat tax evasion after introducing the proposed two-tiered profits tax rates regime.

Other suggestions on the profits tax system

41. Some members including Hon WU Chi-wai, Hon KWOK Wai-keung and Hon CHAN Chi-chuen have suggested that the Administration consider introducing a progressive profits tax rates system with more tax bands (including one for assessable profits of HK\$10 million or above for instance) in

the long run, with a view to better enhancing vertical equity, narrowing disparity between the rich and the poor, or increasing government revenue.

42. The Administration has advised that introducing a progressive profits tax rates system warrants careful consideration. In view of the international trend of reducing corporate tax rates, it may not be appropriate at this stage to consider the suggestion lest Hong Kong's competitive edge would be eroded. Nevertheless, the tax policy unit of FSTB will review Hong Kong's tax regime, including how to broaden the tax base and increase government revenue in the long run.

Proposed amendments to the Bill to be moved by the Administration

43. The Bills Committee has examined and agreed to the Administration's proposed amendments to the Bill mentioned in paragraph 35 above. In addition, members note that the Administration will move amendments to clauses 8, 11 and 12 of the Bill, which are technical amendments involving only renumbering of the proposed new section 89(21) and the proposed new Schedule 43 to IRO.⁷ The Bills Committee will not propose any amendment to the Bill.

Resumption of Second Reading debate on the Bill

44. The Bills Committee has no objection to the resumption of the Second Reading debate on the Bill at the LegCo meeting of 21 March 2018.

Consultation with the House Committee

45. The Bills Committee reported its deliberations to the House Committee on 23 February 2018.

Council Business Division 1
Legislative Council Secretariat
13 March 2018

⁷ As the Administration expects that the Bill will be enacted before the Inland Revenue (Amendment)(No. 6) Bill 2017, the Administration has subsequently advised that it will move amendments to renumber the proposed new section 89(21) and the proposed new Schedule 43 to IRO. Members were informed on 1 March 2018 vide LC Paper No. CB(1)616/17-18(01) on the updated amendments to the Bill provided by the Administration.

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

Membership list

Chairman Hon Holden CHOW Ho-ding

Members Hon WONG Ting-kwong, GBS, JP
Hon Starry LEE Wai-king, SBS, JP
Hon Paul TSE Wai-chun, JP
Hon WU Chi-wai, MH
Hon YIU Si-wing, BBS
Hon CHAN Chi-chuen
Hon Kenneth LEUNG
Hon KWOK Wai-keung, JP
Hon Christopher CHEUNG Wah-fung, SBS, JP
Hon CHUNG Kwok-pan
Hon Alvin YEUNG
Hon Jimmy NG Wing-ka, JP
Hon CHAN Chun-ying

(Total : 14 members)

Clerk Miss Cindy HO

Legal Adviser Mr Cliff IP

Appendix II

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

List of organizations which have provided written submissions to the Bills Committee

1. Hong Kong Institute of Certified Public Accountants
2. Hong Kong Small and Medium Enterprises Association
3. Liberal Party
4. The Chinese Manufacturers' Association of Hong Kong
5. The Society of Chinese Accountants & Auditors

**Examples set out in LC Paper Nos. CB(1)513/17-18(01) and
CB(1)549/17-18(02) to illustrate the meaning of connected entities
under clause 4 of the Bill**

Example (1)

In the case of a natural person A ("A") who solely owns only one corporation B ("B"), please clarify whether:

- (a) A and B are considered as "connected entities" pursuant to the proposed section 14AAB(1)(a) of Cap. 112 under clause 4; and*
- (b) B would not benefit from the proposed lower profits tax rate if it does not proactively make an election in writing for the proposed lower profits tax rate to apply to it, pursuant to the proposed section 14AAC(4) of Cap. 112. Please also explain how that written election is to be made in practice.*

Please clarify if it is the legislative intent to allow only one of two corporations which are connected entities defined under the proposed section 14AAB of Cap. 112 to benefit from the proposed lower profits tax rate even if their combined profits are less than HK\$2 million.

The Administration's response:

A and B are considered as connected entities under the proposed section 14AAB(1)(a). 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. 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 HK\$2 million.

Example (2)

Please provide clarifications in respect of the following scenario in the year of assessment commencing on 1 April 2018:

	<i>HK resident X ("X")</i>	<i>HK resident Y ("Y")</i>
<i>Corporation(s)</i>	<i>X solely owns: (i) corporation F (only business is to sell flowers in HK); and (ii) corporation N (only business is to sell noodles in HK).</i>	<i>Y solely owns only one corporation T (only business is to sell toys in HK).</i>
<i>Net profits (HK\$)</i>	<i>F: 800,000 and N: 800,000 (i.e. X's overall profits are 1,600,000)</i>	<i>T: 2,000,000</i>

Scenario 1

- (a) is X allowed to elect in writing only one of his corporations (either F or N) for the proposed lower profits tax rate pursuant to the proposed section 14AAC(4) of Cap. 112?*

- (b) whether X would have to pay more profits tax than Y, even if X has less overall profits than Y. Please explain the rationale behind this policy intent.*

The Administration's response:

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). 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. 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.

Scenario 2

Suppose X restructures his businesses, so that N's business selling noodles is completely transferred on 1 March 2019 to F. N ceases its business and is wound up/de-registered on 1 March 2019. If the only reason that X restructures his businesses is to benefit from the lower profits tax rate in the year of assessment commencing on 1 April 2018 and the subsequent years (if the Bill is passed), would F and/or N be entitled to the proposed lower profits tax rate in the year of assessment commencing on 1 April 2018 and the subsequent years, and would not be treated as avoiding liability for tax?

The Administration's response:

According to the Administration, 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 2018-2019, 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 HK\$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.