REPORT ON THE PROFITS TAX REVIEW

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Introduction

This report sets out in detail the proposals which the Financial Secretary has announced in the 1998-99 Budget following the comprehensive review of Profits Tax.

Background

2. In his 1997-98 Budget Speech, the Financial Secretary announced that he would conduct a comprehensive review of Profits Tax to examine whether we can make our taxation system and business environment more competitive.

Establishment of the Working Group on Profits Tax Review

3. We established a Working Group on Profits Tax Review in July 1997 for the purpose of conducting the review. The Secretary for the Treasury chaired the Working Group, which comprised representatives from the Finance, Financial Services, Trade and Industry and Economic Services Bureaux, the Inland Revenue Department and the Business & Services Promotion Unit of the Financial Secretary's Office.

Consultation

4. One of the immediate tasks of the Working Group was to carry out a public consultation exercise. On 29 July 1997, it issued a consultation document to Provisional Legislative Council Members, political groups, professional bodies, business associations, chambers of commerce and academic institutions to solicit their views. The document was also available on the Internet and from the Inland Revenue Department. When the consultation exercise ended on 6 September 1997, a total of 74 written submissions had been received. Many views were also expressed in the media.

Recommendations

5. The Working Group carefully examined all the submissions and views received in the consultation exercise and made recommendations to the Financial Secretary on the review. On the basis of these recommendations, the Financial Secretary announced the following proposals in his 1998-99 Budget Speech.

Profits Tax rate

6. Divergent views were expressed in the consultation exercise on whether or not to reduce the corporate Profits Tax rate from its current level of 16.5%. Some submissions supported a reduction on the grounds that this would increase our competitiveness and attract investment. Others considered that our tax rate was already very low when compared with our regional competitors and that further reduction was not warranted. There was also a concern that a reduction in Profits Tax rate would affect revenue, which in turn might have an adverse impact on Government expenditure on essential programmes.

7. Our conclusion is that a moderate reduction in Profits Tax rate is both affordable and necessary. As a matter of fiscal policy, we should not tax more than we need. Our fiscal strength permits us to make a modest reduction without imperilling our ability to maintain Profits Tax as a main revenue stream. Neither will such a reduction have any adverse impact on our expenditure programme which will remain fully funded from revenues. Although our tax rate is very low when compared with those of our regional competitors, there is no room for complacency, particularly with the recent regional currency devaluations. Our competitors are also introducing a wide range of tax incentives to attract investors. We have to respond to these challenges, if we want investors and the international business community to know that Hong Kong continues to offer far and away the most attractive tax environment in the Asia-Pacific region and remains the best place for them to carry on profitable business.

8. With the above considerations, the **Financial Secretary proposes to reduce the corporate Profits Tax rate from 16.5% to 16% from 1 April 1998.** The current standard Profits Tax rate for unincorporated businesses will remain unchanged at 15%, in line with the standard rate of Salaries Tax.

Depreciation allowance

9. We provide generous depreciation allowance in taxation for plant and machinery. These encourage businesses to invest in such items and so to enhance their efficiency and productivity. The initial allowance is 60% in the year in which the expenditure is incurred. The annual allowance ranges from 10% to 30% for different types of plant and machinery. The total depreciation allowance for the first year can thus be as high as 72% (i.e. 60% plus 30% of the remaining 40%).

10. We intend to maintain the current initial and annual depreciation allowances. To provide further incentives for investment in high value manufacture and modern business systems, thereby strengthening the competitiveness of our businesses, **the Financial Secretary proposes to allow an immediate 100% write-off for new expenditure on plant and machinery specifically related to manufacturing, and on computer hardware and software, which are owned by end-users. We will also allow an immediate write-off of the residual value of such items already in hand.**

Tax deductions

11. At present, all revenue expenses incurred in the production of assessable profits are in general fully deductible for taxation purposes. In respect of scientific research, we also allow expenditure of a capital nature (apart from that on land or buildings) for tax deduction. Payments to approved research institutes for conducting scientific research are also deductible. We do not consider it justified, however, to provide an enhanced deduction, as some have suggested, to further encourage expenditure in research and development. This would contradict our basic tax principle that deductions should not exceed the actual expenditure incurred. It would also complicate tax administration and generate scope for abuse.

12. However, with the change in focus of our economy towards the development of service industries, and to cope with changes in the modern day business environment, **the Financial Secretary proposes to expand the scope of tax deduction for expenditure on scientific research to cover capital expenditure incurred on market research, feasibility studies and other research activities related to business and management sciences.** This will provide an additional incentive for our businesses to find ways to add higher value and to achieve higher productivity.

Rebuilding allowance

13. At present, we allow for taxation purposes a 20% initial depreciation allowance and a 4% annual depreciation allowance for investment in industrial buildings. This is a concession introduced some years ago to support industrial development.

14. In respect of commercial buildings, no initial depreciation allowance is granted but there is an annual depreciation allowance of 2% which was intended to write off the cost of construction of the buildings over a period of 50 years. This is no longer appropriate in present day circumstances. With the change in focus of Hong Kong's economy towards the development of service industries, there are strong grounds to increase the annual depreciation allowance for commercial buildings as a means to promote that development. **The Financial Secretary proposes to double the annual depreciation allowance for commercial buildings from 2% to 4%, to align it with that for industrial buildings.**

15. While industrial buildings are purpose-built and normally have a high degree of wear and tear once they are occupied and are thus subject to a high initial depreciation, this is not generally the case for commercial buildings. We therefore do not consider it justified to extend the initial depreciation allowance for industrial buildings to commercial buildings.

Refurbishment and renovation

16. In the 1996-97 Budget, we introduced a concession for hotels which allowed their capital expenditure on refurbishment and renovation to be written off for taxation purposes over a period of five years, based on a 20% amortisation per year. With the change in focus of our economy towards the development of service industries, there is a need for other businesses, e.g. restaurants, retail shops and offices, to maintain and upgrade the standards and quality of their premises regularly, thereby strengthening their competitiveness and enhancing their image, and that of Hong Kong. **The Financial Secretary proposes to extend the concession to all other business sectors and allow their capital expenditure on renovation and refurbishment to be amortised for taxation purposes over a period of five years, based on a 20% straight-line annual write-off.**

Tax incentives

17. Since our Profits Tax regime is itself an attractive general incentive for a business to operate in Hong Kong, we have no strong reasons to introduce special tax measures in order to attract businesses to Hong Kong. But we do provide tax incentives in specific areas where this may be necessary to provide a level playing field for our businesses vis-à-vis their competitors in the region. For example, we have introduced special tax concessions to encourage the issue of quality debt instruments in Hong Kong.

18. To allow Hong Kong to develop into a regional reinsurance centre and to provide a level playing field, **the Financial Secretary proposes to provide a concessionary tax rate at 50% of normal Profits Tax rate for the offshore business of professional reinsurance companies authorised in Hong Kong.** Reinsurance companies can opt for the concession on an irrevocable basis.

Fund management

19. To update our tax legislation concerning fund management, **the Financial Secretary proposes to replace the present restrictive listing of the types of income derived by beneficiaries from fund management which qualify for tax exemption with a general definition in order to keep pace with the fast-changing developments in financial services.** This will obviate the need to amend the legislation on a piecemeal basis whenever new types of market instruments become available for investment.

Relief for losses

20. We allow business losses to be carried forward for set-off against profits of future years of assessment. There is no restriction on the length of time that losses may be carried forward prior to being set off in this way. A business, therefore, needs only to pay tax on net profits over its lifetime.

21. With our generous tax treatment for losses, we feel that there is no justification for introducing group relief as has been requested by some. Places which offer such relief normally impose Profits Tax at rates substantially higher than in Hong Kong. Many tax residents on their world-wide income. Some also impose a time limit on the carrying forward of unrecouped losses. Our treatment is thus more favourable. Introduction of group relief in our tax regime would complicate tax administration, and create scope for abuse. On the other hand, the absence of group relief has not affected our competitiveness.

Double taxation

Airline income

22. It is our policy to include double taxation relief arrangements for airline income in the bilateral Air Services Agreements (ASAs) negotiated between Hong Kong and our aviation partners. We have made such arrangements with the Republic of Korea, New Zealand, Canada, Germany, the Netherlands, and the United Kingdom. Similar arrangements with other places are in the pipeline. In the majority of cases, these arrangements will bring a net revenue gain in favour of Hong Kong. **The Financial Secretary proposes to continue to negotiate such arrangements with our aviation partners.**

Shipping

23. We are committed to maintaining Hong Kong as a major world shipping centre. We have concluded a reciprocal exemption of taxation arrangement on shipping with the United States of America.

24. Many places either allow reciprocal exemption of taxation on shipping in their tax law, or have entered into double taxation relief arrangements, which effectively exempt their ship operators from paying freight tax in respect of their operation in other places.

25. To enable Hong Kong ship operators to compete on level terms in the international shipping arena, **the Financial Secretary proposes -**

a) **to amend the Inland Revenue Ordinance to provide reciprocal exemption of taxation on shipping so that Hong Kong ship operators can benefit from the tax relief offered by those places which have similar reciprocal tax exemption in their legislation; and**

b) **to enter into negotiation of double taxation relief arrangements on shipping with major shipping centres which do not provide reciprocal tax exemption in their legislation, with priority to be given to those places which are the main cargo sources for Hong Kong ship operators.**

Double taxation vis-à-vis the Mainland of China

26. Business contacts between the Mainland of China and Hong Kong are well-established. These will further develop and flourish now that Hong Kong is a Special Administrative Region of China. It is our objective to further promote and facilitate this development. **We have reached an understanding with the relevant authorities in the Central People's Government on arrangements aimed at minimizing the scope for double taxation between the Mainland and Hong Kong. The arrangements cover airline and shipping operations as well as other business areas.** They will enhance the competitiveness of Hong Kong businesses operating on the Mainland.

Comprehensive double taxation agreements

27. We accept that comprehensive double taxation agreements can bring economic benefits to Hong Kong under a combination of circumstances. However, these must be weighed against the potential revenue loss in making such agreements, which may require us to give up our taxing rights in respect of profits sourced in Hong Kong while not taxing off-shore profits in return. Moreover, there may be demands for exchange of information between the tax authorities of the agreement parties which may be in conflict with the secrecy provisions under our tax legislation. These are issues which need further careful examination.

28. The Financial Secretary therefore proposes as a first step to explore with the governments of a few countries the negotiation of comprehensive double taxation agreements, where this would be in Hong Kong's overall interests.

Certainty in the operation of the tax regime

29. Our simple and predictable Profits Tax regime offers certainty to investors. Our tax legislation is relatively straightforward, but, where necessary, we clarify it through the issue of administrative practice notes. **The Financial Secretary proposes that the Inland Revenue Department should continue to issue practice notes for clarification of the operation of the taxation system.**

30. Under our territorial source principle of taxation, only income which has a source in Hong Kong is taxable here. While the principle itself is clear, its application in individual cases has been, at times, contentious. To enhance certainty in its operation, **the Financial Secretary proposes that the Inland Revenue Department should provide an advance ruling service for the business community on source of profits.** Businessmen will be able to learn in advance whether or not profits to be derived from a proposed venture would be subject to Hong Kong Profits Tax. The Inland Revenue Department will provide the advisory service on a full cost recovery basis from 1 April 1998.

31. To explain and illustrate the operation of the territorial source principle to a wider audience, **we are publishing a simple guide on the principle for distribution to the business community.** We will also put the guide on the Internet to ensure that it is widely available.

Promotion

32. We recognize that we have to adopt a more pro-active approach than hitherto to publicize the merits of our Profits Tax regime in order to attract investments and businesses to Hong Kong. **We are publishing a booklet to publicise the advantages of our Profits Tax regime.** The booklet will be written principally for corporate managers and directors who may not have a professional background in tax matters. The booklet will hopefully lead them to make business and investment decisions in Hong Kong's favour. We will distribute the booklet both locally, and internationally through our overseas economic and trade offices. We will also put it on the Internet to ensure that it is widely available.

Cost to the revenue

33. The total cost of the proposals arising from the Profits Tax review is $1.6 billion in 1998-99. Because of our provisional tax payment arrangement, the first year cost is comparatively low and does not reflect the full picture. **The cumulative cost of the package for four years over the Medium Range Forecast period up to 2001-02 is $19.9 billion.**