

Tax

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Tax Analysis

Two-tiered Profits Tax Rates Regime Introduced in Hong Kong

Author:

Hong Kong

Ryan Chang

Tax Partner

Tel: +852 2852 6768

Email: ryanchang@deloitte.com

Doris Chik

Tax Senior Manager

Tel: +852 2852 6608

Email: dchik@deloitte.com.hk

The Hong Kong profits tax rate has been set as a flat rate for decades. The current tax rate is 16.5% for a corporation and 15% for an unincorporated business. A two-tiered profits tax rates regime was proposed by the Chief Executive in October 2017, which targets to reduce the tax burden of small and medium enterprises ("SMEs") and start-up enterprises. The relevant Inland Revenue (Amendment) (No.7) Bill 2017 (the "Bill") was gazetted on 29 December 2017 and will be introduced to the Legislative Council on 10 January 2018. Subject to the enactment of the legislation, the two-tiered tax rates will apply starting from the year of assessment 2018/19.

This article highlights the features of this two-tiered profits tax rates regime and the issues that need to be clarified, and analyses the implications to the Hong Kong economy and businesses.

Key features

Under the proposed two-tiered system, the first HK\$2 million of assessable profits for corporations and unincorporated businesses (including sole proprietorships and partnerships) will be taxed at half of the current tax rate, i.e. 8.25% and 7.5% respectively. The remaining assessable profits will be taxed at the current full tax rates of 16.5% and 15% for corporations and unincorporated business respectively, as shown in the table below:

<i>Assessable Profits</i>	<i>Tax Rate</i>	
	<i>Corporation *</i>	<i>Unincorporated Business</i>
<i>First HK\$2 million</i>	8.25%	7.5%
<i>Remainder</i>	16.5%	15%

* When a corporation is a partner of a partnership, the concessional tax rate of 8.25% will only apply to the first HK\$2 million pro-rated by its share in the partnership.

Other Features

1. Only one entity in each group is eligible

The main objective of the regime is to reduce the tax burden of SMEs and start-up enterprises. To avoid group enterprises splitting income amongst numerous entities in order to enjoy the lower tax rate, restrictions are introduced which limit the application of the two-tiered tax rates to only one entity nominated by a group of "connected" entities. The "connected" relationship is determined by their status at the end of the basis period.

Generally speaking, an entity is a "connected" entity of another entity if:

- a. one of them has "control" over the other; or
- b. both of them are under the "control" of the same entity.

"Control", in simple terms, generally refers to holding directly or indirectly more than 50% of issued share capital, voting rights, capital or profits in another entity.

For sole proprietorship business, one is "connected" to another if it is carried on by the same natural person.

2. No double benefits

Certain entities may have already enjoyed half tax rate under the current preferential tax regimes, such as reinsurance business, captive insurance business, corporate treasury centre, aircraft leasing business and aircraft leasing management business. Under the proposed Bill, entities elected for these preferential half-rate tax regimes will be excluded from the two-tiered profits tax system. Once an entity has made an election for either of these preferential tax regimes so that its qualifying assessable profits are subject to the half tax rate, the remaining non-qualifying profits will be subject to the full tax rate.

Under such rules, an entity should consider whether or not to elect for the preferential tax regime. For example, a reinsurance business derives total assessable profits of HK\$3 million, of which HK\$1 million are qualifying profits and HK\$2 million are non-qualifying profits. If it elects the preferential tax regime under Section 14B, only HK\$1 million are subject to the half tax rate of 8.25% while HK\$2 million are subject to the full tax rate of 16.5%. If it does not elect the preferential tax regime, it can enjoy the two-tiered tax rates, where HK\$2 million of its assessable profits, no matter qualifying or non-qualifying, will be taxed at half rate and HK\$1 million at full rate. Under this circumstance, it may be more beneficial not to elect the preferential tax regime, but enjoy the two-tiered tax rates regime.

Under the existing tax law, assessable profits from qualifying debt instruments e.g. interest, gain or profit are already taxed at half rate. According to the proposed Bill, such assessable profits will continue to be subject to the half rate and not eligible for double benefits. Nevertheless, unlike the above preferential tax regimes for reinsurance, corporate treasury centres, aircraft leasing etc., the entity itself is not excluded from the two-tiered profits tax rates regime. However, whether or not such assessable profits from the qualifying debt instruments will be counted as the first HK\$2 million threshold of the two-tiered tax regime may need to be clarified.

3. Election

The proposed Bill is constructed in a way that the two-tiered profits tax rates regime will apply to all entities by default, except connected entities.

For connected entities, the Bill provisions are drafted in a not-easy-to-follow logic that the default two-tiered tax rates are modified as full tax rate unless the entity elects to be exempt from the modification for a specified year of assessment. Our interpretation, in simple terms, is that the entity nominated by the group needs to elect in writing to enjoy the two-tiered tax rates for a specified year of assessment. Following this logic, it can be assumed that a group can nominate a different entity to enjoy the two-tiered tax rates every year. However, the draft Bill contains a provision that "the election, once made, is irrevocable". Clarification¹ may be needed on whether or not the irrevocability applies to that specified year of assessment only. Otherwise, a group should carefully analyse which entity to be nominated if the election is irrevocable for good.

We consider that the above default and election system is reasonable. As the main objective of the Bill is to reduce the tax burden on SMEs and start-up enterprises, the default two-tiered system will not bring additional tax administration burden to them. On the other hand, the election system for connected entities is also reasonable because only the nominated entity will need to file the election in writing while other group entities will be subject to the full tax rate by default.

4. Provisional profits tax for transitional arrangement

As mentioned above, subject to the enactment of the legislation, the two-tiered tax rates will apply starting from the year of assessment 2018/19. It will also apply to the provisional profits tax.

During the transitional period, if the 2018/19 provisional profits tax is imposed based on the full tax rate for certain entities, the draft Bill provides an additional ground for holdover of the 2018/19 provisional profits tax on top of the holdover grounds under the existing rules. In particular, an application for holding over the payment of 2018/19 provisional profits can be made based on the ground that the entity is likely to be chargeable under the two-tiered profits tax regime. The application must be made in writing to the Commissioner within the prescribed time limit.

Implications to the Hong Kong Economy and Businesses

We believe the Bill is a positive step towards making Hong Kong a competitive tax regime. In particular, the lower tax rate will reduce the tax burden on SMEs and startup businesses and help foster a favourable business environment, drive economic growth and enhance Hong Kong's competitiveness in general. The government envisages that the tax savings by enterprises can be reinvested in upgrading their existing equipment, which would increase efficiency and stimulate innovation. Social enterprises will have more freedom to pursue their social objectives with the extra tax savings. Overall, the Bill will gain international publicity mileage in promoting Hong Kong as a preferred investment destination which in turn could bring in additional tax revenue in the future.

For businesses, the management of a group should consider which entity to be nominated for the two-tiered tax rates regime, subject to further clarification on the irrevocability issue as analyzed above¹. In addition, certain special businesses should consider whether it is beneficial to elect for preferential tax treatments. Finally, all entities should keep track of its 2018/19 provisional profits tax payment status, and consider if a holdover application should be made, subject to the enactment of the legislation.

¹ According to the FAQs issued by the IRD on 7 August 2018, once the election is made, it is irrevocable for that year. However, a different connected entity may elect the two-tiered profits tax rates for a different year of assessment if all conditions are met.

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Beijing

Andrew Zhu
Partner
Tel: +86 10 8520 7508
Fax: +86 10 8518 1326
Email: andzhu@deloitte.com.cn

Chengdu

Frank Tang / Tony Zhang
Partner
Tel: +86 28 6789 8188
Fax: +86 28 6500 5161
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Chongqing

Frank Tang / Tony Zhang
Partner
Tel: +86 23 8823 1208 / 1216
Fax: +86 23 8859 9188
Email: ftang@deloitte.com.cn
tonzhang@deloitte.com.cn

Dalian

Bill Bai
Partner
Tel: +86 411 8371 2816
Fax: +86 411 8360 3297
Email: bilbai@deloitte.com.cn

Guangzhou

Victor Li
Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: vicli@deloitte.com.cn

Hangzhou

Qiang Lu / Fei He
Partner / Director
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@deloitte.com.cn
fhe@deloitte.com.cn

Harbin

Jihou Xu
Partner
Tel: +86 451 8586 0060
Fax: +86 451 8586 0056
Email: jihxu@deloitte.com.cn

Hong Kong

Sarah Chin
Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@deloitte.com.hk

Jinan

Beth Jiang
Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: betjiang@deloitte.com.cn

Macau

Raymond Tang
Partner
Tel: +853 2871 2998
Fax: +853 2871 3033
Email: raytang@deloitte.com.hk

Nanjing

Frank Xu / Rosemary Hu
Partner
Tel: +86 25 5791 5208 / 6129
Fax: +86 25 8691 8776
Email: frakxu@deloitte.com.cn
roshu@deloitte.com.cn

Shanghai

Eunice Kuo
Partner
Tel: +86 21 6141 1308
Fax: +86 21 6335 0003
Email: eunicekuo@deloitte.com.cn

Shenzhen

Victor Li
Partner
Tel: +86 755 3353 8113
Fax: +86 755 8246 3222
Email: vicli@deloitte.com.cn

Suzhou

Maria Liang / Kelly Guan
Partner
Tel: +86 512 6289 1328 / 1297
Fax: +86 512 6762 3338
Email: mliang@deloitte.com.cn
kguan@deloitte.com.cn

Tianjin

Jason Su
Partner
Tel: +86 22 2320 6680
Fax: +86 22 2320 6699
Email: jassu@deloitte.com.cn

Wuhan

Gary Zhong
Partner
Tel: +86 27 8526 6618
Fax: +86 27 6885 0745
Email: gzhong@deloitte.com.cn

Xiamen

Jim Chung / Charles Wu
Partner / Director
Tel: +86 592 2107 298 / 055
Fax: +86 592 2107 259
Email: jichung@deloitte.com.cn
chwu@deloitte.com.cn

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National Tax Technical Centre

Email: ntc@deloitte.com.cn

National Leader

Ryan Chang
Partner
Tel: +852 2852 6768
Fax: +852 2851 8005
Email: ryanchang@deloitte.com

Southern China (Hong Kong)

Ryan Chang
Partner
Tel: +852 2852 6768
Fax: +852 2851 8005
Email: ryanchang@deloitte.com

Northern China

Julie Zhang
Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@deloitte.com.cn

Southern China (Mainland/Macau)

German Cheung
Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@deloitte.com.cn

Eastern China

Kevin Zhu
Director
Tel: +86 21 6141 1262
Fax: +86 21 6335 0003
Email: kzhu@deloitte.com.cn

Western China

Tony Zhang
Partner
Tel: +86 23 8823 1216
Fax: +86 23 8859 9188
Email: tonzhang@deloitte.com.cn

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wendy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.

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