

HONG KONG TAX

HONG KONG INTRODUCES TWO-TIERED PROFITS TAX SYSTEM



The Inland Revenue (Amendment) (No 7) Bill 2017 (Amendment Bill) was gazetted on 29 December 2017 and was introduced into the Legislative Council on 10 January 2018. It aims to implement the two-tiered profits tax system unveiled in the Chief Executive's maiden Policy Address delivered on 11 October 2017.

KEY FEATURES

1. Half tax rate for the first HK\$2 million of assessable profits

From the year of assessment 2018/19 onwards, profits tax rate for the first HK\$2 million of assessable profits of corporations will be lowered to 8.25% with the excess assessable profits continue to be taxed at 16.5%. For unincorporated businesses (eg partnerships and sole proprietorships), the profits tax rate for the first HK\$2 million of assessable profits will be lowered from 15% to 7.5% with the excess assessable profits continue to be taxed at 15%. The maximum tax savings for incorporated and unincorporated businesses will be HK\$165,000 and HK\$150,000 each year respectively.

2. Only one nominated entity of a group of connected entities is entitled to the two-tiered profits tax regime

To ensure that the tax benefits will target at small and medium enterprises, there are restrictions to limit the application to only one nominated entity of a group of connected entities. An entity is a "connected entity" of another entity if:

- One of them has control over the other;
- Both of them are under the control of the same entity; or
- In the case of the first entity being a natural person carrying on a sole proprietorship business, the other entity is the same person carrying on another sole proprietorship business.

One entity will be considered to have "control" over the other if the entity, whether directly or indirectly through one or more than one interposed entity:

- Owns or controls more than 50% in aggregate of the issued share capital of the other entity;
- Is entitled to exercise or control the exercise of more than 50% in aggregate of the voting rights in the other entity;
- Is entitled to more than 50% in aggregate of the capital or profits of the other entity; or
- In the case where the other entity being a trust, the entity concerned is entitled to a vested interest in more than 50% of the capital of the property of the trust.

Under the proposed regime, the two-tiered profits tax rates are to be applied in default with a modification for a “connected entity” such that its assessable profits would be charged at the full tax rate instead. The “connected entity” nominated by the group is required to elect in writing to be so exempted from the modification for a specified year of assessment. Once an entity has been so exempted for a year of assessment, the exemption will not be given to other connected entities for that year of assessment. In addition, the election, once made, is irrecoverable.

3. No double benefits

It should also be noted that where a corporation has made an election to have part of its assessable profits taxed under any of the preferential half-rate tax regimes (eg professional reinsurance companies, captive insurance companies, corporate treasury centres and aircraft leasing companies), it is excluded from the two-tiered profits tax regime.

4. 2018/19 provisional tax

The Amendment Bill also provides a new ground for holding over of 2018/19 provisional profits tax, ie the taxpayer is likely to be chargeable to profits tax under the two-tiered profits tax regime.

group. For entities which are formed by two or more shareholders or partners, each owning 50% or less of the issued share capital, voting rights, capital or profits of the entities, it appears that such entities could be entitled to the two-tiered profits tax regime even though they may be owned by the same shareholders or partners.

- ii. It is unclear whether a different entity of the group can be nominated each year to enjoy the two-tiered tax rates. We assume it is possible as the exemption is granted on a specified year of assessment basis. We expect the IRD to provide further clarification when it issues administrative procedures on how to implement the regime. Subject to further clarification, group companies should carefully consider which entity to be nominated and seek professional advices if required.
- iii. It is uncertain how can the IRD determine whether taxpayers are “connected entities” for administrating the two-tiered profits tax system. One possibility is that the IRD may request taxpayers to declare in the tax returns whether they are connected entities. Taxpayers should consider their group structure before making the declaration in order to avoid making any incorrect statement in the tax return which may attract penalty.
- iv. Taxpayers should also be mindful of the 2018/19 provisional profits tax charged by the IRD during this transitional period and consider whether it is necessary to apply for a holdover of the 2018/19 provisional tax after the legislation comes into effect.

OUR OBSERVATIONS

- i. An entity with over 50% of its issued share capital, voting rights, capital or profits held by another entity will be considered as “connected entity” and not eligible for the two-tiered profits tax regime unless it is nominated by the

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