28 February 2018

Hong Kong 2018 - 19 Budget insights

Early days for the new fiscal philosophy

Highlights

- Reduce profits tax, salaries tax and tax under personal assessment for 2017-18 by 75%, capped at HK$30,000
- Widen the marginal bands for salaries tax from HK$45,000 to HK$50,000
- Adjust the marginal tax rates for salaries tax from 2%, 7%, 12% and 17% to 2%, 6%, 10%, 14% and 17%
- Introduce personal disability allowance of HK$75,000
- Introduce a tax deduction of up to HK$8,000 per person (including dependents) for premium paid for qualified health insurance products
- Raise basic and additional child allowances from HK$100,000 to HK$120,000
- Raise basic and additional dependent parent or grandparent allowances from HK$46,000 to HK$50,000 (aged 60 or above) and from HK$23,000 to HK$25,000 (aged 55 to 59)
- Raise deduction ceiling for elderly residential care expenses from HK$92,000 to HK$100,000
- Relax the requirement for election of Personal Assessment by married persons
- Waive government rates for 2018-19, capped at HK$2,500 per quarter for each rateable property
- Provide two additional months of various social security payments

Whilst the Financial Secretary concluded his 2018-19 budget speech by noting his belief that Hong Kong can brave stormy winds and turn its dreams into reality, a portion of his audience may have hoped for more.

Talk around town for several weeks has focused on the likely magnitude of the 2017-18 fiscal surplus and what should be done to share this bounty with Hong Kong taxpayers and the general public alike. The usual pressure groups have been making suggestions on behalf of their stakeholders, whilst the general public hoped for a cash handout that they could spend in ways that are most appropriate to their individual circumstances. Combined with the Chief Executive's declaration of a new fiscal philosophy aimed at making better use of fiscal reserves, there was perhaps a heightened optimism that the 2018-19 budget would be something special bringing together a raft of tax breaks with a detailed plan for implementing the government's declaration of a new philosophy.

Based on the Financial Secretary's budget speech, we may need to wait a little longer to see the full implementation of the new fiscal philosophy, at least in terms of dipping into our fiscal reserves to fund future investment and of using those reserves to substantially increase the provision of government services in the medium term.

Prudence would however appear to have the upper hand in the 2018-19 budget. Whilst touting the intention to make better use of the 2017-18 surplus, the Financial Secretary nonetheless forecast that public expenditure within the next five years will still be in the range of 21.2% to 21.8% of GDP, a figure not too dissimilar from that appearing in the mid-range forecast contained in last year's budget. In fact, Hong Kong's fiscal reserves are projected to increase from the current level of HK$1,091 billion to HK$1,222 billion as at 31 March 2023. Listeners may therefore wonder how better use of a fiscal reserve can be achieved if the absolute fiscal reserve does not reduce.

Furthermore, whilst the planned increased expenditure on innovation and technology is to be applauded, there remains a question of measuring the effectiveness of such expenditure and ensuring that Hong Kong gets the best bang for its tax dollars.

EY 安永
Building a better working world

On a more positive note, the Financial Secretary appears to have come up with a couple of novel ideas to address the ageing population concern. Both the annuity scheme and the tax deduction for voluntary MPF contributions should incentivize people to prepare for their retirement. The ultimate success of these two ideas may depend on the final operational details which will be forthcoming.

Alas, the wished-for cash handouts failed to make an appearance in the budget speech. However, the middle class should be pleased with the reasonably generous salaries tax rebate, amended marginal tax rates and increased personal allowances, whilst small or medium sized businesses should be pleased to receive a similar tax rebate.

The Financial Secretary has frequently noted his desire for a caring and just society. In his budget speech, he has to a degree included steps to achieve the same by way of the extra two months of social security payment. The HK$2,000 handout per annum to students from less privileged backgrounds would however appear somewhat on the low side.

In conclusion, the proposals outlined by the Financial Secretary in the 2018-19 budget would appear to be first steps toward a wider implementation of the government's new fiscal philosophy. We await, with interest, the full roll-out of the new philosophy.

Forward-looking tax measures to promote Hong Kong's economic development

In today's budget, the Financial Secretary detailed those tax measures which have been adopted by the government based on the findings of the Tax Policy Unit (TPU) and their review of the merits of each.

The TPU was established last year under the Financial Services and Treasury Bureau with a view to examining the international competitiveness of Hong Kong's tax regime and fostering the development of the innovation and technology sector in particular.

Proposed two-tiered profits tax rates regime

In response to the international trend of reducing corporate income tax rates as a means of attracting foreign investment and businesses, Hong Kong will, subject to legislative approval, introduce a two-tiered profits tax rates regime effective from the year of assessment 2018-19.

Under the proposed regime, the rate of tax for the first HK$2 million of profits of corporations and unincorporated businesses (UBs) will be reduced by half (i.e., reduced from 16.5% to 8.25% for corporations and from 15% to 7.5% for UBs). The remainder of the profits will continue to be taxed at the normal applicable rates.

To ensure that the proposed regime primarily benefits small and medium enterprises and startups, and in order to prevent income splitting, the bill contains restrictive provisions prescribing that "connected entities" can only elect a single entity as eligible for the proposed two-tiered profits tax rates regime for a given year of assessment.

Proposed super tax deductions for expenditure on qualifying research and development (R&D) activities

As regards the proposed super tax deductions for expenditure on qualifying R&D activities, the Financial Secretary announced that the relevant bureaus had consulted the views of stakeholders and are formulating draft legislation. The Government aims to submit the draft legislation to the Legislative Council as soon as possible, with a view to implementing the proposal in 2018.

Under the proposal, the first HK$2 million of eligible R&D expenditure will enjoy a 300% tax deduction and the remainder a deduction at 200%.

While we welcome this initiative as a means of spurring innovation and technology in Hong Kong, the Financial Secretary may need to give further thought to certain features of the proposed legislation.

Firstly, it is understood that the proposed super tax deductions would only apply to expenditure incurred for R&D activities undertaken in Hong Kong. Furthermore, the super deductions may not cover R&D activities which have been subcontracted out, whether undertaken inside or outside Hong Kong.

As a practical reality, enterprises may often find it necessary to subcontract out their R&D activities to be undertaken by a service provider inside or outside Hong Kong, including those undertaken under cost-sharing arrangements in a group context. This is particularly the case given that Hong Kong may lack sufficient talent with the necessary skills and expertise to conduct certain types of R&D activities. Under the proposed regime, such enterprises would not be able to enjoy the proposed super tax deductions for expenditure on R&D.

It may also be worth considering the introduction of an additional provision into the proposed legislation granting taxpayers an option to convert their super tax deductions into a cash subsidy or refundable tax credit.

Such an option would in particular encourage enterprises not currently making profits (and for whom super tax deductions would be of no current value) to continue to undertake R&D activities.

We hope that the Financial Secretary will take the above into consideration when finalizing the draft legislation.

Further strengthening Hong Kong's asset management industry

When presenting the budget, the Financial Secretary noted the initiatives the government has already introduced with a view to strengthening the ability of the Hong Kong fund industry to compete in the market and to diversify the management platform.

These initiatives include a legislative bill granting profits tax exemption to resident privately offered open-ended fund companies (OFCs) incorporated in Hong Kong. To ensure that the proposed tax exemption regime for OFCs complies with the international standards, it is understood that the government is considering making certain technical amendments to the bill to remove the potential ring-fencing features of the proposed regime.

Furthermore, to facilitate Hong Kong's development into a full-fledged fund service center, the Financial Secretary also announced that the government will examine the feasibility of introducing a limited partnership regime in Hong Kong for private equity funds and the related tax arrangements.

We welcome the above initiatives. In addition, the Financial Secretary may also consider the desirability of extending the proposed tax exemption for resident OFCs to cover all types of resident funds in Hong Kong, including resident trust funds and other resident fund companies not incorporated in Hong Kong, and resident partnership funds not established under the proposed limited partnership regime.

Developing Hong Kong's bond markets

Under the current Qualifying Debt Instrument (QDI) scheme, interest income and trading profits arising from QDIs will be tax exempt in Hong Kong if the term of maturity of the QDIs are not less than seven years. QDIs with a shorter term of maturity can also enjoy a 50% concession from the normal profits tax rate. To be eligible for the tax concession, the instruments must lodged and cleared by the Central Moneymarkets Unit of the Hong Kong Monetary Authority (HKMA).

In order to promote the further development of the bond market in Hong Kong, the Financial Secretary announced in the budget that the QDI scheme will be extended to cover debt securities which are not cleared with the HKMA but are listed on the Stock Exchange of Hong Kong. In addition, the scope of tax exemption will also extend from debt instruments with a term of maturity of not less than seven years to an instrument of any duration.

Key budget assumptions, budgetary criteria and projections

Assumptions used for the medium range forecast (MRF) for the period from 2018-19 to 2022-23

- Real GDP growth rate for the forecast period is 3% to 4% for 2018 and the trend rate for 2019 to 2022 is 3%.
- Investment return is estimated to be 4.6% in 2018 and in the range of 3.7% to 4.9% per annum thereafter.
- Land premium is estimated to be 3.6% of GDP for 2019-20 onwards.
- The fiscal reserves balance as at 31 March 2022, previously estimated at HK$942.9 billion is now revised to HK$1,202.7 billion, representing about 36.8% of GDP for that year. By 31 March 2023, the estimated fiscal reserves balance is estimated at HK$1,222.6 billion, representing 35.6% of GDP for that year.

Budgetary criteria

- *Budget surplus/deficit*
  To sustain balance in the consolidated account in the longer term
- *Expenditure policy*
  To commensurate public expenditure with the growth rate of the economy in the longer term
- *Fiscal reserves*
  To maintain adequate reserves in the long run

Medium range forecast and fiscal reserves (in HK$ billion)

Year	**2017-18 (Revised)**	**2018-19**	**2019-20**	**2020-21**	**2021-22**	**2022-23**
Operating revenue	436.9	456.1	508.0	505.0	532.0	568.7
Operating expenditure	(372.9)	(441.5)	(470.3)	(498.0)	(526.0)	(557.1)
Operating surplus	64.0	14.6	37.7	7.0	6.0	11.6
Capital revenue	175.5	148.4	125.7	129.9	138.1	147.1
Capital expenditure	(101.5)	(116.4)	(117.9)	(121.9)	(139.0)	(138.7)
Repayment of bonds and notes	-	-	(1.5)	-	-	-
Capital surplus/(deficit) after repayment of bonds and notes	74.0	32.0	6.3	8.0	(0.9)	8.4
Consolidated surplus/(deficit)	**138.0**	**46.6**	**44.0**	**15.0**	**5.1**	**20.0**
Fiscal reserves as at 31 March	**1,091.9**	**1,138.6**	**1,182.6**	**1,197.6**	**1,202.7**	**1,222.6**

Source: Budget 2018-19

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