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Building a better working world

Hong Kong 2020-21 Budget insights

26 February 2020

Financial Secretary opens his umbrella for that rainy day

Highlights

- Disburse HK$10,000 to each Hong Kong permanent resident aged 18 or above
- Reduce profits tax, salaries tax and tax under personal assessment for 2019-20 by 100%, capped at HK$20,000
- Waive government rates for 2020-21, capped at HK$1,500 per quarter for each domestic rateable property
- Provide one additional month of various social security payments
- Pay one month's rent for lower income tenants living in public rental units
- Waive rates for non-domestic properties for 2020-21, subject to a ceiling of HK$5,000 per quarter in first two quarters and HK$1,500 per quarter for remaining two quarters
- Waive the business registration fees for 2020-21
- Waive registration fees for company annual returns for 2 years
- Lower the minimum entry age of the HKMC Annuity Plan from 65 to 60 so as to facilitate early participation by those in need.
- Issue inflation-linked retail bonds and Silver Bonds totaling not less than HK$13 billion

After a decade or more of warnings by successive Financial Secretaries (FS) that Hong Kong must carefully maintain its fiscal reserves in order to save for a rainy day, that rainy day certainly arrived in the fiscal year 2019-20.

Already facing headwinds due to ongoing trade disputes between China and the United States, the FS noted in today's Budget Speech that 2019-20 also brought with it "social incidents" and the coronavirus. After such a perfect storm, the FS readily acknowledged that the public had expectations for a package of relief measures, adding this was the trigger for his decision to implement counter-cyclical measures of a "massive scale" involving more than HK$120 billion. In opening his fiscal umbrella, the FS stated his purpose was fourfold: to support enterprises, safeguard jobs, stimulate the economy and relieve people's burden.

The most significant portion of the relief measures was the proposed cash payout of HK$10,000 to each Hong Kong permanent resident aged 18 or above, costing the HKSAR Government (the Government) HK$71 billion. The FS went on to note that although the cash payout scheme involved a huge sum of public money, it was an exceptional one-off measure taken in light of the current unique circumstances and should not therefore impose a burden on Hong Kong's long-term fiscal position. Indeed, perhaps wary of being viewed as having strayed too far from the well beaten path of fiscal prudence, the FS was at pains to reassure listeners that the budget deficit for 2020-21 would be reduced from HK$139.1 billion to HK$59 billion after excluding the one-off relief measures (and excluding certain items that do not actually represent revenue). Viewed in this light, the HK$59 billion deficit would be well within the internationally accepted limit of 3% of GDP.

Whilst the FS also forecast successive deficits for 2021-22 – 2024-25 of between 0.2% to 0.6% of Hong Kong's GDP for the years concerned, such relatively insignificant deficits should not be too much of a concern. However, one thing worth noting is that such deficits are based on the projection that Hong Kong's economy will achieve a growth rate of 2.8% for these years, i.e., a rate comparable to the actual average growth rate that Hong Kong achieved in the past 10 years. As such, it is imperative that the Government ensure that Hong Kong can re-emerge from its current economic difficulties and rebound strongly. In this regard, the initiatives outlined by the FS in today's Budget to diversify Hong Kong's economy should help, barring any major shocks.

The longer term measures announced by the FS to strengthen the healthcare system and increase the housing supply were welcome. The FS's assurances that the Government can implement stringent audit and monitoring mechanisms covering the use of public funds on projects such as Lantau Tomorrow, might however be met with a degree of concern given the recent track record of budget overruns on large scale public infrastructure works.

The FS was correct to note that the Government should also pay close attention to the everchanging global tax environment and the need to ensure that Hong Kong's tax system continues to be capable of attracting businesses and talent. Whilst stressing Hong Kong's commitment to a simple and low tax regime based on the principle of territorial source, the FS left open the possibility of revising tax rates and considering new revenue sources.

Overall, the FS delivered a Budget that met the public's expectations and will provide some immediate relief from the twin shocks of the recent social unrest and the coronavirus outbreak. We believe the "one-off" nature of the more substantial relief measures announced today are such that future structural deficits should not arise, provided Hong Kong's economy can recover from its current downturn and return to a more normal rate of growth. With this in mind, today's decision by the FS to spend a portion of Hong Kong's fiscal reserves, previously hoarded by himself and his predecessors, makes sense. Afterall, it certainly is raining.

Promoting ship leasing and ship leasing management businesses in Hong Kong

With a view to promoting ship leasing and related maritime business activities in Hong Kong, the FS noted in today's speech that a legislative bill has already been introduced to offer tax concessions to taxpayers undertaking said activities in Hong Kong. Under a dedicated tax regime proposed in the bill, Hong Kong will offer the following tax concessions to relevant taxpayers:

i. the tax rate on the qualifying profits of qualifying ship lessors derived from a qualifying ship leasing activity, in respect of both an operating lease or a finance lease, will be 0%;

ii. the tax rate on the qualifying profits of qualifying ship leasing managers carrying out qualifying ship leasing management activities for a non-associated qualifying ship lessor will be 8.25% (i.e., 50% of the current normal corporate tax rate of 16.5%); the tax rate being further reduced to 0% if the qualifying ship lessor is an associated corporation;

iii. in lieu of the denied tax depreciation allowances, the deemed taxable amount in respect of the qualifying ship leasing income of a qualifying ship owner-lessor derived from an operating lease, will be equal to 20% of rentals less deductible expenses, but excluding depreciation; and

iv. the taxable amount in respect of income derived from a finance lease by a qualifying ship lessor, will be equal to the relevant finance charges or interest received from the lease less deductible expenses.

However, in order to be eligible for the above tax concessions, taxpayers must meet the following substance thresholds (i) employ at least 2 qualified full-time employees in Hong Kong for a ship lessor and at least 1 qualified full-time employee in Hong Kong for a ship leasing manager; and (ii) incur annual operating expenditure in Hong Kong of not less than HK$ 7.8 million for a ship lessor and 1.0 million for a ship leasing manager.

However, it is not entirely clear how the number of qualified full-time persons employed is to be evaluated when the persons involved are employed at a group level working for more than one group company, all of which are eligible for the proposed tax regime.

Furthermore, the phraseology of the terms employed to define the scope of "ship leasing management activities" under the bill is different from that of the corresponding tax regime in Singapore. It is therefore also unclear how closely the scope of the proposed tax regime under the bill compares with that of Singapore, a major competitor of Hong Kong in the region.

We hope that the Government will clarify the above issues and ensure that the tax concessions offered under the bill are competitive as compared with those offered by our competitors.

Enabling Hong Kong to compete internationally for reinsurance and specialty insurance businesses

The demand for insurance and reinsurance businesses for specialty risks (e.g., marine, aviation, agriculture, catastrophe, political risk, war risk and trade credit) is expected to increase significantly under the Belt and Road Initiative of mainland China.

To enable Hong Kong to compete in the international market and seize new opportunities in this regard, the FS noted that a separate legislative bill has been introduced. Under the bill, Hong Kong will offer the following tax concessions to relevant insurers and insurance brokers:

i. profits derived by a direct insurer (referred to as a specified insurer) from their general insurance business, other than profits from certain local-demand driven business, will be taxed at the concessionary tax rate of 8.25% (i.e., 50% of the normal corporate tax rate of 16.5%);

ii. the current 8.25% concessionary tax rate afforded to professional reinsurers will be extended to cover the general reinsurance business of a specified insurer; and

iii. profits of a licensed insurance broker company that relate to a contract of insurance effected by (a) a professional reinsurer; or (b) a specified insurer that is eligible for the concessionary tax rate under the bill, will also be taxed at the 8.25% concessionary tax rate.

We welcome the introduction of the bill which will make Hong Kong more competitive vis-à-vis other major insurance hubs. Regionally, the enactment of the bill into law will help Hong Kong close the gap with Singapore which currently provides a concessionary tax rate of 8% to 10% for a wide range of insurance and insurance-related brokerage businesses.

Promoting private equity fund industry in Hong Kong

To encourage more private equity (PE) funds to domicile and operate in Hong Kong, the FS noted today that legislation on a limited partnership regime specifically catering to the needs of such funds is being prepared.

In addition, the FS will also consult the industry on the proposal to provide tax concessions for "carried interest" issued by PE funds to their fund managers, subject to the fulfilment of certain conditions.

"Carried interest" generally refers to an equity stake of a fund manager in a PE fund that entitles the fund manager to have a preferential share of the profits of the fund when the financial performance of the fund exceeds a specified hurdle rate.

Currently, the Inland Revenue Department has often challenged that such "carried interest" is fully taxable as disguised management fee income.

Further developing Hong Kong into a green finance hub

The FS noted that in May 2019 the Government successfully offered its inaugural green bond of US$1 billion under the Government Green Bond Programme. Having regard to the market situation, the Government also plans to issue further green bonds totalling HK$66 billion within the next five years.

To maximize the potential for Hong Kong to develop into a leading hub for green finance in the region, the FS should perhaps also consider introducing tax measures to incentivize the issuance of, and investment in, green bonds in Hong Kong.

In this regard, the FS may consider allowing a super tax deduction of 200% for qualifying expenditure with respect to the issuance and compliance costs regarding the issuance of qualifying green bonds (QGBs). This would offset the additional costs that issuers incur in issuing green bonds, such as costs related to obtaining third party verification and costs related to compliance with regular reporting requirements after issuance. To attract more investors to invest in QGBs trading in Hong Kong, the FS may also consider extending the scope of tax exemption of the existing Qualifying Debt Instrument scheme to include all QGBs.

We hope that the FS will give further thought to the above proposed tax measures.

How Hong Kong should respond to the proposed global minimum tax rate under BEPS 2.0

The new international tax environment created by the Base Erosion and Profit Shifting (BEPS) initiative, launched by the Organization for Economic Development and Co-operation, continues to evolve and pose many challenges to Hong Kong's existing tax rules and system.

Under BEPS 2.0, a set of inter-related rules would effectively operate as a global minimum tax to ensure all internationally operating businesses pay a minimum level of tax, irrespective of the locations where they carry on their operations.

If, in the implementation of BEPS 2.0, there is no carve-out for BEPS-compliant preferential tax regimes or territorial sourced-based tax regimes, the viability or relevance of many of Hong Kong's current tax rules, features and systems could be seriously called into question and require a fundamental overhaul.

To respond to these challenges, the FS announced today that he will invite scholars, experts and members of the business community who are experienced in the fields of international taxation and economic development to tender advice on the matter.

Key budget assumptions, budgetary criteria and projections

Assumptions used for the medium range forecast (MRF) for the period from 2020-21 to 2024-25

- Real GDP growth rate for the forecast period is -1.5% to 0.5% for 2020 and the trend rate for 2021 to 2024 is 2.8%.
- Investment return is estimated to be 3.7% in 2020 and in the range of 4% to 5.3% per annum thereafter.
- Land premium is estimated to be 4.2% of GDP for 2021-22 onwards.
- The fiscal reserves balance as at 31 March 2024, previously estimated at HK$1,224.6 billion is now revised to HK$944.5 billion, representing about 28.0% of GDP for that year. By 31 March 2025, the estimated fiscal reserves balance is estimated at HK$937.1 billion, representing 26.5% 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	2019-20 (Revised)	2020-21	2021-22	2022-23	2023-24	2024-25
Operating revenue	410.2	434.7	519.6	545.7	557.8	580.7
Operating expenditure	(528.2)	(617.7)	(568.1)	(594.8)	(613.6)	(636.4)
Operating deficit	(118.0)	(183.0)	(48.5)	(49.1)	(55.8)	(55.7)
Capital revenue	157.0	137.8	155.6	172.8	173.8	178.8
Capital expenditure	(83.1)	(113.4)	(135.6)	(152.4)	(145.4)	(134.4)
Capital surplus before repayment of bonds and notes	73.9	24.4	20.0	20.4	28.4	44.4
Add: Net proceeds from issuance of green bond	7.8	19.5	11.7	11.7	11.7	11.7
Less: Repayment of bonds and notes	(1.5)					(7.8)
Consolidated deficit	**(37.8)**	**(139.1)**	**(16.8)**	**(17.0)**	**(15.7)**	**(7.4)**
Fiscal reserves as at 31 March	**1,133.1**	**994.0**	**977.2**	**960.2**	**944.5**	**937.1**

Source: *Budget 2020-21*

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About EY's Tax services
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