Equiom

Hong Kong **Budget Commentary**

2018/2019

Hong Kong Budget Overview February 2018

We are pleased to share with you our commentary on the 2018/19 Hong Kong Budget.

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On 28 February 2018, Financial Secretary Mr Paul Chan Mo-Po delivered his second Hong Kong Budget, the first one under the administration of Chief Executive Mrs Carrie Lam-Cheng Yuet Ngor. Last year, Mr Chan did not have much opportunity to provide his input to the Budget, which was largely prepared by his predecessor, Mr John Tsang Chun-Wah, before the latter resigned from his post.

Overall, in his first year as "chief architect", Mr Chan offered up a proactive yet relatively conservative fiscal approach to what is an enormous budget surplus. In our Budget commentary, we seek to highlight some of the noteworthy matters that are likely to impact Hong Kong's aspiration to remain competitive in the global business environment.

Amongst others, it is noted that:

- Hong Kong's surplus for the financial year 2017/18 and fiscal reserves by 31 March 2018 are expected to reach HK$ 138 billion, respectively, HK$ 1,092 billion;
- The primary drivers of the Government's unexpected fiscal surplus are the increase in revenue from land sales and stamp duty. However, the Government is conscious that the reliance will have to be changed in the long run in the event of a downturn in the property market;
- The Financial Secretary will direct 40% of the projected surplus to the community and invest 60% in the future. With respect to the latter, the targeted industries include Innovation & Technology and Financial Services, particularly with respect to wealth and asset management, insurance, debt markets, and renewable energy;
- A series of "sweeteners" will mainly be given again to individual taxpayers. These includes adjustments of salaries, tax bands and marginal tax rates, increments of various existing allowances and the introduction of several deductions;
- The Government believes in maintaining "a simple and competitive tax regime, as well as a transparent and efficient regulatory regime". It will continue its efforts in expanding Hong Kong's network of double tax treaties with other jurisdictions.

As always, we would be delighted to meet with you to discuss how the Budget proposals might affect your business and/or personal affairs in Hong Kong.

Thank you again for your ongoing and valued support.

Kenneth Yim

Main Budget Commentary

The 2018/19 Budget is the first in which Mr Chan can be considered the true architect, given that he had only been in the job four weeks before delivering last year's financial blueprint, which marked the 10th that was drawn up by his predecessor, John Tsang. This is also the first Budget prepared under the administration of Chief Executive Carrie Lam-Cheng Yuet-Ngor, who was sworn in on 1 July 2017.

As such, big themes are laid out early on in this year's Budget, with Mr Chan referencing global trends and how he views emerging threats to Hong Kong's economy. Among them, he spoke of the "unstoppable wave" of innovation and technology, the emergence of China and Southeast Asia as the single biggest driver of global economic growth, and rising protectionist movements that undermine globalisation.

The change of political leadership was referenced by Mr Chan in a section entitled "New Fiscal Philosophy". Whereas the previous Financial Secretary was known for conservatism and saving fiscal surpluses for a rainy day, Mr Chan spoke of a policy U-turn in the current-term Government to "adopt forward-looking and strategic financial management principles in optimising the use of surplus to invest for Hong Kong". Mr Chan indicated last year he would try to be more assertive in using the fiscal surplus for investment. This year, he left no doubt he was on board with Ms Lam's thinking, telling Hong Kong lawmakers, "I agree entirely with her view."

In fiscal year 2017/18, Hong Kong managed a budget surplus of HK$138 billion (US$17.6 billion), or about eight times the original estimate of HK$16.3 billion. Government revenues for the year were 20% higher than forecast, rising to HK$612.4 billion. Revenue from land sales was 62% higher than forecast, at HK$163.6 billion.

By 31 March 2018, the fiscal reserves are expected to reach a historical high of HK$1,092 billion, while a Housing Reserve is expected to rise to HK$78.8 billion. The 2018/19 budget is generally considered forward-looking in investing for the future, as the Financial Secretary indicated that 40% of the projected surplus will be redirected back to the community and 60% will be invested in the future. Furthermore, the Government proposes to spend more, as public expenditure as a percentage of GDP will rise to more than 21 per cent, breaking with a tradition of capping spending below 20 per cent of GDP. Notably, Mr Chan also announced HK$50 billion in funding to encourage Innovation and Technology, adding to HK$10 billion that was announced in last year's Budget. He added that legislation was in process for a proposal to provide companies with a 300% deduction for the first HK$2 million in R&D expenditure, a policy announced in the Chief Executive's Policy Address last year.

In the section on medium-term outlook, Mr Chan says he is cautiously optimistic, forecasting GDP growth of between 3 to 4% in the year ahead. But he also cautioned of impacts on the global economy from interest rate normalisation. In a direct warning to property investors, he referenced underlying change in key factors that have propelled local housing prices, with supply of new homes set to increase as the ultra-low interest rate environment winds down.

Having said that, we would refer again to the risks that stem from an overly narrow tax base due to highly cyclical property tax-related revenues and direct taxes. The Financial Secretary conceded profits tax, salaries tax, stamp duties and land premium accounted for about 74% of total Government revenue in 2017-18. It was

Main Budget Commentary (continued)

recognised that, among them, land premium and stamp duties fluctuate the most, and they account for 27% and 15% of the total revenue respectively (i.e. 42% in total).

Notwithstanding this, it would appear the Government is still uncertain and undecided about how to resolve the problem of a narrow tax base and the concentration of the revenue sources from real estate. Mr Chan made no mention of the introduction of a goods and services tax ("GST") or value-added tax ("VAT") to resolve this long-standing problem, a reluctance that was also shared by his predecessor.

As such, our criticism remains on the Government's emphasis on short-term measures to stimulate the economy. It continues to reduce tax burdens on individuals at the expense of a more meaningful effort to diversify the tax base and foster long-term investment and planning to limit the vulnerability to a structural deficit of the Government revenue. More specifically, the Budget laid out a wide range of relief measures, including a 75% reduction in profits and salary tax (capped at HK$30,000), a waiver on Government rates for four quarters (capped at HK$2,500 per property, per quarter), and a number of beefed-up allowances for taxpayers. Unavoidably, the vulnerabilities of such a model will surely come under increasing pressure when the property market cools.

In a departure, Mr Chan emphasised the need to "think outside the box" in a push to help diversify the economy. Furthermore, he expressed "we will maintain a simple and competitive tax regime as well as a transparent and efficient regulatory system, while encouraging investment and innovation". Another positive is that the Government will continue its efforts in expanding the network of tax treaties with other jurisdictions, in addition to the existing 38. This is an initiative that we of course support, as double tax treaties contain various measures (e.g. the reduction in withholding tax rates) that will help to facilitate cross-border business investments involving Hong Kong.

It goes without saying that the Government must continue being assertive to address the said issues with proposals, in order to protect Hong Kong's economic future in the coming years. At the moment, the Government's focus appears to be on investing in targeted industries for returns and, again, the emphasis was on mostly the same initiatives including, among others, innovation and technology, asset and wealth management, and financial services. Broadly, it would appear that the same matters are continually under discussion without having had any major achievements yet.

In concluding his Budget speech, Mr Chan remarked, "Our country's economic development has entered a new phase. This, coupled with the ever-changing global economic landscape, has created a very favourable external environment for Hong Kong. If we can capitalise on the opportunities, the wind beneath our wings will bear Hong Kong far and high."

Despite these strong words, we must wait longer to see how this "New Fiscal Philosophy" will be implemented.

Noteworthy Aspects

Financial Services

We welcome the Government setting aside funds for the development of financial services over the next five years, supporting the development of the bond market, fin-tech, green finance, manpower, training and other areas in this sector. In a rapidly changing global environment, Hong Kong simply must maintain its competitiveness as an international financial centre.

Amongst others, the Financial Secretary has touched upon the following matters and provided brief updates:

Qualifying Debt Instruments

Currently, half of the ordinary profits tax rate (i.e. 8.25%) applies to income including interest, gain on disposal, redemption on maturity or presentment of the debt instrument received in respect of medium-term qualifying debt instruments by taxing the gain (after deducting outgoings and expenses). For long-term debt instruments (i.e. with a maturity period of not less than 7 years) issued on or after 5 March 2003, the income is fully exempt from profits tax.

Essentially, the Government intends to broaden the types of qualified instruments and extend the application of tax exemption to these regardless of the duration, so that Hong Kong investors will enjoy tax concessions for interest income and trading profits, derived from a more diverse range of debt instruments.

Asset and Wealth Management

In recent years, the Government has introduced several initiatives to enhance the competitiveness of Hong Kong's fund industry and diversify the management platform. In June 2017, it proposed to further extend the existing profits tax exemption for offshore funds, including private equity, to privately offered open-ended fund companies in Hong Kong. It is expected that the extended exemption will come into force later this year.

The Government will examine the feasibility of introducing a limited partnership regime for private equity funds and related tax arrangements, and review the existing tax concessions applicable to the fund industry with regard to international standards on tax cooperation between tax authorities of different jurisdictions.

Noteworthy Aspects (continued)

Corporate Treasury Centres

In 2015, the Government introduced a tax incentive to attract multinational and Mainland Chinese enterprises to establish corporate treasury centres in Hong Kong. The Financial Secretary announced that the Government will further amend the Inland Revenue Ordinance to extend the coverage of profits tax concession to specified treasury services, provided by qualifying corporate treasury centres to all their onshore associated corporations.

Offshore Renminbi ("RMB") Business

Hong Kong maintains the world's largest offshore RMB liquidity pool, but the Government is also seeking to explore the possibility of widening the range of investment products in addition to RMB sovereign bonds. Apart from issuing RMB sovereign bonds in Hong Kong, the Ministry of Finance also issued USD sovereign bonds last October. Accordingly, Hong Kong has provided profits tax exemption for non-RMB sovereign bonds issued, to ensure that the city continues to be the premier platform for the issue of sovereign bonds in different currencies.

Insurance

Life Annuity

The Government encourages the public to purchase deferred annuity products, and the Insurance Authority will be requested to issue relevant guidelines, with a view to enabling all deferred annuity products available in the market to become eligible for tax concessions.

Furthermore, as contributions made to financial products for retirement protection are similar in nature to voluntary contributions made to the Mandatory Provident Fund ("MPF"), (proposed) tax concessions will also become applicable to MPF voluntary contributions. To meet the long-term saving objective for retirement protection, voluntary contributions that have enjoyed tax deduction will be transferred to the mandatory contribution accounts and become subject to the same withdrawal restrictions on mandatory contributions.

Voluntary Health Insurance

As Hong Kong has an aging population and there has been a substantial increase in medical expenditure over the years, the Government proposes to encourage people to voluntarily purchase health insurance, by providing a tax deduction for acquiring eligible health insurance products for themselves or their dependents. The annual tax ceiling of premium for tax deduction is HK$8,000 per insured person.

It seems that this plan aims to encourage Hong Kong residents to make use of the private health care system and ease the pressure on overloaded public hospitals. We would welcome a further boost to the insurance industry in Hong Kong by also considering (both tax and non-tax) measures which are relevant from the insurers' perspective.

Noteworthy Aspects (continued)

Innovation and Technology ("I&T")

In our commentary on last year's Budget, we encouraged the Government to introduce tax incentives, including, but not limited to, enhancing tax deductions on I&T expenditures, and accelerating the deductions of capital expenditure for the purchase of relevant intelligence properties ("IPs").

In this Budget, the Financial Secretary reserves HK$50 billion to support the I&T development in Hong Kong, which is five times the sum under the 2017/18 Budget. It is clear that the Government is very keen to enhance the competitiveness of Hong Kong in Asia Pacific, and to attract Research & Development ("R&D") investment.

Research and Development

In addition to several non-tax measures, such as the injection of cash into the Innovation and Technology Fund, we welcome the introduction of various tax deductions on qualifying (domestic) R&D expenditure, in accordance with the 2017 Policy Address, presented by the Chief Executive of Hong Kong on 11 October 2017.

In short:

1. 300% tax deduction is allowed on the first HK$2 million of qualifying (domestic) R&D expenditure; and
2. 200% tax deduction is allowed on the remaining qualifying expenditure.

These proposed measures are expected to become effective as of the year of assessment 2018/19, upon the enactment of the pertinent bill by the Legislative Council.

In this regard, it is hoped that the Government will consider commercial flexibility, particularly avoiding complexity and uncertainty to taxpayers in respect of the scope of R&D and I&T activities, criteria and/or restrictions on qualifying expenditures, and existing anti-avoidance measures

We would also encourage the Government to consider the tax regimes of other jurisdictions (such as Singapore, United Kingdom, Ireland, Canada, Australia), where a series of attractive tax incentive schemes (such as tax exemption in the early stages of start-ups, refundable tax credits, etc.) have been offered to taxpayers to entice R&D investments and I&T start-ups.

Noteworthy Aspects (continued)

Energy-efficient installations and renewable energy devices

Currently, taxpayers can claim tax deduction on capital expenditures in respect of environmental protection facilities, such as (i) environmental protection machinery, (ii) environmental protection installations, and (iii) environmentally friendly vehicles.

In this Budget, the Financial Secretary proposes to enhance the tax deduction on capital expenditures in respect of eligible energy-efficient building installations and renewable energy devices, which are very much appreciated as they encourage taxpayers to tackle important environmental issues.

The key features can be summarised as follows:

	2017/18 Current Tax Law	2018/19 Proposed Tax Law
Initial Allowance (i.e. tax deduction allowed in the year in which a taxpayer incurs the respective capital expenditure)	60% tax deduction	100% tax deduction
Annual Allowance	20% on the remaining qualifying capital expenditure (i.e. on a five-year timeframe)	N/A

Table of Hong Kong Tax Facts

APPENDICES

Summary of Tax Rates and Deductions

	2017/2018 Current Tax Law	2018/2019 Proposed Tax Law
Profits Tax		
Corporations	16.5%	16.5%/8.25%*
Unincorporated businesses	15.0%	15.0%/7.50%#

**The reduced profits tax rate of 8.25% would apply to corporations with an assessable profits below HK$ 2,000,000 and is subject to the enactment of the Inland Revenue (Amendment) (No. 7) Bill 2017. The maximum annual tax savings would be capped at HK$ 165,000.*

#The reduced profits tax rate of 7.50% would apply to unincorporated businesses with an assessable profits below HK$ 2,000,000 is subject to the enactment of the Inland Revenue (Amendment) (No. 7) Bill 2017. The maximum annual tax savings would be capped at HK$ 150,000.

Salaries Tax

	2017/2018 Current Tax Law	2018/2019 Proposed Tax Law
Standard rate	15.0%	15.0%

Progressive rate

2017/2018

Net Chargeable Income (HK$)	Marginal Tax Rate (%)
1- 45,000	2.0%
45,001 - 90,000	7.0%
90,001 - 135,000	12.0%
above 135,001	17.0%

2018/2019

Net Chargeable Income (HK$)	Marginal Tax Rate (%)
1- 50,000	2.0%
50,001 - 100,000	6.0%
100,001 - 150,000	10.0%
150,001 - 200,000	14.0%
above 200,001	17.0%

Salaries Tax charge is the lower of:

a) net assessable income less charitable donations and allowable deductions at the standard rate; or

b) net assessable income less charitable donations, allowable deductions and personal allowances charged at progressive rate.

Table of Hong Kong Tax Facts

	2017/2018 Current Tax Law	2018/2019 Proposed Tax Law
Property Tax	15.0%	15.0%
Personal Assessment	15.0%	15.0%
One-off tax reduction	**HK$**	**HK$**
Salaries Tax & Tax under Personal Assessment 75% tax reduction subject to a cap at (HK$):	20,000	30,000
Profits Tax 75% tax reduction subject to a cap at (HK$):	20,000	30,000
Personal Allowances	**HK$**	**HK$**
Basic	132,000	132,000
Married person	264,000	264,000
Single parent	132,000	132,000
Disabled* (new allowance for 2018/19)	Nil	75,000
Child 1st to 9th (each)		
Year of birth	200,000	240,000
Other years	100,000	120,000
Dependent parent/ grandparent		
Aged 60 or above		
Basic (each)	46,000	50,000
Additional for each dependent residing with taxpayer	46,000	50,000
Aged between 55 and 59		
Basic (each)	23,000	25,000
Additional for each dependent residing with taxpayer	23,000	25,000
Dependent brother/ sister (each)	37,500	37,500
Disabled dependent (each)	75,000	75,000

**The personal disability allowance for 2018/19 as proposed by the Financial Secretary is subject to the enactment of the relevant legislation.*

Table of Hong Kong Tax Facts

		2017/2018 Current Tax Law	2018/2019 Proposed Tax Law
Deduction Ceilings		**HK$**	**HK$**
Self-education expenses		100,000	100,000
Home loan interest		100,000	100,000
Number of years of deduction		20 years	20 years
Elderly residential care expenses		92,000	100,000
Contribution to MPF / exempt scheme		18,000	18,000
Approved charitable donations		35% of income	35% of income
Depreciation Allowances			
Plant and machinery	- Initial allowance	60%	
	- Annual allowance	10% / 20% / 30%	(depending on types and on reducing balance)
Industrial building	- Initial allowance	20%	
	- Annual allowance	4%	(of qualifying expenditure)
Commercial building allowance		4%	(of qualifying expenditure)

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Stamp Duty (Enacted 22 February 2014)

Residential Property (Scale 1)

Exceeds	Does not exceed	Duty payable*^
HK$	**HK$**	
	2,000,000	1.5%
2,000,000	2,176,470	$30,000 + 20% (Y#- $2,000,000)
2,176,470	3,000,000	3%
3,000,000	3,290,330	$90,000 + 20% (Y#- $3,000,000)
3,290,330	4,000,000	4.5%
4,000,000	4,428,580	$180,000 + 20% (Y#- $4,000,000)
4,428,580	6,000,000	6%
6,000,000	6,720,000	$360,000 + 20% (Y#- $6,000,000)
6,720,000	20,000,000	7.5%
20,000,000	21,739,130	$1,500,000 + 20% (Y#- $20,000,000)
21,739,130 and above		8.5%

**Unless specifically exempt or otherwise arranged.*

#The consideration or value of the residential property, whichever is the higher.

^Following the Stamp Duty (Amendment) Ordinance 2018 enactment on 11 January 2018, the Ad Valorem Stamp Duty ("AVD") with a flat rate of 15% applies to residential property which was acquired on or after 5 November 2016, determined on the basis of the consideration or value of the residential property, whichever is the higher. The new AVD flat rate of 15% also applies to a Hong Kong Permanent Resident acting on his/her own behalf who own more than one other residential property in Hong Kong under one instrument at the time of acquisition.

Special Stamp Duty (Enacted 22 February 2014)

Holding periods of the properties	SSD payable**
Less than 6 months	20%
More than 6 months but less than 12 months	15%
More than 12 months but less than 36 months	10%

***On the basis that the property was acquired on or after 27 October 2012.*

Leases

Does not exceed one year	0.25% of total rent payable
Exceeds one year but does not exceed 3 years	0.5% of the average yearly rent
More than 3 years	1.0% of the average yearly rent
Premiums	4.25% of the premiums if rent is also payable

Table of Hong Kong Tax Facts

Hong Kong Stock

Sold note or bought note for sale or purchase of Hong Kong stock	0.1%
Transfer operating as a voluntary disposition inter vivos	$5 + 0.2%
Transfer of any other kind	$5
Bearer instrument	3.0%

As of 13 February 2015, contract notes and instruments of transfer (i.e., transaction documents) with respect to shares or units of Exchange Traded Funds are not subject to Stamp Duty.

Capital Duty

Capital Duty was abolished on 1 June 2012.

Estate Duty

Estate Duty was abolished from 11 February 2006.

Excise Duty with respect to Tobacco

	($ per 1000 sticks)
Cigarettes	1,906

	($ per kg)
Cigars	2,455
Chinese prepared tobacco	468
All other manufactured tobacco except tobacco intended for the manufacturing of cigarettes	2,309

Excise Duty with respect to Hydrocarbon Oil

Oil Type	($ per liter)
Aircraft spirit	6.51
Motor spirit (leaded petrol)	6.82
Motor spirit (unleaded petrol)	6.06
Light diesel oil	2.89
Ultra Low Sulphur diesel	2.89
Euro V diesel	0.00

Business Registration Fee

1-year certificate plus levy	2,250
3-year certificate plus levy	5,950

Other duties and fees remain the same until further notice.

FURTHER INFORMATION

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