Two-tiered Profits Tax Rates Regime in Hong Kong: Is it a relief or a burden ?

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Background

- Chief Executive's 2017 Policy Address
  - To reduce the tax burden on SMEs and startup enterprises
  - To benefit more social enterprises by alleviating their tax burden
  - To remain competitive and attract foreign investment into Hong Kong

Overview of the Two-tiered Profits Tax Rates Regime

Assessable profits	Tax rate for Corporations	Tax rate for unincorporated businesses
First HK$2 million	8.25%	7.5%
Remainder	16.5%	15%

- The IRO was amended to introduce the Two-tiered Profits Tax Rates ("TTT")
- For the years of assessment commencing on or after 1 April 2018
- Potential tax saving- Corporation:HK$165,000; UB: HK$150,000

Overview of the Two-tiered Profits Tax Rates Regime

- Inland Revenue (Amendment) (No.3) Ordinance 2018 passed on 29 March 2018
    - Section 14AA: entity and sole proprietorship business
    - Section 14AAB: connected entity
    - Section 14AAC: charge of profits tax for connected entities

Overview of the Two-tiered Profits Tax Rates Regime

- No double benefits
  - Lowered tax rates: irrespective of the size and industry
  - Exception 1: income from businesses under existing preferential tax regimes—professional reinsurance business, captive insurance business, corporate treasury centres, aircraft leasing business; either elect the preferential half-rate tax regime for the "qualifying" profits or the two-tiered tax rates on the whole of qualifying profits and non-qualifying profits.
  - Exception 2: income from qualifying debt instruments (QDI) subject to the preferential half-rate; non-QDI income (e.g. rental income) may still be eligible for two-tiered tax rates

Overview of the Two-tiered Profits Tax Rates Regime

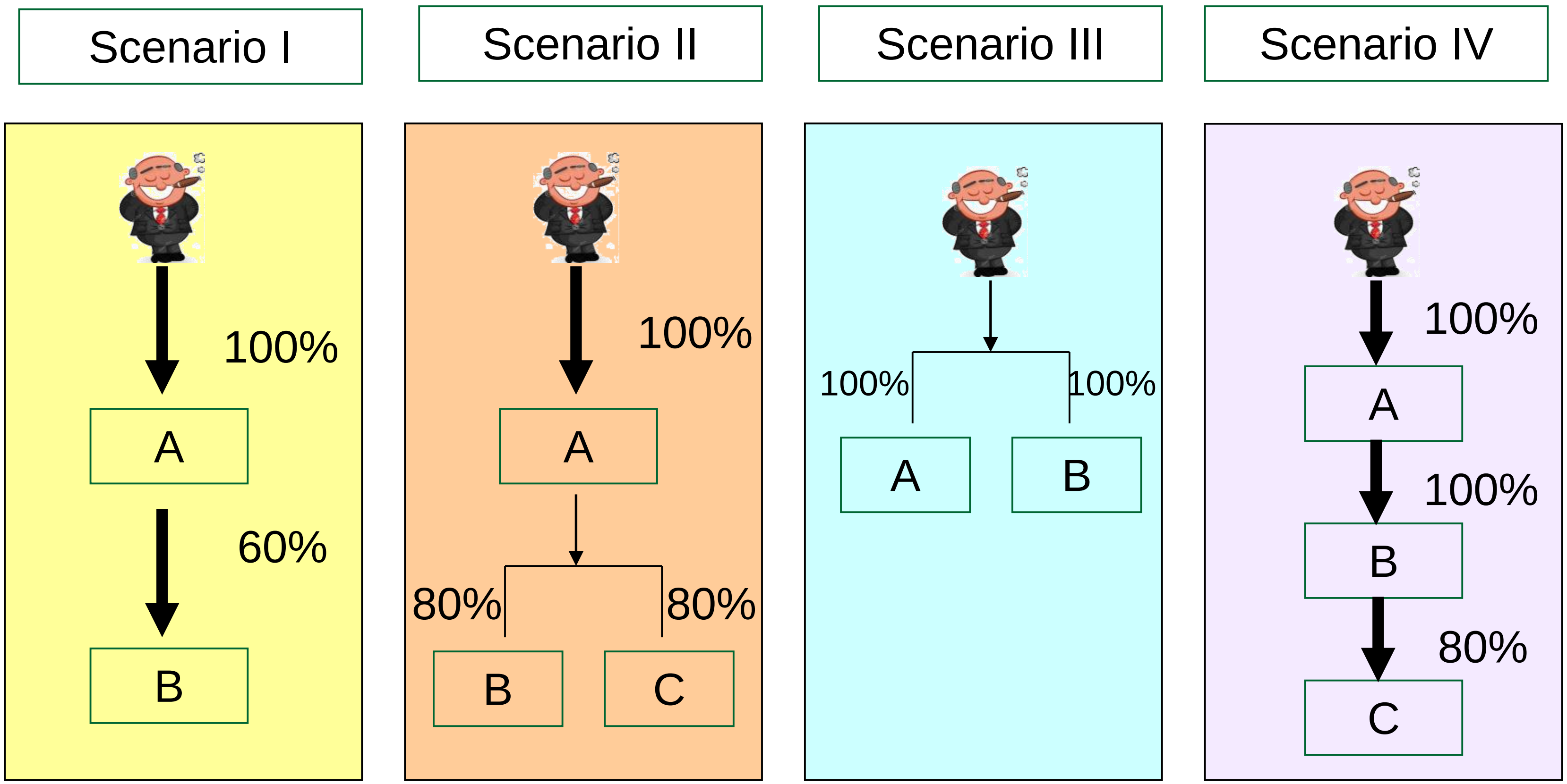
- Entity
  - A natural person
  - A body of persons
  - A legal arrangement, including a corporation, a partnership and a trust

Overview of the Two-tiered Profits Tax Rates Regime

- An entity is considered a connected entity of another entity if, at the end of the basis period for a particular year of assessment:
  - *Entity A has control over Entity B;*
  - *Entity A and Entity B are under the control of Entity C; or*
  - *Two sole proprietorship businesses are carried on by the same natural person (proprietor)*
  - *In general, control = holding directly or indirectly more than 50% of the issued share capital, voting rights, capital or profits in another entity.*
  - *No extension of definition of control to 'associates' !*
  - *An associate under IRO typically includes: relative (e.g. spouse, parent, child, brother, sister), partner, principal officer etc..*

Overview of the Two-tiered Profits Tax Rates Regime

Examples of connected entities



Overview of the Two-tiered Profits Tax Rates Regime

- Election for the TTT
  - Can only nominate one entity within the same group to make an election.
  - Only those connected entities carrying on a trade, profession or business in Hong Kong for the subject year of assessment are relevant.
  - Election is irrevocable for the particular year of assessment.
  - A different connected entity may be nominated for a different year of assessment.
  - A natural person operating 2 or more sole proprietorship businesses is only allowed to elect TTT for one of these entities.

Overview of the Two-tiered Profits Tax Rates Regime

- Part 2.3 of the Profits Tax Return-2017/18
  - *"For 2018/19 Provisional Tax, are you chargeable at two-tiered rates? (For a corporation with connected entities, no other connected entity elects two-tiered rates.)" Yes/No*

- Part 2.3 of the Profits Tax Return-2018/19
  - *"Are you chargeable at two-tiered rates for this year of assessment? (For a corporation with connected entities, no other connected entity elects two-tiered rates.)" Yes/No*
  - Note that it is necessary to complete a Supplemenary Form S1 for providing the details of connected entities at the same time, if any.

- Important: Whole assessable profits will be chargeable at the full Profits Tax Rate if the election is ineffective or if no election has been made.

Overview of the Two-tiered Profits Tax Rates Regime

- If a taxpaying entity has no connected entity:
  - Declare “YES” in the tax return that it is chargeable at the TTT.

- If a taxpaying entity has connected entity :

  - Declare “YES” in the tax return that it is chargeable at the TTT if the connected entity will not make the election.
  - Declare “NO” in the tax return that it is not chargeable at the TTT if the connected entity will make the election.
- If a taxpaying entity, which has no connected entity, does not intend to make the election, should it declare YES or NO in the tax return?
- Incorrect declaration of “no connected entity” or “no connected entity making an election for TTT” without a reasonable excuse will attract penalties.

Overview of the Two-tiered Profits Tax Rates Regime

Incorrect declaration of connected entity

Entity	Selected	Should have selected	Example of possible causes
Single entity	NO	YES	Typing error
	YES	NO	Existence of connected entities not known to the taxpayer
Multiple entities	NO	YES	Receipt of wrong financial information
	YES	NO	Oversight of election already made by another CE

Overview of the Two-tiered Profits Tax Rates Regime

- Non-resident person
  - If a NRP receives certain deemed trading receipts in Hong Kong (e.g. receiving royalties), the person in Hong Kong who pays or credits the receipts is required to deduct from the amount paid or credited to the NRP the relevant Profits tax.
  - HK payer is obliged to check with the NRP about the applicability of TTT (i.e. whether it has any connected entity or none of its connected entities intends to elect TTT).
  - The assessable profit of the NRP qualifying for the TTT still cannot exceed HK$2 million in total for the year of assessment concerned.
  - It may be necessary to retain the amount of tax payable as if the NRP is not chargeable at two-tiered rates, if HK payer is not certain about the total amount of assessable profit of the NRP.

Implementation in practice

- Self-declaration for Connected entities
  - No other connected entities elected for the TTT
  - List of connected entities is complete
  - To be best of the taxpayer’s knowledge and belief….true, correct and complete

Implementation in practice

Election of TTT by connected entities in the same year of assessment

Y/A 2018/19	Company A (connected entity)	Company B (connected entity)	TTT to be elected by
(1)	Profit	Loss	A
(2)	Loss	Profit	B
(3)	Profit	Profit	A (if A’s profit >B’s profit)
(4)	Loss	Loss	A (if A has almost used up its tax losses b/f and is more likely to have assessable profit in Y/A 2019/20)

Implementation in practice

- Group of connected companies
  - Different financial year end
  - Different shareholding
  - Different auditors/tax representatives
  - Complex group structure and identication of UBOs
  - Details of latest financial results not yet available
  - Details of companies not necessarily made known to the parties concerned
  - Access of information and confidentiality

Implementation in practice

Analysis of connected entities and election of TTT

	Co. A	Co. B	Co. C	Co. F
Shareholder(s)	X – 80% Y – 20%	X – 10% Y – 90%	X – 70% Z – 30%	Y – 100%
Nature of business	Trading	Manufacturing	Retail	Investment holding
Assessable profit	HK$1M	HK$2M	HK$3M	HK$3.5M
Financial year end	31 March 2019	31 December 2018	30 June 2018	31 December 2018
Audited accounts	No	No	Yes	Yes
Auditor	CPA-1	CPA-2	CPA-1	CPA-3
Connected entity	C	F	A	B
TTT	No ?	No ?	Yes ?	Yes ?

Remarks: Y is the spouse of X Z is the father of X F was set up by Y without X's knowledge

Implementation in practice

- Potential abuse
  - Shift of profits/losses within the connected entities
  - Shift of profits/losses to “non-connected” entities
  - Cessation of ‘connection’ before the end of basis period
  - Normal business restructuring?
  - Anti-avoidance provision-S.61A of the IRO: “sole or dominant purpose of obtaining a tax benefit”?

Implementation in practice

- Limitations

1. Total tax liability could be higher if with connected entities

	Multiple entities Mr. X		Single entity Mr. Y
	100%	100%	100%
	Co. A	Co. B	Co. C
Assessable profit	$1M	$0.6M	$1.8M
Tax @8.25%	$82,500*	-	$ 148,500
@16.5%	-	$99,000*	

*$181,500

Implementation in practice

- Limitations

2. Total tax liability could be higher if electing personal assessment

PERSONAL ASSESSMENT		WITHOUT PERSONAL ASSESSMENT #					
	Total Income				Profits Tax -		Profits Tax -
	(2018/19)		Salaries Tax		Business X		Business Y
	$		$		$		$
Employment income	2,332,000	Employment income	2,332,000	Profit	1,000,000	Profit	500,000
Sole proprietor business - X	1,000,000	Less: Perosnal allowance	(132,000)				
- Y	500,000						
			2,200,000				
	3,832,000						
		Tax at progressive rate	360,000	Tax @7.5%	75,000	Tax @15%	75,000
Less: Personal allowance	(132,000)						
		OR At the lower of					
	3,700,000	Tax at standard rate					
		$2,332,000 x 15%	349,800				
Tax at progressive rates	$						
- First $200,000	16,000						
- Remainder $3,500,000 x 17%	595,000						
	611,000						
OR At the lower of							
Tax at standard rate							
$3,832,000 x 15%	574,800						

Total tax calculated under schedular basis is $349,800 + $75,000 + $75,000 = $499,800

Implementation in practice

- Limitations

3. Total tax liability could be higher if not drawing a salary

	Prior to TTT - Co. paying a salary		Under TTT - Co. without paying a salary		Under TTT - Co. paying a salary	
	$		$		$	
Profit before salary	5,100,000		5,100,000		5,100,000	
Salary (e.g. year-end bonus) -director/shareholder	(2,100,000)		-		(2,100,000)	
	3,000,000		5,100,000		3,000,000	
Tax @16.5% ($3M)	(495,000)		-		-	
@8.25% ($2M)	-		(165,000)		(165,000)	
@16.5% ($3.1M)	-		(511,500)		-	
@16.5% ($1M)	-		-		(165,000)	
Profits after tax (available for dividend distribution)	2,505,000		4,423,500		2,670,000	
Dividend	-		(2,100,000)		-	
Retained profits	2,505,000		2,323,500		2,670,000	
Personal Income Tax for Mr. X						
Salary - $2.1M x 15%	315,000		-		315,000	
Dividend - $2.1M x 0%	-		-		-	
Total tax liability	810,000	N1	676,500	N2	645,000	N3

N1 = $495,000 + $315,000
N2 = $165,000 + $511,500
N3 = $165,000 + $165,000 + $315,000

Possible steps to be taken

- Review TTT election every year
- Document the relationship of connected entities
- Understand client business and review the relevant financial information
- Obtain confirmation from client
- Assess the likelihood of restructuring (e.g. segregation or amalgamation of businesses; alteration of shareholding)

A relief or a burden?

- Is it possible for a stand-alone company not to elect TTT?
- Is it commercially viable or realistic to proceed with the business restructuring?
- How to deal with the situation where no consensus can be obtained about election of TTT for a group of connected entities?
- What would be the effect of TTT on the provisional tax?
- After all, how could a tax advisor justify the review of tax affairs for a client based on cost-benefit analysis?

QUESTIONS?
THANK YOU !