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2023/24 Hong Kong Budget Commentary

Overview

On 22nd February, 2023, Mr. Paul M Chan, the Financial Secretary of Hong Kong, delivered his seventh budget speech to the Legislative Council.

Affected by geopolitics, disrupted supply chains, high inflation, aggressive tightening of monetary policy by major central banks around the world, sharp rise in interest rates and the continued impact of the epidemic, Hong Kong's real GDP recorded a negative growth for the year 2022 of -3.5% as a whole, which is much worse than 6.4% in 2021. Even though the economy of Hong Kong is worsen, benefited from the consumption voucher policy, local consumption is boosted. As such, the underlying consumer price inflation was relatively stable. The inflation rate for the year 2022 is 1.7%, which is higher than 0.6% in 2021. At the same time, the labour market improved gradually. The unemployment rate for the year 2022 is 3.4%, which is less than 3.9% in 2021.

With the COVID-19 epidemic finally coming to an end, many countries are relaxing their disease prevention measures in order to let the economy resume in the year 2022. Specially with the full restoration of traffic between Hong Kong and Mainland China on 6th February, 2023, it is expected that certain industries, such as tourism, catering and retail industry, will be benefited.

The budget deficit of 2022/23 is HKD140 billion, which is HKD56 billion higher than the original deficit projection of HKD84 billion. With the goal to strengthen the momentum of economic recovery on the road to normalcy under the new milestones of governance and prosperity, the Government will adopt different financial measures to provide the public with more appropriate and high-quality public services. As such, the budget has proposed the following relief measures:-

Highlights

	Proposed fiscal/ tax measures
1	Reduce profits tax, salaries tax and tax under personal assessment for 2022/23 by 100 percent, subject to a ceiling of HKD6,000
2	Waive rates for residential properties and non-residential properties for the first two quarters of 2023/24, subject to a ceiling of HKD1,000 per quarter
3	Issue HKD5,000 electronic consumption vouchers in instalments to each eligible Hong Kong permanent resident and new arrival aged 18 or above
4	Increase basic child allowance and the additional child allowance for each child born from HKD120,000 to HKD130,000
5	Adjust the ad valorem scale of Scale 2 of Stamp Duty, so as to ease the burden on ordinary families of purchasing their first residential properties
6	Provide profits tax exemption for qualifying transactions of family-owned investment holding vehicles managed by single family offices for any years of assessment on or after 1 April 2022
7	Increase tax deduction of MPF Voluntary contributions expenditure made by employers for their employees aged 65 or above from 100% to 200%

	Policies for long-term development
1	Setting up of an Infrastructure Bond Scheme, allowing public participation in bond subscription, to enable the Government to better manage the cash flow needs of major infrastructure projects and facilitate the early completion of projects for the good of the economy and people's livelihood
2	Introducing a "patent box" tax incentive to provide tax concessions for profits sourced in Hong Kong from qualifying patents generated through R&D activities
3	Introducing a mechanism to provide facilitation for companies domiciled overseas, particularly enterprises with a business focus in the Asia Pacific region, for re-domiciliation to Hong Kong
4	Implementing the Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks in the LegCo in the first half of this year, so as to enable trademark owners to register and manage their trademarks in multiple jurisdictions under one single application

Introduction to Tax Deduction for Domestic Rent under Salaries Tax and Personal Assessment

Tax deduction for domestic rent paid by taxpayers under Salaries Tax and Personal Assessment would be implemented from the year of assessment 2022/23. The Inland Revenue (Amendment) (Tax Deductions for Domestic Rents) Ordinance 2022 sets out the relevant deduction rules.

Eligible Persons

The tax deduction for domestic rent is applicable to taxpayers who are liable to Salaries Tax or Personal Assessment**.** Deduction is allowed to the taxpayer for the rent paid as a tenant or co-tenant in respect of a qualifying tenancy of domestic premises held either by him/her or his/her spouse who is not living apart.

Qualifying Tenancy and Eligible Premise

To qualify for the deduction, a tenancy (or a sub-tenancy) in writing must be procured in respect of any domestic premises. The tenancy must be stamped within the meaning of the Stamp Duty Ordinance. In addition, the captioned premise should be a building or any part of such a building that is not prohibited by or pursuant to any law or any specified instrument from being used for residential purposes. If the taxpayer has more than one place of residence, the relevant premises must be his/her principal place of residence.

However, the deduction is not applicable under following situations:-

- The taxpayer or the taxpayer's spouse who is not living apart is a legal and beneficial owner of any domestic premises in Hong Kong;
- The landlord of the tenancy concerned is an associate of the taxpayer or the taxpayer's spouse;
- The taxpayer or the taxpayer's spouse has entered into a lease purchase agreement in respect of the premises concerned with the landlord;
- The taxpayer or the spouse who is not living apart is a tenant or authorized occupant of public rental housing flat; or
- The taxpayer is provided with a place of residence by his/her employer (including those who receive a refund for any rent paid).

Allowable Deduction Amount

The deduction ceiling of a tenancy is HKD100,000 for each year of assessment. However, the deduction ceiling will be proportioned under the following situations:-

- If there is more than one tenant under the tenancy – in proportion to the number of co-tenants; or
- If the period of the tenancy covers only a part of a year of assessment – in proportion to the period of the tenancy falling within the year of assessment.

For a married couple that is not living apart, the total amount of deduction allowable to the couple in respect of the domestic rent paid will not exceed the amount of deduction allowable to one person under the same tenancy condition.

Conclusion

It is worth notice that tax deduction of domestic rent is not allowed if the taxpayer is provided with a place of residence by his/her employer (including those who receive a refund for any rent paid). Under the current provisions, when an employee is provided with a place of residence by the employer or when the employer reimburses the rental expense of an employee by establishing clear guidelines and exercising proper control over the reimbursement process, the Inland Revenue Department (the IRD) assesses a rental value on the place of residence provided rather than the actual rental reimbursement amount borne by the employer. As such, it is not rare that the employer would provide a rental scheme to the staff as part of the remuneration package, because a rental scheme from the employer can enhance the tax efficiency of the employee. However, after the tax deduction of domestic rent took effect, the employee should consult its tax consultant and discuss with his / her employer to review whether the rental scheme is still the most tax efficient to the employee.

<u>Enactment of the Foreign Source Income Exemption (FSIE) Regime for Passive Income</u>

The Inland Revenue (Amendment) (Taxation on Specified Foreign-sourced Income) Ordinance 2022 has been enacted on 1st January, 2023. Under the FSIE regime, offshore passive income that is interest, dividend, disposal gain in relation to shares or equity interest (Disposal gain) and income from intellectual properties (IP income) will be deemed to be sourced from Hong Kong and chargeable to profits tax if the income is received in Hong Kong by a covered constituent entity of an multinational enterprise group (MNE entity). Unless the MNE entity meets the exception requirements specifically for the particular types of incomes as follow:-

Exceptions	Applicable incomes
Economic substance requirement	Interest, dividend and disposal gain
Participation requirement	Dividend and disposal gain
Nexus requirement	IP income

For a more detailed introduction on the implementation of the FSIE regime, please refer to our newsletter. ("Hong Kong Proposes Refinements to Foreign Source Income Exemption Regime for Passive Income")

Further Explanations from the IRD

As the FSIE regime brings about a set of new deeming provisions that may cause the abovementioned specified foreign sourced incomes, which are likely eligible for offshore exemption previously, to be chargeable to profits tax in Hong Kong, lots of questions were raised by the taxpayers prompting the IRD to provide further explanations on the interpretations of the terms and examples for certain common practical situations. Below are some of the issues recently clarified by the IRD:-

<u>Outsourcing of specified economic activities</u>

In assessing whether the economic substance requirement would be met under a group outsourcing arrangement, the IRD specified that a taxpayer should have an internal service agreement and other proper documentation to record the outsourcing arrangement, including the identities of the outsourcing entity and outsourced entity, nature of specified economic activities outsourced, fees charged, monitoring mechanism, etc., to prove that the outsourcing and the monitoring have taken place. For a pure equity-holding entity or its outsourcing service provider, the IRD further clarified that the specified economic activities for holding and managing equity participations should include making decisions on the holding and selling of equity interests, calculating risks, and reviewing or revising financing arrangement for acquiring the equity interests. The IRD will take into consideration the commercial reality, the overall operation and the level of resources in Hong Kong for the taxpayer or the service provider in assessing if the economic substance requirement would be satisfied.

<u>Switch-over rule under participation requirement</u>

Switch-over rule is an anti-abuse rule for participation requirement, which states that participation requirement only applies if the disposal gain / the dividend or the underlying profits out of which the dividend is paid is subject to a tax that is of substantially the same nature as profits tax in the foreign jurisdiction (foreign tax) and the tax rate applicable to the sum (applicable rate) is at least 15% (subject to tax condition), otherwise the tax relief available would be switched to tax credit claim.

Generally, the applicable rate refers to the headline rate (i.e. the highest corporate tax rate) of the jurisdiction in which the specified foreign-sourced income, underlying profits or related downstream income is taxed. The IRD clarified that this headline rate need not be the actual tax rate imposed on the income or profits concerned. If an income or profits are subject to the foreign tax at more than one rate (e.g. progressive corporate tax rates), the applicable rate will be the highest corporate tax rate applied to that income. If an income or profits are taxable under a special tax legislation at a lower rate than in the main legislation of the jurisdiction, and the lower rate is not a tax incentive for carrying out substantive activities, the headline tax rate should be the highest stipulated tax rate in the special legislation. At the same time, a new example was given by the IRD that, if the income concerned is subject to a tax at a lower rate under a comprehensive avoidance of double taxation arrangement, the applicable tax rate would still be the headline corporate tax rate of that tax jurisdiction.

Furthermore, in determining whether the subject to tax condition is met in relation to underlying profits out of which the subject dividend is distributed, the IRD states that, in general, if the investee entity sustains a loss and has no profits chargeable to tax for the relevant period, the subject to tax condition cannot be met. However, the IRD also states that if the taxpayer can provide sufficient evidence showing that the corresponding underlying profits have been taxed for a taxable period or periods at a rate of at least 15% prior to the subject dividend is declared and that the total amounts are equal to or larger than the dividend paid, the subject to tax condition may be met. In this regard, a taxpayer should keep consistent written record to track: (a) the total dividends paid by investee entities; and (b) the total profits of the entities that are taxed at a rate of at least 15%, for each taxable period.

Conclusion

Even with the IRD's further clarifications, many questions still remain on the interpretation of the concepts set out in the FSIE regime and the implementation in practice. It is expected that departmental interpretation and practice notes would be later issued to provide for a much more comprehensive explanation and more detailed examples. Meanwhile, an MNE entity is required to comply with the reporting obligation or to notify the Commissioner of its chargeability with regards to the specified foreign sourced incomes in accordance with the FSIE regime. We recommend that MNE entities should review their operation and asset holding structures that generate or potentially generate offshore passive income, including share/equity holding structure, IP holding structure and loan arrangements to assess the potential tax impact bring by the FSIE regime and consult with their tax consultant in a timely manner.

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The Aoba & Hopkins Group consists of CPA firms and full service consulting firms located in Hong Kong, Guangzhou and Beijing that have been providing quality and efficient professional services to our valued clients aboard and at home since 1989.

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