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Hong Kong 2012/13 Budget analysis – robust and comprehensive, but long-term measures needed

The Financial Secretary for the Hong Kong Special Administrative Region, John Tsang Chun-wah, delivered the 2012/13 Budget (the "Budget") on 1 February 2012. The Budget is his fifth and may not be considered by some as attractive as expected given the lack of a cash handout or sufficient long-term measures to strengthen Hong Kong's competitiveness against neighboring economic rivals. Nevertheless, the Budget is comprehensive and offers wide-ranging and solid measures that should largely be helpful to stabilize the economy, alleviate the financial burden of taxpayers and assist the small and medium-size enterprises (SMEs) that form the backbone of Hong Kong's economy to sail through any global economic turmoil in the forthcoming year.

The Budget was prepared against the backdrop of the sovereign debt crisis in Europe and a weak U.S. economy still facing the prospect of a double dip recession. Hong Kong as a small, open economy is unfortunately not immune to these factors. The drop in demand for imported goods from these regions (both being Hong Kong's major trading partners) led to a severe decline in Hong Kong's export trade. Such a slowdown in export performance hindered economic growth, which, as revised, stands at 5% in real terms for 2011 as a whole and is expected to drop to 1% to 3% for 2012.

In this regard, the economic outlook of Hong Kong for the upcoming fiscal year is rather uncertain and volatile. It is therefore not surprising to have a robust budget for fiscal year 2012/13 proposed by the government. In fact, there is a genuine need to adopt a prudent fiscal budget and conserve Hong Kong's current financial strength in terms of its substantial existing fiscal reserves for any adverse impact that could result from an expansion of Europe's debt crisis or worsening external economic situations in general.

This article highlights the Budget's key proposals to prepare against any such possible spillover effects, as well as measures to support Hong Kong's SMEs and middle class. An appendix ("Summary of allowances, deductions and tax rates") summarizing proposed tax changes also is provided. All measures will apply for fiscal year 2012/13, which begins 1 April 2012, unless otherwise noted. The Budget is expected to be debated and voted upon in the next few months.

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Initiatives for SMEs

Profits tax rebate – In response to the general public's call for tax relief, a 75% profits tax rebate, capped at HKD 12,000, has been proposed for the year of assessment 2011/2012 final tax payable. While Deloitte welcomes the tax rebate, we also recommend the government provide tax incentives targeting selected industries to consolidate Hong Kong's competitive edge as the financial, investment and commercial hub for the Asia Pacific region.

Hong Kong's profits tax rate has remained stagnant in the past years. Deloitte believes that the government can afford to lower the corporate profits tax rate from 16.5% to 16% given its current substantial fiscal reserves and added benefits that exceed the costs of lowering the rate. Such a measure would not only enhance Hong Kong's competitiveness over neighboring regions such as Taiwan and Singapore in terms of attracting foreign investments, but also would alleviate the tax burden of SMEs.

SME Financing Guarantee Scheme and enhanced Export Credit Insurance measures – Employing more than 1.2 million, SMEs have always been a major contributor to the success of Hong Kong. The Financial Secretary has proposed a series of supportive measures to ease the financial pressure SMEs face under the fluctuating economic environment. In particular, the government will enhance the SME Financing Guarantee Scheme by raising the maximum loan guarantee ratio from 70% to 80% and reducing guarantee fees.

In addition, the Hong Kong Export Credit Insurance Corporation will be incorporating new terms to its insurance policy, which will include special concessions and premium discounts for SME policyholders. While Deloitte appreciates the government's effort in facilitating the development of SMEs, we would be pleased if the government could also introduce such tax initiatives as allowing a 150% tax deduction on rental expenses for office space usage and providing a double deduction on salaries paid to employees with disabilities (relieving the tax burden of SMEs and encouraging them to employ more disabled persons).

Other measures – Apart from the above, the government has laid out the following incentives in an attempt to promote business activities in Hong Kong:

- Abolition of capital duty levied on local companies;
- Waiver of business registration fees for 2012/13; and
- Reduction of the import and export declaration charges by half.

These suggestions are generally in line with the public's expectation, and Deloitte views these as effective incentives to fuel the development of SMEs.

The Financial Secretary stressed in the Budget the importance of employment in stabilizing the economy and safeguarding people's livelihood. Through assigning funds to the Four Pillar Industries (trading and logistics, financial services, business and professional services and tourism) and the Six Industries (cultural and creative industries, medical services, education services, innovation and technology, environmental industries and testing and certification services), the government aims to stimulate employment for each sector. Deloitte applauds the government's care for SMEs and the labor market.

Caring for the middle class

The Financial Secretary introduced a number of tax relief measures to ease the pressure on the middle class from the economic downturn and inflation. Exceeding the general public's expectations, a salaries tax and tax under personal assessment rebate of up to HKD 12,000 for the year of assessment 2011/12 final tax payable was proposed. In addition, the maximum entitlement period for the tax deduction on home loan interest would be lengthened from 10 to 15 years of assessment, with the maximum annual deduction remaining unchanged at HKD 100,000.

An increase to the following allowances and deductions, ranging from 5% to 21%, also was proposed:

Allowances –

- Basic, single parent and married person's allowances;
- Dependent parent and grandparent allowances;
- Child allowance and additional one-off child allowance in the year of birth;

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- Dependent sibling allowances; and
- Disabled dependent allowance.

Deductions –

- Deduction ceiling for elderly residential care expenses; and
- Maximum annual tax deduction for mandatory contributions to Mandatory Provident Fund (MPF) scheme.

While the above reliefs are expected to be broadly welcomed by the middle class, Deloitte suggests that the government also allow such tax deductions as a premium paid for self-participating medical insurance schemes, actual medical expenses and the principal amount repaid for home mortgage loans. Although the government has extended the entitlement period of the home loan interest deduction to 15 years of assessment, Deloitte favors an extension to 20 years to lessen taxpayers' high housing cost burdens.

Additionally, more employees are encountering double taxation issues on employment income due to increasing cross-border activity. We suggest the government allow a full income exemption from salaries tax in respect of income reported and taxed in Mainland China.

Other one-time reliefs – The government also put forward a basket of one-time "sweeteners," including:

- Extending the rates waiver for 2012/13, subject to a cap of HKD 2,500 per quarter for each ratable property;
- Providing electricity subsidies in the amount of HKD 1,800 to each residential electricity account in the coming fiscal year;
- Paying two months' base rent for public housing tenants and two-thirds of rent for two months for the non-elderly tenants of the Hong Kong Housing Society's Group B estates;
- Providing an extra allowance to Comprehensive Social Security Assistance recipients and Old Age Allowance and Disability Allowance recipients that equals one month of the standard rate payments and allowances; and
- Allocating an additional HKD 100 million for short-term food assistance services to ease the low income group's financial burden from surging commodities prices, etc.

Investing in the future

To maintain Hong Kong's competitiveness and economic growth, the government has proposed to combat inflation and safeguard the livelihood of the public. Notable measures include the promotion of the retail bond market and enhancement of healthcare facilities.

Promoting the retail bond market – To foster the development of the retail bond market, the government will issue another tranche of iBonds, capped at HKD 10 billion. The new series of iBonds will retain the same payout options as those of the previous year, with a maturity of three years and interest payable semi-annually at a rate linked to the inflation of the last six-month period. While investors were not as responsive to iBonds as anticipated at the first launch in July 2011, the iBonds should be well-received by investors in the coming year due to better-than-expected returns (despite pressures from the European debt crisis) and the low expected yield of conventional fixed-rate investment instruments. The government is treating the iBonds as a special measure taking into account the current market situation. In the long run, an expansion of other kinds of bonds, such as conventional fix-rate bonds and Islamic bonds, will be beneficial for developing a mature bond market in Hong Kong. Deloitte applauds the government's attempt to ease the public's financial burden under soaring inflation rates and to encourage the development of the retail bond market.

Enhancing healthcare facilities – The burden of elderly and public healthcare services is rapidly increasing along with the aging population. The government has taken forward projects of various scales at the district level, including the redevelopment of Queen Mary Hospital and Kwong Wah Hospital, as well as the expansion of Tseung Kwan O Hospital in the coming year, to address the population's surging demand for medical services.

Conclusion

This year's budget is generally appreciated as a comprehensive one that offers wide-ranging and solid measures to stimulate the local economy and lessen the financial burden of SMEs, which contribute to a stable job market. There also are various

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relief measures to rightly address the imminent call for financial assistance to the middle class. In addition, there are important measures to improve education, medical and healthcare facilities, as well as social services (in particular, those delivered to the elderly).

While we are impressed by the robust budget, there is room for more long-term policies and measures to attract foreign investment and enhance the competitiveness of Hong Kong. We look forward to seeing the next government formulate longer term policies and capitalize on Hong Kong's competitive edge to sustain its status as a world-class financial and services center.

Appendix: Summary of allowances, deductions and tax rates

Salaries tax

The standard rate is 15% for 2011/12 and 2012/13.

Progressive tax rates 2011/12 and 2012/13	
Net chargeable income (HKD)	Marginal tax rate (%)
First 40,000	2
Next 40,000	7
Next 40,000	12
Remainder	17

Allowances and deductions	2011/12 (HKD)	2012/13[1] (HKD)
Personal allowances:		
Basic	108,000	120,000
Married	216,000	240,000
Single parent	108,000	120,000
Children (1st through 9th child):		
Year of birth	120,000	126,000
Other years	60,000	63,000
Dependent parent/grandparent (aged 60 or above):		
Basic	36,000	38,000
Additional allowance (for each dependent living with taxpayer)	36,000	38,000
Dependent parent/grandparent (aged between 55-59):		
Basic	18,000	19,000
Additional allowance (for each dependent living with taxpayer)	18,000	19,000
Other dependents:		
Dependent sibling	30,000	33,000
Disabled dependent	60,000	66,000
Deductions (maximum amount):		
Self-education expenses	60,000	60,000
Home loan interest (years of assessment)	100,000 (10)	100,000 (15)
Elderly residential care expenses	72,000	76,000
Contributions to recognized retirement schemes	12,000	14,500[2]
Approved charitable donations (as percent of income)	35%	35%

[1] Legislative amendments are required.
[2] The maximum level of relevant income under the Mandatory Provident Fund Schemes Ordinance will be increased to HKD 25,000 with effect from 1 June 2012. Hence, the maximum amount of deductible contributions is HKD 14,500 for the year of assessment 2012/13 and HKD 15,000 for the year of assessment 2013/14 and onwards.

One-off measure on salaries tax and the tax under personal assessment – A reduction of 75% of final tax payable under the salaries tax and the tax under personal assessment for 2011/12, subject to a ceiling of HKD 12,000, is proposed. (A legislative amendment is required.)

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Profits tax

Profits tax rates 2011/12 and 2012/13 (%)	
Incorporated	16.5
Unincorporated	15

One-off measure on profits tax – A reduction of 75% of final tax payable under the profits tax for 2011/12, subject to a ceiling of HKD 12,000 is proposed. (A legislative amendment is required.)

Property tax

The rate is 15% for 2011/12 and 2012/13.

Other measures

Other measures under 2012/13 Budget	
Capital duty	The Budget would abolish the capital duty levied on local companies.
Import and export declaration charges	The Budget would halve the charges for import and export declarations.
Rates	The Budget would waive full year rates for 2012/13, subject to a ceiling of HKD 2,500 per quarter for each ratable tenement.
Government fees and charges	The Budget would waive business registration fees for 2012/13.
Legislative amendments are required for all of the above items.	

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Greece:
Blacklist of uncooperative countries announced for 2012 transactions

Greece's Ministry of Finance announced a Ministerial Decision that sets forth the official list of uncooperative countries for 2012 for purposes of applying the provisions of articles 51a and 51b of the Income Tax Code.

According to these articles, transactions between Greek companies and entities located in countries included on the blacklist may lead to the disallowance of expenses or adjustments of revenue. There are exceptions to this general anti-avoidance rule, which allow the taxpayer to demonstrate the *bona fide* nature of such transactions and, therefore, avoid the negative consequences.

The 2012 list contains no changes to the list for 2011, but for the removal of Chile, and is as follows:

2012 blacklist			
Andorra	Cook Islands	Liechtenstein	Philippines
Anguilla	Costa Rica	Macedonia	St. Lucia
Antigua & Barbuda	Dominica	Malaysia	St. Kitts & Nevis
Aruba	Gibraltar	Marshall Islands	St. Vincent and the Grenadines
Bahamas	Grenada	Mauritius	Samoa
Bahrain	Guatemala	Monaco	Seychelles
Barbados	Guernsey	Montserrat	Singapore

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2012 blacklist			
Bermuda	Hong Kong	Nauru	Turks and Caicos
Belize	Isle of Man	Netherlands Antilles*	U.S. Virgin Islands
British Virgin Islands	Jersey	Niue	Vanuatu
Brunei	Lebanon	Panama	Uruguay
Cayman Islands	Liberia		
* The Netherlands Antilles ceased to exist as a jurisdiction effective 10 October 2010 due to a constitutional reform of the Kingdom of the Netherlands.			

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Russia: Changes in court practice concerning thin capitalization rules

Russia's tax authorities have been subjecting the tax accounting treatment of interest paid on loans granted by foreign affiliated companies to increasing scrutiny, particularly regarding whether the thin capitalization (thin cap) rules apply to such loans. The thin cap rules stated in article 269(2) of the Russian Tax Code (RTC) disallow an interest deduction if the amount of "controlled debt" of a Russian borrower exceeds a debt-to-equity ratio of 3:1 (or 12.5:1 for banks and leasing companies). In such cases, the excess interest is recharacterized as a dividend subject to a 15% withholding tax (unless the rate is reduced under an applicable tax treaty). Based on the law's literal wording, however, the thin cap rules do not apply to financing by "foreign sister companies" (defined below).

With the ongoing challenges by the tax authorities, there is an emerging trend in arbitration court practice regarding two issues relating to the thin cap rules:

- The possible application of the rules where a loan is granted by a foreign "sister" company and there is evidence that the loan was financed and/or controlled by the parent company; and
- The possible application of the rules even where a relevant tax treaty includes a nondiscrimination provision.

Loans from a foreign sister company

Under the RTC, the thin cap rules apply to interest paid on a loan obtained by a Russian taxpayer's direct or indirect foreign shareholder that holds 20% or more of the share capital of the taxpayer (the "parent company"), whereas a loan from a foreign sister company (i.e. a foreign subsidiary of the Russian borrower's foreign parent company) is not subject to the rules.

In the 2011 *Narianmarneftegaz LLC* case, however, the decisions of the Moscow Arbitration Court and the Ninth Arbitration Appeal Court indicated that the issue of whether clause 2 of article 269 applies to the deduction of interest on loans issued by the borrower's sister company, rather than its parent, should not be determined exclusively by reference to a formal evaluation of the relationship between the parties: it is necessary to examine all relevant transactions to determine the true source of the loan.

The facts of the case indicate that the Russian LLC received a number of loans from its U.S. sister company. The sister company, however, was fully owned by another U.S. company indirectly holding 30% of the Russian LLC. The sum of the loans received exceeded the LLC's debt-to-equity ratio by more than 3:1. The courts upheld the position of the tax authorities that the granting of the loan by the foreign sister company was purely a formality and was done to avoid the restriction in clause 2 of article 269. The real lender was the parent company.

To justify their position, the tax authorities had relied mainly on the provisions of the shareholders' agreement and the consolidated financial statements of the parent company. The fact that that borrower obtained part of the loans directly from the parent company also bolstered the tax authorities' argument.

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Notably, the courts disregarded the formal structure of the transaction, i.e. the fact that there was a formal loan agreement concluded with the sister company, which advanced the loan principal and received payments of interest.

In the 2010 *Gidromashservice LLC* case, the Russian tax authorities tried to prove that the loan was actually granted by the parent company of the borrower even though, in formal terms, the loan was granted by the foreign sister company. The court of cassation strictly interpreted the statute, ruling against the tax authorities, and noted that the provision did not apply to foreign sister companies.

Interestingly, the *Narianmarneftegaz* case is scheduled to be appealed to the court of cassation, so the final outcome is far from certain. Nevertheless, it would be fair to conclude that some change to the position of the courts on applying the thin cap rules to loans from a foreign sister company may have occurred.

Until there is clarity on this issue, therefore, there is a considerable risk that the thin cap rules will be applied if the parent company is the actual initiator, controller and source of the financing, even if the loan is formally made by the sister company. The tax authorities may become more active in this area, using evidence obtained during tax audits and from third parties (including state control authorities) to challenge financing structures.

Tax treaty or Russian Tax Code?

Over the last six years, the Russian courts have consistently maintained the position that the thin cap rules do not apply if the loan is granted by, and the interest is paid to, a company resident in a country that has concluded a tax treaty with Russia. The nondiscrimination clause in the relevant treaty has been the legal basis for not applying clause 2 of article 269.

The Presidium of the Supreme Arbitration Court considered this issue at the end of 2011 in a case in which the taxpayer claimed that the thin cap rules did not apply due to the nondiscrimination clauses in Russia's tax treaties with Cyprus and Switzerland. According to the facts of the case, a Russian joint stock company (Severniy Kuzbass or "JSC") obtained loans from two unrelated Russian entities. Subsequently, the loans were assigned by one of the Russian lender entities to a Swiss entity.

The lower and appeal courts in the case established that the Russian lender entities were affiliated with a Cyprus entity that indirectly held more than 20% of the shares of the JSC and the loans exceeded a 3:1 debt-to-equity ratio. The Swiss entity to which one of the Russian lender entities assigned the loans also was established to have held more than 20% of the shares of the JSC in the tax period under review. Nevertheless, the lower courts supported the taxpayer's position based on the non-discrimination clause. The JSC claimed a deduction for loan interest paid to both the Swiss-based parent company and Russian affiliates of the Cyprus-based parent company. The courts all relied upon the fact that Russia's treaties with Cyprus and Switzerland include non-discrimination clauses and, therefore, the interest was deductible without limitation.

The Presidium of the Supreme Arbitration Court disagreed with the lower courts and ruled for the tax authorities. For now, the Presidium's reasoning in arriving at this position is unclear, as the full text of their resolution has not been issued. It could, however, be presumed that the Presidium emphasized the position outlined by certain lower courts. These courts noted that the treaties do not regulate the recognition of expenses for tax purposes – which is under the jurisdiction of national legislation – and it is, therefore, inappropriate to refer to the provisions of a treaty for this purpose.

It should be noted that courts in certain districts have already started changing their position in favor of the tax authorities with regard to this area of dispute.

Conclusion

At the present time, it is difficult to draw any final conclusion as to how the thin cap rules will be applied in future with regard to whether the Presidium's ruling will leave any room for applying treaty non-discrimination provisions as a general defense, or whether the "substance over form" approach adopted by the courts in the *Narianmarneftegaz LLC* case will be overturned on appeal. Nevertheless, it seems clear that foreign investors now need to pay specific attention to how the financing of Russian companies is structured, including existing investments where thin capitalization may be a risk.

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United States: Few tax policy surprises in State of the Union address

President Obama used his State of the Union address on 24 January 2012 to restate several familiar proposals related to high-income individuals, multinational corporations, large oil companies and financial institutions that generally will not surprise taxpayers, but may rankle some.

"Buffett Rule"

The president emphasized his continued commitment to enacting the so-called "Buffett Rule" – a proposal he unveiled last September as part of the deficit reduction recommendations he submitted to the now-defunct congressional "supercommittee" – to ensure that very high-income taxpayers pay tax at an effective rate at least equal to that of the middle class. Significantly, the president provided the first concrete details around what had been an enigmatic concept when he explained that taxpayers who make more than USD 1 million a year should not pay less than 30% in taxes.

In remarks to reporters in the days following the speech, White House officials explained that high-income earners with effective tax rates below 30% would be subject to a new minimum tax – akin to a super alternative minimum tax – to boost their rates up to 30%. This millionaire's minimum tax would carve away the benefits associated with various tax breaks, including reduced rates for carried interests, long-term capital gains and qualified dividends. The administration promised that the rule would be applied equitably, without "disadvantaging" those individuals who make significant charitable contributions.

According to a "blueprint" document released 24 January, the administration also has recommended limiting or eliminating deductions or credits for home mortgages, health care, retirement and children for individuals earning over USD 1 million.

Obama also renewed his pledge to allow the 2001 and 2003 tax cuts to expire for upper-income individuals and to prevent tax hikes for taxpayers with incomes below USD 250,000.

Promoting domestic manufacturing

The president spoke in broad terms about eliminating certain tax benefits for companies that move jobs offshore and providing new incentives to promote corporate "insourcing." A White House fact sheet released 25 January outlines a revenue-neutral set of proposals that would:

- Deny deductions for costs associated with moving U.S. operations abroad in order to fund a new 20% tax credit for costs associated with returning foreign operations to the U.S.;
- Tighten rules related to the taxation of income generated by intangible property that has been transferred abroad;
- Repeal the domestic production activities deduction under Internal Revenue Code section 199 for oil and gas producers, while expanding the deduction for manufacturers and doubling the allowable deduction – from 9% to 18% – for advanced manufacturing technologies;

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- Create a new Manufacturing Communities Tax Credit for qualified investments in communities that have suffered a major job-loss event;
- Extend the Code section 48C Advanced Energy Manufacturing Tax Credit and increase the allocable credit amount from USD 2.3 billion to USD 5 billion; and
- Extend 100% bonus depreciation through 2012.

These proposals also are expected to appear in the president's fiscal year 2013 budget to be released on 13 February.

Corporate tax reform

Although the president did not specifically call for fundamental reform of the corporate tax rules, the White House indicated in its 25 January fact sheet that the administration will release a corporate tax reform "framework" that would include proposals to:

- Make companies pay a minimum tax for profits and jobs overseas and invest the savings in cutting taxes domestically, especially for the manufacturing sector;
- Make the research and experimentation credit permanent; and
- Simplify the tax code and close loopholes.

The fact sheet did not elaborate on how these proposals would work. White House officials have indicated that the tax reform framework would be released in February.

Energy

Obama reiterated his longstanding support for eliminating tax incentives for large oil companies and enacting new tax credits to promote clean energy. In a separate fact sheet issued 26 January, the administration urged extension of the production tax credit – citing in particular the credit's impact on the generation of wind and solar power – as part of an overarching strategy to double the share of U.S. electricity that comes from clean energy sources by 2035.

Financial institutions

The president proposed a new fee on large financial institutions to pay for a federal program that would allow certain homeowners who were adversely affected by the downturn in the housing market to refinance their mortgages at lower interest rates.

Action unlikely this year

For taxpayers, the key concern is whether any of the president's proposals will translate into legislative action this year. The conventional wisdom in Washington – that election years are for campaigning and not legislating – seems particularly apt for this deeply divided Congress, which just returned to Capitol Hill following one of the least productive tax policy sessions in recent history. The deep divisions that have stymied Washington to date will not easily be resolved without an outcome in November that signals a clear electoral mandate or fundamentally alters the balance of power.

This has led many to speculate that the bulk of the nation's biggest tax policy challenges – most notably reforming the corporate and individual tax rules – will be deferred until after the election, and that 2012 will prove to be largely a stage setter for the action that will unfold in 2013-2014.

In the coming months, two potential developments in particular could challenge this status quo:

- Specifics in the president's fiscal 2013 budget could plow new ground in the tax policy arena and potentially open a window to compromise; and
- A strong catalyst outside Washington (e.g. the European Union debt crisis) could compel policymakers to turn to tax in the context of addressing an immediate debt/deficit crisis.

All that said, there are some significant tax policy issues that lawmakers will be unable to avoid in 2012 and that will require taxpayer vigilance. The individual tax cuts enacted in 2001 and 2003 and extended under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 are set to expire at the end of this year. Unless Congress acts,

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rates on ordinary income, capital gains and qualified dividends, as well as estates and gifts, will revert to their pre-2001 levels. In addition, the most recent "patch" for the individual alternative minimum tax (AMT) expired at the end of 2011, which means congressional intervention will be required to prevent millions of taxpayers from being swept into the AMT regime. Although this situation is likely to dominate the tax policy discussion on Capitol Hill and on the campaign trail in the coming months, we expect that resolution will have to wait until a lame-duck session after the elections.

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No new alerts were issued this week. Be sure to refer to the archives to ensure that you are up to date on the most recent releases.

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