The Ability - To - Pay Concept For Hong Kong Corporate Profits Tax System

Koon Hung Chan
Department of Accounting and Finance
Lingnan University

摘要

本港利得稅不妨引入累進機制。尤其是處於經濟不景時，累進機制讓有能力負擔多一些的企業負擔多一點。這樣，負擔能力較低的中小企業就有更大的生存和發展空間。

During this year's budgetary process, the Financial Secretary has repeatedly stressed that tax changes will reflect the residents' ability-to-pay. Unfortunately, the only obvious example in the Budget Speech that reflects the ability-to-pay concept is the Motor Vehicles First Registration Tax. I believe that a progressive tax system is more suitable to fairly assess the tax burden of residents and corporations according to their abilities to pay. Since salary tax in Hong Kong is already partially progressive (although the proposed reduction in allowance makes the salary tax rate structure less progressive), this article will focus on discussing taxation for corporate profits.

Hong Kong's Profits Tax Collection

Profits tax is levied on corporations, individuals, bodies of persons and partnerships, in respect of assessable profits arising in or derived from Hong Kong. Currently, the profits tax rate for corporations has remained unchanged at 16% flat rate since 1998-99 (to be changed to 17.5% in 2003-2004). In 2001-02, the total collection of profits tax was $44 billion which represents 25.3% of the total government revenue. In 2002-03 (updated scenario in March 2002), the total profits tax collection is 42.9 billion representing 20.0% of the total government revenue. Compared to the collection of $55.3 billion (37% of the total government revenue) in 1997-98, profits tax revenue has declined during most of the past five years.

Tax Rate System Concepts

Hong Kong has long been adopting a flat profits tax rate system, as it is easy to understand and simple to administer. Currently, no matter how much the companies earn, a fixed proportion of their business income will channel to the Government. In other words, the average tax rate (being the total tax assessed as a proportion of the business income) equals to the marginal tax rate (the profits tax rate on the additional unit of profits generated).

Amongst the four Asian Little Dragons, South Korea and Taiwan are assessing corporate income at progressive tax rates. Singapore has a semi-progressive tax rate system. Corporations with higher income in these countries pay a higher proportion of their income as tax payment. Under the progressive tax rate system, if the corporate income of an enterprise doubles to the extent that it exceeds the boundary of a lower tax rate, the increase in its income tax liability will be more than double. Simply speaking, the marginal tax rate exceeds the average tax rate leading to an average tax rate increase with income. In comparison with South Korea and Taiwan, Hong Kong seems to be recovering from the Asian Financial turmoil at a slower rate and we do currently face some severe economic problems. It should be time for the administrator to consider an alternate tax system, i.e. progressivity, as it may be more equitable, particularly for less profitable small and medium sized businesses hit hard by the current economy. The proposed new tax system may also provide the Government more flexibilities in adjusting the tax burden of taxpayers of different profits levels.

Ability-to-pay Principle

The social purpose of taxation is to achieve a more even distribution of income and to reduce the inequality of wealth. To achieve a vertical equity, we expect that taxpayers of different taxable capacities should pay equally. However, we also expect to levy taxes on taxpayers according to their tax paying ability. In other words, on a horizontal equity basis, we should have equal treatment of taxpayers of similar taxable capacity and thus support progressivity of taxation. Progressive tax rate means a larger proportion of tax will be derived from people with higher income, as marginal tax rate rises with income. In the context of corporate profits tax, this does not necessarily mean that more profitable companies are penalized. Instead, they are those more capable to generate higher profits and thus more able to contribute their income to the Government's coffer. The progressive tax rate system, in an economic way, saves the necessities for the poorer by taking part of the luxurious goods from the richer. This argument is based on the theory of the declining marginal utility of income. According to this theory, a progressive tax rate structure in which the rates increase as income increases results in an equality of sacrifice across taxpayers. Many tax policymakers believe that the justification for a progressive income tax rate structure is its potential for rectifying distributive inequity in our tax system.

Under a flat tax rate structure, the marginal and the average tax rates are the same for all levels of taxable income. Under a progressive tax rate structure, the marginal tax rate is higher than the average tax rate for taxable income in excess of the first tax rate bracket. Indeed, one of the identifying features of progressive tax rate system is that the marginal rate of tax will be above the average rate of tax. It is this fact that the imposition of gradually increasing marginal tax rate causes the average tax rate to increase.

Less Tax Burden for Small and Medium Sized Businesses

Under current economic environment, small and medium enterprises are lack of sufficient support for starting, developing, operating and expanding their businesses. Government has been finding ways and launching programs, for example, Small and Medium Enterprises (SME) Funding Schemes (中小企業資助計劃), to facilitate and enhance the development and growth of these enterprises.

Progressive tax rate system not only levies higher tax on those who earn more, thus more able to pay, but can also relieves partially the tax burden of small- and medium- sized companies. As the profits tax system becomes more progressive, corporations on lower income can pay less, and those with higher income pay more. Hence, instead of taxing all companies at a standard rate and providing the inferior with loans or subsidies by the Government, the progressive tax rate system allows the small- and medium- sized firms to save more for working capital and reinvestments purposes.

Large corporations may argue that the progressive tax rate system discriminates them as they are losing their competitive advantages to the small and medium sized enterprises. In fact, for investment decision-making, companies should continue their investment in projects as long as the rate of return from the investment is greater than or equal to their own cost of capital. Large corporations can normally obtain capital at a lower cost than small and medium sized businesses.

Allowable Deductions

In order to reduce the adverse effect from the adoption of a progressive tax rate system, Government can offer some deduction schemes, which can provide direct welfare to the community. This includes imposing higher marginal tax rate coupled with higher charitable donation deduction rates which were already been proposed in the Budget Speech.

Donations to educational institutions, cultural centers, medical centers, hospitals, elderly residential homes, daily activity centers and sheltered workshops for the under-privileged will actually reduce the demand on the Government in incurring these kinds of public expenditure. Thus, reduction in taxable income arising from increase in charitable deductions will be partially offset by the savings from provision of public goods. From the viewpoints of the enterprises, increase in donation will not only reduce the tax payment, but will also enhance the corporate image with the general public that big firms do concern about the society and are bounded with the community, in addition to making profits from business.

Drives Investors Away?

It has been worried that increase in tax rate will discourage investment. By increasing the marginal tax rate, it is speculated that investment from large local enterprises and international organizations will be driven away. In order to generate the higher after-tax return, local investors will try to look for more attractive investment alternatives outside Hong Kong whilst foreign investors will channel their investments elsewhere. However, the Hong Kong profit tax rate is still significantly below neighboring jurisdictions and our major trading partners. While these jurisdictions may offer more tax incentives for selected enterprises, overall and in the long run, these incentives do not appear to be enough to bridge the significant gap in tax rates in most cases. Also, the simple tax system and the “territorial concept” of taxation system in Hong Kong still provide investors a good environment for investing in Hong Kong.

Furthermore, surveys demonstrate that taxation of profits is only one of the many factors in the investment location decision, and not the most important one (Simmons, R. 2000. Hong Kong, China. How Important are Changes in Profits Tax to Hong Kong’s “Competitiveness”? The Lingnan Commentary (January): 2-5.) And amongst all tax factors, investors are more concerned about the transparency, stability and consistency of the tax system than the tax rate itself.

Nowadays, many countries have offered tax relief on double taxation. A moderate rise in profits tax rate for large profitable multinational corporations should not affect the eventual tax burden on the foreign investors. As long as our profits tax rate remains competitive as compared with those of neighboring countries and major trading partners, multinational corporations will be willing to save their total tax payment by settling their profits tax liabilities in Hong Kong instead of elsewhere. Needless to say, in a progressive tax rate system, tax planning will be more complicated, and in this sense, more important.

Same as Singapore, one of the Asian Little Dragons, Hong Kong does not impose capital gains tax as South Korea and Taiwan do. Hence, if income of capital nature is generated, no profits tax will be levied upon. The absence of capital gains tax tends to benefit high net-worth corporations, as it is easier for them to finance funding for investment. Furthermore, large multinational corporations are more able to afford to hire expensive professionals to advise them to structure offshore businesses (with income sourced outside Hong Kong and thus not subject to Hong Kong taxation) than small and median sized local businesses. Therefore, these multinational corporations tend to be more able to take advantage of the "territorial concept" of the Hong Kong taxation system. It seems to be fair to increase the income tax on large corporations as they are already benefited from the absence of capital gains tax and profits derived from offshore businesses, at least more so than smaller businesses.

Conclusions

Flat tax rate system can assure a certain level of revenue for the Government when the economy is booming. The Government can adjust the tax rate to levy whatever is required to finance the public expenditure.

During economic downturn, however, the national income declines and the disposable income of the general public drops. It may be difficult to increase the flat tax rate further. If a progressive tax rate system is in place, the government tax revenue can be adjusted more easily by monitoring the tax rates for those categories of taxpayers who are more or less able to pay tax. Thus, this may be time for the Hong Kong SAR Government to launch a new tax rate system.