

Press release

LCQ13: Profits tax

Wednesday, January 13, 2010

Following is a question by Dr the Hon Lam Tai-fai and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (January 13):

Question:

At present, the Inland Revenue Department may, on a 50:50 basis of apportionment, assess Hong Kong profits tax payable by Hong Kong enterprises in respect of profits from sale of products processed by mainland manufacturing units under "contract processing", but this arrangement is not applicable to Hong Kong enterprises engaged in "import processing". In this connection, will the Government inform this Council:

(a) whether it has assessed the negative impact on Hong Kong enterprises engaged in "import processing" of the aforesaid method of assessing Hong Kong profits tax not being applicable to such enterprises; if it has, of the details; if not, the reasons for that;

(b) whether government officials have visited Hong Kong enterprises engaged in "contract processing" and "import processing" on the Mainland and looked into their modes of operation and manufacturing procedures; if they had, of the number of visits made in the past three years, the numbers and types of enterprises visited, as well as the conclusions after the visits; if not, the reasons for that;

(c) whether it has assessed if the aforesaid method of assessing Hong Kong profits tax not being applicable to Hong Kong enterprises engaged in "import processing" is contradictory to the policies of the HKSAR Government and mainland authorities at various levels of encouraging the upgrading and restructuring of Hong Kong enterprises; if it has, of the details; if not, the reasons for that;

(d) whether it will amend the Departmental Interpretation and Practice Notes to allow the aforesaid method of assessing Hong Kong profits tax to apply to Hong Kong enterprises engaged in "import processing", so as to better cater for the needs of enterprises under the current business environment; if it will, of the details; if not, the reasons for that;

(e) of the number of Hong Kong enterprises originally engaged in "contract processing" but had restructured to engage in "import processing" in each of the past three years, and the total amount of tax recovered from such enterprises by the authorities; and

(f) whether it has compiled statistics on the number of enterprises engaged in "contract processing" still operating in Hong Kong at present?

Reply:

President,

(a), (c) and (d) Hong Kong adopts a territorial source principle of taxation. Under the Inland Revenue Ordinance, only those profits arising in or derived from Hong Kong from any trade, profession or business carried on in Hong Kong will be subject to Hong Kong profits tax. For Hong Kong enterprises with cross-boundary businesses in Hong Kong and the Mainland, no matter whether they engage in "contract processing", "import processing" or any other modes of operation, the Inland Revenue Department (IRD) assesses the Hong Kong profits tax payable by such enterprises in accordance with the above basic principle.

There are differences between "contract processing" and "import processing" in terms of status of legal person, ratio of domestic and export sales, mode of operation, ownership of goods, mode of payment for raw materials as well as ownership and provision of production equipment. Under "contract processing" arrangements, Hong Kong enterprises have to participate in the production activities in the Mainland in various ways, including providing raw materials, machinery and plant and technical support as well as assigning technical and managerial staff to the Mainland. At the same time, the Hong Kong enterprises have to conduct part of the business and production activities in Hong Kong. As a result, part of the profits of the Hong Kong

enterprises will be regarded as sourced in Hong Kong and taxed accordingly. Based on the same facts, the Mainland authorities may treat the Hong Kong enterprises carrying out the said production activities in the Mainland as permanent establishments, and consider imposing taxes on them for the profits they derive from their subsequent sales of products. To avoid disputes between taxpayers and the IRD on the apportionment of profits, the IRD has all along allowed Hong Kong enterprises engaging in "contract processing" to apportion their profits on a 50:50 basis according to the territorial source principle for assessment of Hong Kong profits tax payable.

However, under the "import processing" mode, Hong Kong enterprises are in effect traders only. They purchase finished products from entities carrying out production activities in the Mainland (foreign invested enterprises) for export. They can claim full tax deductions for the purchase costs in Hong Kong. The purchases made by such Hong Kong enterprises are no different from those that they make from manufacturers in Hong Kong, the Mainland or other countries. Since the trading activities are mainly carried out in Hong Kong, the profits from such trading activities should be fully chargeable to Hong Kong profits tax whereas the foreign invested enterprises in the Mainland bear no tax liabilities in Hong Kong.

Individual enterprises make their own commercial decisions on what mode of business operation is to be adopted. IRD assesses taxes based on facts and in accordance with the laws. IRD's Departmental Interpretation and Practice Notes are intended to assist the industry to better understand relevant tax laws and they could in no way serve to revise the laws.

(b) Government officials of the Hong Kong Special Administrative Region (HKSAR) visit Hong Kong enterprises in the Mainland from time to time to understand their situation, including their experiences gained after relocation of industries and difficulties encountered. Between 2007 and 2009, HKSAR government officials made a total of 44 visits to the Mainland covering 75 Hong Kong enterprises, including those engaging in "contract processing" and "import processing". However, we have no detailed breakdown of the types of enterprises visited.

(e) and (f) We do not have information in this regard.

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