

## Press release

### LCQ14: HK enterprises engaged in processing operations

Wednesday, April 13, 2011

Following is a question by Dr 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 (April 13):

Question:

Regarding the taxation problems in Hong Kong faced by enterprises engaged in processing trade operations in Hong Kong in the course of upgrading and restructuring, will the Government inform this Council:

(a) given the substantial difference between the interest rate on Tax Reserve Certificates (TRCs) (0.0433% per annum at present) and the "Judgment Interest Rate" (8% per annum at present), whether the authorities have assessed if the following scenario complies with the taxation principle of fairness: a taxpayer had concurrently and separately lodged objections against tax assessments in two cases; in one of the cases, an unconditional stand-over was ordered but he eventually failed the case, whereas in the other case, the taxpayer was required to purchase TRCs but he eventually succeeded the case; with respect to the unsuccessful case, the taxpayer had to pay a huge amount of interest which was calculated at the "Judgment Interest Rate", yet with respect to the successful case, he might only receive a small amount of interest from TRCs; if the outcome of the authorities' assessment is in the affirmative, whether the authorities can offer a detailed explanation; if the outcome of the assessment is in the negative, what remedial plan is in place;

(b) given that the authorities have admitted that for most of the objection or appeal cases with "conditional stand-over orders" issued, the purchase of TRCs will be required, whether the authorities have assessed if, because of the low interest rate on TRCs, the Commissioner of Inland Revenue (the Commissioner) adopts the attitude of exercising "excessive control even to the extent of victimising the innocent" when issuing orders for taxpayers to purchase TRCs; whether the authorities will consider fixing the interest rate of TRCs for objection cases at the same level as the "Judgment Interest Rate" in order to comply with the principle of fairness, and to make the Commissioner adopt a more prudent attitude in ordering taxpayers to purchase TRCs;

(c) given the authorities' view that the granting of tax deductible allowances for machinery and plant outside Hong Kong goes against the "tax symmetry" principle, whether the authorities can explain if it complies with the "tax symmetry" principle when the profits derived from machinery and plant outside Hong Kong are liable to profits tax in Hong Kong but tax deductible allowances are not granted for these machinery and plant;

(d) given the authorities' view that the granting of tax deductible allowances for machinery and plant outside Hong Kong goes against the "territorial source principle", yet many Hong Kong enterprises which have set up offices outside Hong Kong pay profits tax in Hong Kong in respect of all their profits, whether the authorities will, on the ground of the "territorial source principle", disallow these enterprises from deducting the daily operating costs of their offices outside Hong Kong during tax assessments; if not, of the reasons for that;

(e) given the authorities' view that depreciation allowances may not be granted for Hong Kong enterprises' machinery or plant used outside Hong Kong, whether Hong Kong enterprises can claim depreciation allowances for the portable computers and mobile phones provided for their staff for use on trips to places outside Hong Kong and for private vehicles and coaches travelling between Hong Kong and the Mainland for that purpose, as well as of the reasons for that;

(f) given that companies engaged in transportation business between Hong Kong and the Mainland have to deploy their goods vehicles to travel between various provinces/municipalities on the Mainland over a prolonged period of time to deliver goods, whether these companies, when being charged profits tax payable to the Inland Revenue Department (IRD) of Hong Kong on all their profits, are eligible to claim depreciation allowances for these goods vehicles, as well as of the reasons for that;

(g) given that the officials of the Commerce and Economic Development Bureau (CEDB) had, at various meetings of the committees of this Council, repeatedly undertaken that they would follow up with the Financial Services and the Treasury Bureau (FSTB) the issue relating to section 39E of the Inland Revenue Ordinance (Cap 112) (section 39E), whether the former had ever followed up the issue with the latter in the past three years; if they had, of the details of the follow-up actions, when such actions were taken, and the response of the latter; if not, the reasons for that;

(h) whether FSTB had taken the initiative to approach CEDB in the past three years to learn about the impact of section 39E on the upgrading and restructuring of enterprises; if it had, of the details of such actions, when such actions were taken, and the response of CEDB; if not, the reasons for that;

(i) whether FSTB or IRD had consulted CEDB or the Department of Justice (DoJ) on the issue of section 39E in the past three years; if it had, of the details of such consultations, when such consultations were conducted, as well as the relevant response; if not, the reasons for that;

(j) whether DoJ had provided legal advice to other government departments on issues relating to section 39E in the past three years; if it had, of the details of the legal advice, when such advice was given, and the government departments which received such advice; if not, the reasons for that;

(k) given that the authorities pointed out that in the process of reviewing section 39E, the views of the industrial and commercial sector, the accounting sector and tax experts on this issue had been taken into consideration, whether the authorities can disclose to the public these views; whether the government's conclusion is consistent with these views; if not, of the reasons for that;

(l) given that when the Government introduced the bill to amend section 39E, Hong Kong had not yet entered into comprehensive avoidance of double taxation agreements with other countries, whether the authorities can explain in detail the reasons why providing depreciation allowances for machinery and plant outside Hong Kong would give rise to the problem of transfer pricing and jeopardise the "arm's length principle";

(m) regarding cases in which Hong Kong businessmen's enterprises operated under partnership or sole proprietorship on the Mainland were approved by the relevant mainland authorities to sign "contract processing" contracts, but such enterprises continue to operate in accordance with the previous mode of "contract processing", whether IRD will continue to assess the tax payable by these Hong Kong enterprises on a 50:50 basis of apportionment; if not, of the reasons for that; and

(n) given that according to the existing requirement of IRD, after Hong Kong enterprises have upgraded and restructured themselves from "contract processing" to "import processing", they are no longer eligible for the depreciation allowances for machinery and plant, and the 50:50 basis of tax apportionment is also no longer applicable to them, whether an enterprise which gives up its efforts of upgrading and restructuring itself and then engages itself again in "contract processing" will become eligible for this allowance again, and whether the 50:50 basis of tax apportionment will then become applicable to it again; if not, of the reasons for that?

Reply:

President,

(a) and (b) In our respective replies to Dr Hon Lam Tai-fai's written questions on March 9 and April 6, 2011, we have already explained in detail the legal basis and relevant criteria for the Commissioner of Inland Revenue (the Commissioner) to issue, in relation to objections to tax assessments or appeal cases, "unconditional stand-over orders" or "conditional stand-over orders". In relation to objection or appeal cases where the taxpayers have been granted with "unconditional stand-over orders" issued by the Commissioner or have furnished banker's undertakings according to the Commissioner's "conditional stand-over orders", our above replies also set out the relevant legal basis for requiring the taxpayers to pay interest based on the judgment debt rate on so much of the tax which is found payable upon the withdrawal of the objections or appeals by the taxpayers or the determination of the objections or appeals against the taxpayers.

All along, the Inland Revenue Department (IRD) handles tax matters in a fair, impartial and professional manner. The Commissioner will also continue exercising prudently and impartially the relevant legal power vested in him. In a number of judicial review cases, the Court of First Instance and the Court of Appeal unanimously ruled that it was reasonable for the Commissioner to issue "conditional stand-over orders" requiring the taxpayers to purchase tax reserve certificates (TRCs) in relation to objection or appeal cases. If taxpayers disagree with the Commissioner's decision to require them to purchase TRCs or to furnish banker's undertakings in pursuance of "conditional stand-over orders", they may seek judicial review in the High Court.

(c), (m) and (n) In response to Dr Hon Lam Tai-fai's oral and written questions, we have on a number of occasions explained to Members of the Legislative Council that under the "import processing" arrangements, the machinery or plant is used wholly by the Mainland enterprises (being separate legal entities) for production of chargeable profits in the Mainland. Granting depreciation allowances to Hong Kong enterprises for such machinery or plant would violate the principles of "territorial source" and "tax symmetry" of Hong Kong.

We wish to reiterate that there are fundamental 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 and production equipment. In assessing the chargeable profits of the relevant Hong Kong enterprises, IRD would adopt appropriate assessment criteria based on the above facts. In other words, IRD would adhere to the "territorial source" principle in assessing the chargeable profits of the Hong Kong enterprises according to their actual processing trade operations in the Mainland rather than the nomenclature of such processing trade. The mode of operations adopted by individual enterprises is a commercial decision. IRD assesses taxes based on the relevant facts of individual cases in accordance with the law.

(d) to (f) Whether taxpayers can be granted with depreciation allowances depends on the facts of each case. In general, according to the principles of "territorial source" and "tax symmetry", taxpayers can claim deductions or depreciation allowances under section 16, section 18F and other relevant provisions of the Inland Revenue Ordinance (IRO) for revenue expenses incurred in or outside Hong Kong for production of chargeable profits in Hong Kong, and for the machinery or plant purchased for the production of chargeable profits in Hong Kong (regardless of whether they are used in or outside Hong Kong, but in the event that they are used outside Hong Kong, they must be used by the taxpayers themselves).

(g) to (k) In response to Dr Hon Lam Tai-fai's oral and written questions, we have on a number of occasions indicated to Members of the Legislative Council that, during the course of deliberation on whether to relax section 39E of the IRO, the Financial Services and the Treasury Bureau has already taken into consideration the views of the industrial and commercial sector, the accounting sector and tax experts on the matter. The Commerce and Economic Development Bureau has also reflected to us the views of the industry. Nevertheless, given Hong Kong's established taxation principles of "territorial source" and "tax symmetry", as well as the problem of transfer pricing, our review has come to a conclusion that there are no justifiable grounds to relax the existing restriction in section 39E of the IRO.

(l) When replying to the oral question raised by Dr Hon Lam Tai-fai on November 24, 2010, we already explained in detail the concern of the international community about the transfer pricing issue involved in cross-border trading activities between associated enterprises, and the stances taken by the tax authorities around the world on this issue. Given that Hong Kong enterprises and Mainland enterprises are associated enterprises in many cases, we have to examine the proposal relating to the relaxation of section 39E of the IRO from the perspective of transfer pricing.

To address the transfer pricing issue, in the course of negotiating comprehensive avoidance of double taxation agreements (CDTAs), Hong Kong will discuss with negotiation partners the inclusion of provisions stipulating the taxing rights of the two contracting parties for transactions between associated enterprises of the two places according to the "arm's length" principle advocated by the Organisation for Economic Co-operation and Development. As a responsible tax jurisdiction, Hong Kong has to comply with all the provisions in the CDTAs. As such, we should not ignore the possibility of transfer pricing arrangements in the transactions involving provision of machinery and plant between Hong Kong enterprises and their associated enterprises in the Mainland.

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