Press release

LCQ19: Hong Kong enterprises engaged in processing trade operations

Wednesday, May 11, 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 (May 11):

Question:

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

(a) given that in reply to my question on November 4, 2009, the Secretary for Financial Services and the Treasury (SFST) indicated that the practical difficulties in relaxing section 39E of the Inland Revenue Ordinance (Cap 112) (Section 39E) were that as the relevant machinery or plants were used by another enterprise outside Hong Kong, it would be difficult for the Inland Revenue Department (IRD) to check the actual usage of the relevant machinery or plants, whether the authorities will, in order to resolve such difficulties, consider commissioning or establishing an organisation or office on the Mainland which is dedicated to checking the actual usage of those machinery or plants that are used on the Mainland, and is authorised to issue certificates to IRD after verifying that the relevant enterprises have not engaged in any tax avoidance or other illegal activities, so that IRD may accordingly grant approval for the relevant Hong Kong enterprises to claim depreciation allowances in Hong Kong; if they will not, of the reasons for that;

(b) given that Guangdong Province has always been a congregating place for Hong Kong-invested processing trade enterprises, and the Outline of the Plan for the Reform and Development of the Pearl River Delta (2008-2020) has also stipulated that Guangdong Province can fully exert a pioneering role of special economic zones in reforming and opening up the region by supporting the establishment of a national demonstration zone for the transformation and upgrade of processing trade enterprises, whether the authorities will suggest to the Guangdong provincial authorities that concerted efforts be made to implement the proposal in (a) on a trial basis, and that a co-operation platform and a communication and liaison mechanism be established on taxation matters for the purpose of deepening the co-operation between the taxation authorities of the two sides, enhancing information exchange and proactively supporting the development of commerce and trade in Guangdong and Hong Kong; if they will, of the details; if not, the reasons for that;

(c) given that the Commerce and Economic Development Bureau (CEDB) confirmed on April 12 this year that the views raised by the sector on the issue of depreciation allowances under Section 39E had been reflected to the Financial Services and the Treasury Bureau (FSTB), whether the authorities can make public the contents of the views as reflected by CEDB and the details of the response given by FSTB, so that the sector can ascertain that their aspirations have been accurately reflected; if they cannot, of the reasons for that;

(d) given that in reply to my question on April 6 this year, the Government indicated that for those taxpayers who eventually withdrew the relevant objections or appeals, or the objections or appeals were determined against the taxpayers, the taxpayers concerned would be required to pay interest on the tax being held over in accordance with the "judgment debt rate" and that the aim was to protect tax revenue by preventing taxpayers from abusing the objection mechanism for the purpose of deferring tax payment, whether the authorities have taken into account the principle of fairness in formulating this mechanism to guard against abuse; if they have, whether the taxpayers whose objections or appeals have been determined in their favour can, as in the case of the Government, be compensated with interest calculated at "judgment debt rate";

(e) given that in reply to my question on April 13 this year, SFST indicated that 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 on the Mainland rather than the nomenclature of such processing trade, whether the authorities had, in the past decade, permitted Hong Kong companies which were nominally "import processing" enterprises but were actually engaged in "contract processing" mode of operation to be subjected to taxation arrangements that are identical to those applicable to "contract processing" enterprises; if they had, of the annual figures; if they had not, the reasons for that;

(f) given that SFST had not provided a direct response to my question on April 13 this year about whether an "import processing" enterprise which gives up its efforts of upgrading and restructuring and engages in "contract processing" will again be eligible for the depreciation allowances for machinery and plants and whether the 50:50 basis of tax apportionment will again be applicable to it, whether the authorities can give a clear explanation regarding the aforesaid scenario; if not, of the reasons for that;

(g) whether IRD representatives had informed the Board of Review (the Board) of the followings during the Board's hearing on the case numbered D61/08: the purposive approach recognised by the courts, the requirement of establishing the legislative intent in interpreting law under section 19 of the Interpretation and General Clauses Ordinance (Cap 1), the Court of Final Appeal's comments on interpreting law made in its judgment on the case of Medical Council of Hong Kong v Chow Siu Shek David (2000), and the views on interpreting law held by the authorities in the case of CIR v Sawhney (HCIA1/2006); if the Board had not been informed of the above, of the reasons for that; if it had been so informed, whether the Board had considered the above;

(h) given that SFST only repeatedly stated that he had already taken into consideration the views of the industrial and commercial sector, the accounting sector and tax experts on the issue of Section 39E, why SFST has not considered the independent legal advice offered by the legal sector or the Department of Justice (DoJ);

(i) given that both Article 64 of the Basic Law and chapter two of the Code for Principal Officials under the Accountability System stipulate that it is incumbent upon officials to answer questions raised by Members of the Legislative Council, and I asked SFST, at least on six occasions, whether he had sought advice from DoJ or other legal advisors on the issue of Section 39E, as well as requested the Government to make public the views of the industrial and commercial sector, the accounting sector, the tax experts, DoJ and other government departments and to explain why their views are not adequately justified and are against the principles of "territorial source" and "tax symmetry", but SFST still has not provided a direct response, whether the authorities can give a concrete reply to the above questions now;

(j) given that in the past two years, in stating the reasons for not amending Section 39E, the Government had initially given the reasons that it was not necessary to take into consideration the legislative intent in interpreting law and that there were administrative difficulties, etc, yet subsequently it stated the reasons of adhering to the principles of "territorial source" and "tax symmetry" as well as transfer pricing, why the authorities have given inconsistent responses; given that according to the principles of "territorial source" and "tax symmetry", taxpayers can claim deductions for operational expenses incurred in or outside Hong Kong for production of chargeable profits in Hong Kong, why the machinery or plants used outside Hong Kong must be used by the taxpayers themselves in order to comply with the principles of "territorial source" and "tax symmetry"; regarding the molds and machines provided by traders for processors, although the molds and machines are used by the processors, the traders still need to pay for the depreciation costs, why the provision of depreciation allowances for the relevant moulds and machines is against the principle of "tax symmetry";

(k) given that the Government has pointed out that relaxing Section 39E will give rise to the issue of transfer pricing, whether the Government has made any assessment; if it has, whether evidence can be provided to substantiate that the transactions between Hong Kong enterprises and associated enterprises on the Mainland for the provision of machines and plants have given rise to the issue of transfer pricing; if no evidence can be provided, why such a conclusion has been arrived at; and

(l) given that the Financial Secretary was willing to make amendments to his Budget in the light of the public's aspirations after his announcement of this year's Budget, whether SFST will follow suit and amend the taxation arrangements involving Section 39E, etc in response to the sector's aspirations and in tandem with the initiatives of the Mainland government in encouraging Hong Kong-invested enterprises to upgrade and transform; if SFST will not do so, of the reasons for that?

Reply:

President,

(a), (h) to (j) and (l) In our reply to the oral question raised by Dr Hon Lam Tai-fai on November 24, 2010, we have explained in detail the outcome of our review on whether the restriction in section 39E of the Inland Revenue Ordinance (IRO) should be relaxed and the relevant justifications. In short, given the established fundamental principles such as "territorial source principle" and "tax symmetry" of Hong Kong's tax system, as well as the transfer pricing issue, we consider that there are no justifiable grounds to relax the existing restriction in section 39E. Subsequently, we have reiterated the above stance in our replies to a number of written questions raised by Dr Hon Lam Tai-fai.

(b) and (k) On the issue of transfer pricing, the State Administration of Taxation (SAT) has confirmed that if a Hong Kong enterprise provides some machinery and plant (including moulds) to its associated enterprise in the Mainland rent-free for production of finished products which would be sold to the Hong Kong enterprise at a price below normal price, such arrangement may constitute an "offsetting transaction" under the "Implementation Measures of Special Tax Adjustments (Provisional)" (Guoshuifa [2009] No.2) of the Mainland. In the course of conducting transfer pricing investigations, the Mainland tax authorities will make transfer pricing adjustments to restore the offsetting transactions.

Given the above, if we were to accede to the request of some enterprises to relax the current restriction in section 39E such that depreciation allowance would be provided in Hong Kong for such machinery and plant, we would be perceived as encouraging transfer pricing, thus affecting the taxing rights of Hong Kong and the Mainland. Hong Kong may be regarded as a harmful tax competitor. As such, we would not explore with the Guangdong provincial authorities the pilot scheme as proposed in the question.

In fact, for cross-border transactions, there is an increasing international trend for associated enterprises to enter into "advance pricing arrangements" (APAs) with the relevant tax authorities with a view to drawing up criteria for determination of transfer pricing. APAs will help taxpayers ascertain in advance their tax burden and reduce disputes with the tax authorities. The Inland Revenue Department (IRD) will embark on work in this regard under the framework of the comprehensive double taxation agreements. As far as the Mainland is concerned, since SAT is the Mainland competent authorities under the "Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income", it would be necessary to approach SAT rather than the local tax authorities for discussions for entering into APAs.

(c) In our reply to the written question raised by Dr Hon Lam Tai-fai on April 13, 2011, we have already indicated that the Commerce and Economic Development Bureau (CEDB) has reflected to us the industry's views on section 39E of the IRO. CEDB has also conveyed to us the views expressed by Members of the Legislative Council on the subject matter at the Panel on Commerce and Industry. In fact, through repeated questions in relation to the relaxation of section 39E, Dr Hon Lam Tai-fai has already reflected the views of the industry clearly.

(d) In our 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-mentioned replies have 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. As explained in our above-mentioned replies, the relevant provisions aim to protect tax revenue by preventing taxpayers from abusing the objection mechanism for the purpose of deferring tax payment.

(e) and (f) We have reiterated in our reply to the written question raised by Dr Hon Lam Tai-fai on April 13, 2011 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 make tax assessments according to the "territorial source principle" and based on the facts of individual cases rather than the nomenclature of the processing trade or the mode of operation as claimed by the Hong Kong enterprises.

IRD is not aware of any Hong Kong enterprises which are nominally "import processing" enterprises but actually still engage in "contract processing" mode of operation.

(g) The decision of the Board of Review (the Board) on the case with reference number D61/08, which could be downloaded from the Board's website, has already covered the legal grounds submitted by the two parties to the case for the Board's consideration. We understand that each and every case heard by the Board or the court has its unique facts which require application of different legal principles. No particular decision would fit all cases. We respect the taxpayers' rights under the IRO to raise reasonable grounds of appeal against tax assessments to the Board and the court. We also respect the judgments made by the Board and the court of all levels. In fact, the decision made by the Board for the case with reference number D61/08 has become final according to the procedures stipulated under the IRO. There is no legal basis to re-visit the case.

Ends