Press release

LCQ17: Hong Kong enterprises engaged in processing trade operations

Wednesday, May 25, 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 25):

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) of the number of enterprises from which recovery of taxes had been demanded by the Inland Revenue Department (IRD) in the past three years because of issues relating to section 39E of the Inland Revenue Ordinance (Cap 112) (Section 39E) and the 50:50 basis of tax apportionment, the amounts of taxes involved and the amounts of fines imposed, as well as the number of relevant appeal or objection cases in which the Commissioner of Inland Revenue (CIR) had demanded the enterprises concerned to purchase Tax Reserve Certificates; if such records or statistics are not available, whether the authorities will establish a record system for this purpose and provide the number of cases being vetted or reviewed in relation to such issues at present;

(b) given that it is stipulated in the Code on Access to Information that members of the public are entitled to access government documents, yet the Secretary for Financial Services and the Treasury (SFST) has repeatedly ignored my requests for the provision of the contents of the views of the sector on Section 39E as reflected by the Commerce and Economic Development Bureau, of the reasons for that;

(c) given that in reply to my question on May 11 this year, SFST indicated that the State Administration of Taxation (SAT) had confirmed that if a Hong Kong enterprise provided some machinery and plants (including moulds) to its associated enterprise on 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 might constitute an "offsetting transaction" under the "Implementation Measures of Special Tax Adjustments (Provisional)" (Guoshuifa [2009] No.2) of the Mainland, and in the course of conducting transfer pricing investigations, the mainland tax authorities will make transfer pricing adjustments to restore the offsetting transactions, but members of the sector have pointed out that it has been a long-standing practice for Hong Kong enterprises to provide machinery/plants and moulds, etc for mainland processors, and all along, mainland taxation authorities have not questioned that there is any issue of transfer pricing, whether the authorities can put forth facts and examples to illustrate the problems of transfer pricing which have emerged as a result of Hong Kong enterprises providing machinery and plants to mainland processors rent-free;

(d) given that some Hong Kong enterprises have pointed out that since the provision of machinery and plants to mainland processors by Hong Kong enterprises rent-free has made it possible for mainland enterprises to reduce their costs, the prices of the finished products may of course be adjusted downward correspondingly, and that these are reasonable and normal transactions, why the authorities consider the price of such products as "below normal price" and believe that the arrangement may give rise to the issue of transfer pricing, as well as whether the authorities can make public the confirmation documents issued by SAT;

(e) given that in reply to my question on May 11 this year, SFST did not directly explain why taxpayers whose objections or appeals have been determined in their favour cannot be compensated with interest calculated at "judgment debt rate", as in the case of the Government, in order to uphold the principle of fairness, whether the authorities can provide a direct response to this question;

(f) given that SFST has not provided direct responses to my questions raised on April 13 and May 11 this year on whether an "import processing" enterprise which gives up its efforts of upgrading and restructuring itself and then engages itself again 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 reply; if not, of the reasons for that;

(g) given that although I have asked SFST, at least on seven occasions in the past two years, why the authorities had not considered the independent legal advice of the legal sector or the Department of Justice on the issue of Section 39E, SFST still did not provide a direct response, whether the authorities can explain the reasons why SFST is not willing to give a reply;

(h) given that SFST indicated on May 11 this year that IRD was not aware of any Hong Kong enterprises which were nominally "import processing" enterprises but actually still engaged in "contract processing" mode of operation on the Mainland, whether the authorities can explain why such scenarios had been mentioned in the cases of CIR v Datatronic Ltd (CACV 275/2008) and C G Lighting Ltd v CIR (CACV 119/2010), and whether the authorities will approach members of the industrial and commercial sector, the accounting sector, tax experts as well as the legal sector to learn about the facts; if they will, of the details; if not, the reasons for that;

(i) given that SFST indicated on May 11 this year that it would be necessary to approach SAT rather than the local tax authorities for discussions for entering into "advance pricing arrangements", when the authorities plan to initiate such discussions with SAT and of the contents of the relevant discussions; and

(j) whether, when the Board of Review (the Board) heard the case numbered D61/08, the CIR's representative in the hearing was a practising barrister; whether the authorities have assessed if that representative's failure to truthfully and wholly inform the Board of the relevant law interpretation principles and the relevant case law (including 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), etc) constitutes a breach of duty, deliberate

concealment for the purpose of misleading the Board or violation of paragraph 136 of the Code of Conduct of the Bar of the Hong Kong Special Administrative Region?

Reply:

President,

(a) The Inland Revenue Department (IRD) does not have the relevant data and does not have any plan to compile statistics on such data. IRD has to handle a wide variety of data during its day-to-day operations. For better use of resources, the department has to take into account cost-effectiveness in considering what kinds of key data should be included in the compilation of statistics.

(b) and (g) As indicated in our replies to a number of oral and written questions raised by Dr Hon Lam Tai-fai, in reviewing whether the restriction in section 39E of the Inland Revenue Ordinance (IRO) should be relaxed, we have already taken into account the views of the industry, including those conveyed to us through the Commerce and Economic Development Bureau and Members of the Legislative Council. We have also explained to the Legislative Council in detail the outcome of our review and the relevant justifications. We have indicated repeatedly that 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.

(c), (d) and (i) In our reply to the oral question raised by Dr Hon Lam Tai-fai on November 24, 2010, we have already explained in detail the transfer pricing arrangements that may arise from the rent-free provision of machinery and plant by Hong Kong enterprises to their associated enterprises in the Mainland under "import processing", and the stance taken by the tax authorities around the world (including the Mainland) on the issue.

We have already indicated clearly in our reply to the written question raised by Dr Hon Lam Tai-fai on May 11, 2011 that the State Administration of Taxation (SAT) has confirmed with us that if a Hong Kong enterprise provides production equipment 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. We have already conveyed clearly the views of the SAT. There is no need to make public the relevant documents from the SAT. Moreover, if the Mainland tax authorities make transfer pricing adjustments, the Inland Revenue Department (IRD) of Hong Kong has to make corresponding adjustments to the amount of tax charged in Hong Kong in accordance with 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" (the Arrangement).

The "advance pricing arrangement" (APA) mentioned in our reply to the written question raised by Dr Hon Lam Tai-fai on May 11, 2011 is a channel for taxpayers to initiate discussions on transfer pricing issues with their respective tax authorities in order to ascertain in advance their tax burden and to reduce disputes with the tax authorities. Since transfer pricing between Hong Kong enterprises and their associated enterprises in the Mainland involves tax revenue of the two places, according to the Arrangement, the Mainland enterprises should initiate discussions on APAs with SAT whereas the Hong Kong enterprises should approach IRD and the tax authorities of the two places will then enter into discussions. IRD will pursue APA matters with SAT under the framework of the Arrangement. In addition, at the annual working meeting between IRD and SAT on the Arrangement, IRD will discuss with SAT the administrative and implementation details regarding the Arrangement, including the transfer pricing issues between associated enterprises.

(e) Where a taxpayer's objection or appeal case is allowed, the Commissioner of Inland Revenue (the Commissioner) will refund the tax paid by the taxpayer according to the IRO. However, there are no legal provisions requiring the Commissioner to pay any interest on the tax refunded to the taxpayer. If a taxpayer has purchased tax reserve certificates (TRCs) in pursuance of a "conditional stand-over order" in relation to an objection or appeal case, interest will be paid to the taxpayer (the current interest rate on TRCs is 0.0433% per annum) on those TRCs to the extent to which the TRCs are eventually not required to settle the tax held over, that is, the parts in which the taxpayer's objection or appeal are successful. As we have explained in our previous replies to a number of written questions raised by Dr Hon Lam Tai-fai, the relevant provisions of the IRO aim to protect tax revenue by preventing

taxpayers from abusing the objection mechanism for the purpose of deferring tax payment.

(f) In response to the questions raised by Dr Hon Lam Tai-fai, we have explained to the Legislative Council on a number of occasions that whether an enterprise is actually engaged in "contract processing" is determined by the facts of the case. In assessing the chargeable profits of the relevant Hong Kong enterprises, IRD would apportion the profits, according to "territorial source principle", on a 50:50 basis when the activities of the relevant enterprises fully meet the mode of operation of "contract processing", and allow such Hong Kong enterprises to have 50% of the depreciation allowance for their machinery and plant.

(h) As the judicial proceedings of CIR v C G Lighting Ltd (CACV 119/2010) have not completed yet, it is not appropriate for us to discuss the case at this stage. For the case of CIR v Datatronic Ltd (CACV 275/2008), the Court of Appeal, in applying relevant legal principles to the facts of the case, has rejected the contention that Datatronic was engaged in "contract processing" operation, and held that the company was not engaged in manufacturing operation and its chargeable profits were actually derived from selling the goods purchased from the enterprises in the Mainland.

(j) The Commissioner was represented by a practising barrister appointed by the Department of Justice in the Board of Review's hearing of the case with reference number D61/08. As we have stated in our reply to the written question raised by Dr Hon Lam Tai-fai on May 11, 2011, each and every case heard by the Board of Review or the court has its unique facts which require application of different legal principles. No particular decision would fit all cases. In fact, the IRO protects the rights of both parties to an appeal to raise their legal points to the Board of Review and to make reasonable defence against the other party's points.

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