

## **Press release**

### **LCQ3: Assistance to facilitate the development of Hong Kong enterprises**

Wednesday, November 7, 2012

Following is a question by the Hon Chung Kwok-pan and a reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (November 7):

Question:

At the Legislative Council meeting on October 17 this year, the Chief Executive undertook that the Government would assist the industrial, commercial and professional sectors in removing the obstacles in the course of development in Hong Kong and overseas, and will collaborate with the central or local authorities to resolve the difficulties encountered. Although Members from the industrial and commercial sectors in the past few years repeatedly requested the Government to consider and review afresh section 39E of the Inland Revenue Ordinance, the Government had all along rejected the requests for reasons based on such principles as "territorial source" and "tax symmetry", etc. On the other hand, some Hong Kong businessmen on the Mainland have told me that Hong Kong enterprises in the Pearl River Delta are suffering from the severe blow of various negative factors, such as contraction of markets in Europe and America, escalating wages on the Mainland and rising costs of currency exchange, as well as the urgency in restructuring of industries, etc. In this connection, will the Government inform this Council:

(a) in order to honour the principle of appropriately proactive governance, whether the Government will proactively discuss, based on the spirit of taking special measures for special problems and adopting the government-to-government approach, with the mainland authorities ways to remove the obstacles caused by adherence to principles such as "territorial source" and "tax symmetry", etc, so as to review afresh and amend section 39E of the Inland Revenue Ordinance and other relevant tax policies; if it will, of the details; if not, the reasons for that;

(b) whether the Government has specific measures and plans to bring innovation and scientific researches conducted by Hong Kong enterprises on the Mainland into the remit of the tax support policy, and to provide depreciation allowances for the machinery and plants used on the Mainland by Hong Kong enterprises, so as to support

the development of Hong Kong individuals and enterprises on the Mainland; if it has, of the details; if not, the reasons for that; and

(c) given that some small and medium enterprises (SMEs) have pointed out that as production costs on the Mainland have been rising continuously, they have to rack their brains in recent years to explore opportunities for overseas development, lower costs and enhance productivity, whether the authorities will consider offering more subsidies to SMEs, e.g. assisting them in investing in overseas regions such as Burma, etc to develop industrial parks, so as to enable Hong Kong manufacturers to "go global" and maintain their competitiveness internationally?

Reply:

President,

My reply to the various parts of the question is as follows:

(a) In formulating and reviewing any tax provisions, the Administration has to consider carefully such essential factors as whether the proposed changes would be consistent with the established taxation principles of Hong Kong and whether there would be any possible tax avoidance loopholes. All along, Hong Kong adopts the "territorial source" and "tax symmetry" principles as the fundamental principles in tax assessment. According to the "territorial source" principle, only profits arising in or derived from Hong Kong by carrying on a trade, profession or business in Hong Kong are chargeable to profits tax in Hong Kong. In other words, profits not arising in or derived from Hong Kong are not subject to profits tax in Hong Kong. Under the "tax symmetry" principle, if a Hong Kong enterprise has incurred outgoings and expenses (including specified capital expenditure which has been allowed as deductions under the Inland Revenue Ordinance (IRO) in the production of assessable profits in Hong Kong, that Hong Kong enterprise can also claim deductions for such outgoings and expenses according to the IRO. However, if that Hong Kong enterprise has not incurred any outgoings or expenses for the production of assessable profits in Hong Kong, there is neither necessity nor reasonable ground for the enterprise to claim the relevant deductions.

In assessing the tax liability of each taxpayer according to the IRO, the Inland Revenue Department (IRD) adopts the above two fundamental taxation principles for the purpose of tax assessments. The above-mentioned simple, fair and effective taxation principles are the unique features of Hong Kong's tax regime, as distinct from many

other tax jurisdictions. If we were to substitute the long-held principles of "territorial source" and "tax symmetry", we would have to model on the tax systems of many other tax jurisdictions and to charge taxes on Hong Kong taxpayers for their worldwide income. This would cause fundamental changes to our tax regime and undermine the competitiveness of Hong Kong as an international financial and business centre. I believe this is not what we envisage, and this also does not serve the overall interest of Hong Kong.

As pointed out in my reply to the written question raised by Dr Hon Lam Tai-fai on October 31, 2012, the Administration had already conducted an in-depth study on section 39E of the IRO during the last term of the Legislative Council (LegCo). After examining the relevant taxation principles in relation to the processing activities carried out by Hong Kong enterprises in the Mainland, and taking into consideration the views of the industrial and commercial sector, the accounting sector and tax experts on the matter, we already conducted a review on the relevant matter in 2010.

I wish to take this opportunity to reiterate to LegCo the reason underlying our conclusion that the restriction in section 39E of the IRO should not be relaxed. Under the "import processing" mode, Hong Kong enterprises engaging in "import processing" are only involved in trading activities in buying/selling of goods (not manufacturing activities). As such, they would only be liable to profits tax in Hong Kong for taxable profits derived from their trading activities. The relevant machinery or plant is solely used by the Mainland enterprises (being separate legal entities) in their manufacturing activities. The profits thus generated from the manufacturing activities are wholly derived from the Mainland and liable to the Mainland tax.

Any relaxation of section 39E of the IRO to the effect that depreciation allowance in Hong Kong would be provided to such machinery and plant would not only violate the "territorial source" and "tax symmetry" principles, but may also be perceived as encouraging transfer pricing, which would affect the taxing rights of Hong Kong and other tax jurisdictions (including the Mainland). This would not be in line with the international principles and guidelines for handling transfer pricing and Hong Kong may be regarded as a harmful tax competitor. As a matter of fact, we have exchanged views with the State Administration of Taxation on the issue of transfer pricing and secured their confirmation on the implementation arrangements in the Mainland concerning transfer pricing.

As a result, in view of Hong Kong's established taxation principles of "territorial source" and "tax symmetry", as well as the issues relating to transfer pricing, we have

come to the conclusion that it is not justifiable to relax the restriction in section 39E of the IRO. Since the completion of our review in 2010, we note that the industry has raised requests relating to the matter from time to time. In this regard, we would be pleased to continue our effort in explaining to the industry the Administration's stance.

(b) As regards expenditure on research and development (R&D) incurred by enterprises, section 16B of the IRO allows deduction by a person carrying on any trade, profession or business for expenditure incurred on R&D related to that trade, profession or business. Where any expenditure, which qualifies for deduction under section 16B, is incurred outside Hong Kong, full amount of the expenditure is allowable as a deduction under section 16B if the relevant trade, profession or business is carried out solely in Hong Kong. However, if the relevant trade, profession or business is carried out partly in and partly out of Hong Kong, IRD would consider the activities of that trade, profession or business in totality to arrive at a reasonable deductible proportion of such expenditure, which relates to the production of chargeable profits in Hong Kong.

(c) For the development of small and medium enterprises (SMEs), the Commerce and Economic Development Bureau has been implementing various measures to support their development, assist them in moving up the value chain and upgrading and restructuring their operations. The Government provides various support measures to SMEs, including financial support, e.g. the "SME Loan Guarantee Scheme", "SME Export Marketing Fund" and "SME Development Fund" administered by the Trade and Industry Department as well as the newly implemented \$1 billion "Dedicated Fund on Branding, Upgrading and Domestic Sales"; the "Innovation and Technology Fund" and "Research and Development Cash Rebate Scheme" administered by the Innovation and Technology Commission; and the "DesignSmart Initiative" of Create Hong Kong.

As regards assistance for Hong Kong enterprises in expanding overseas, the Government will continue to organise through the Hong Kong Trade Development Council various promotional activities, such as trade missions and exhibitions, to enable enterprises to better understand the investment environment and development potentials of the emerging markets. If Hong Kong enterprises are interested in expanding their business overseas, for example, by setting up an overseas industrial park, the Government would be pleased to convey their concrete proposals to the relevant authorities for consideration. The Government will closely monitor changes in the economy and review the various support measures for SMEs, with a view to maintaining their competitiveness in the international market.

Ends