



Tax exemptions for manufacturing firms

Should 50-50 apportionments for contract processing also apply to import processing? *Ho Chi Ming* gives his views

A taxpayer recently won an appeal to split his profits 50-50 between Hong Kong and offshore. This is the first board of review case (D43/06 20 IRBRD) where apportionment was granted for import processing, and it is a significant development in Hong Kong taxation.

It has been contentious about how tax authorities assess Hong Kong manufacturers' profits earned from selling goods processed by mainland factories. The Inland Revenue Department (IRD) grants a favourable 50-50 apportionment to contract processing arrangements,

but the same did not apply to import processing arrangements.

In this article we look at the difference between contract and import processing arrangements, and the issues that have Hong Kong taxpayers up in arms.

Contract processing

Contract processing was introduced more than 20 years ago when Hong Kong manufacturers shifted their manufacturing base to mainland China. It consists of:

- A processing agreement between a Hong Kong taxpayer and a mainland

factory, which must be approved by the mainland government.

- The Hong Kong taxpayer purchases raw materials and delivers them to the mainland factory for processing. The finished goods have to be delivered back to the taxpayer in Hong Kong.
- The finished goods cannot be sold in China.
- The mainland factory does not own the raw materials and finished goods.
- The mainland workers are employees of the mainland factory, not the Hong Kong taxpayer.



CANON/HUGGETTY IMAGES

The mainland factory – typically a mainland company whose shares are owned by the Hong Kong taxpayer and the local government – provides the land, building and labour. The Hong Kong taxpayer provides the raw materials, plant and machinery, design, technical support and management, and supervises the factory workers.

The IRD's departmental and interpretation practices notes No. 21 states that the Hong Kong taxpayer is running a trading, not manufacturing, business if he or she strictly follows the arrangement above. But in recognition of the taxpayer's substantial involvement in the manufacturing process in China, the IRD is prepared to exempt 50 percent of the taxpayer's profits from profits tax.

Import processing

Subsequently, the majority of cases changed the arrangement to import processing. The essential difference between contract and import processing is that the Hong Kong taxpayer sells the raw materials to the mainland factory that manufactures its own goods, which are then sold back to the Hong Kong taxpayer. As such, in law, the mainland factories changed from being subcontractors to manufacturers of the products.

In some cases, the Hong Kong taxpayer provides the plant and machinery to the mainland factory as part of the capital contribution to the factory. In other cases, the Hong Kong taxpayer is the owner of the plant and machinery, but lets the mainland factory use it without charging them rent.

In import processing cases, the IRD has assessed, without apportionment, all of the Hong Kong taxpayers' profits on the grounds that they are trading gains, which results in a hefty tax bill for Hong Kong manufacturers, although there are no major changes in the way their mainland factories operate. Many manufacturers therefore lodged objections against the withdrawal of the 50 percent tax exemption.

Depreciation allowance

Apart from the issue of tax exemption withdrawal, Hong Kong manufacturers are not allowed to claim depreciation allowance for plant and machinery used by the mainland factories in import processing cases. The IRD says if the plant and machinery are part of the capital contribution to the mainland

factory, they are no longer owned by the Hong Kong taxpayers. Even if the taxpayers continue to own the plant and machinery, the department would regard the plant and machinery as being leased to the mainland factories. Since the plant and machinery are used wholly or principally outside Hong Kong, they do not qualify for the depreciation allowance.

Appeal

Some taxpayers appealed to the Board of Review against the withdrawal of the 50 percent tax exemption on the grounds that the mainland factories, despite being separate legal entities, are in fact branches of the Hong Kong taxpayers' companies. They argued that manufacturing in the mainland should be regarded as manufacturing by Hong Kong taxpayers and be part of their offshore operations. The board, however, rejected the argument on the grounds that the mainland factories were separate legal entities and the workers were employed by the factories, not the Hong Kong taxpayers. The taxpayers then tried arguing that the mainland factories were their agents, but the argument was also dismissed.

In my view, instead of arguing that the mainland factories were their branches or agents, the Hong Kong taxpayers should argue that since they have sent their own employees to work in the mainland factories, this amounts to operations outside Hong Kong and so the profits attributable should be offshore. The only issues to be

Hong Kong tax



CHINA PHOTOS/GETTY IMAGES

determined would therefore be: Whether the profits of the Hong Kong taxpayers are apportionable, and if they are, what should the ratio be?

The first success

In the D43/06 case, the board ruled that although the Hong Kong taxpayer's case concerned import processing, it is considered a manufacturer because of its substantial involvement in the manufacturing process in China. The board went on to rule that part of the company's profits are derived from operations in the mainland and therefore the board granted 50-50 apportionment to the taxpayer.

By "substantial involvement," the board in D43/06 referred to the manufacturer's provision of technical know-how, design, management, training and supervision of the workforce, and supplying plant and machinery to the mainland factory. Four Hong Kong employees were permanently stationed in China and other staff were sent to the mainland on an ad-hoc basis to assist in the production process. An important point to note is that their employment contracts are with the Hong Kong taxpayer.

Observations

The IRD has not been apportioning the

profits of import processing because it considers the involvement of Hong Kong taxpayers in the manufacturing process so minimal that the business of the taxpayers should be trading rather than manufacturing. But in the D43/06 case, the board found there was substantial involvement and that the Hong Kong taxpayer was a manufacturer.

In my view, there is no need to determine whether the Hong Kong taxpayer is a manufacturer or a trader to decide whether apportionment is due. There are two reasons:

- A clear-cut classification into manufacturing, trading or service businesses is often impossible. A business may involve buying and selling of goods plus technical support and after-sale services. See case D77/94, which dealt with the source of profits of a magazine publisher.

In the *Hang Seng Bank Ltd.* case (3 HKTC 351 at 360), Lord Bridge pointed out different tests in determining the source of profits for trading, manufacturing, services, employment of capital or property. In the *HK-TVB International* case (3 HKTC 468 at 480), Lord Jauncey said the examples given by Lord Bridge in the *Hang Seng Bank* case "were never intended to be exhaustive of all situations in which section 14 of

the IRO might have to be considered. The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place." To formulate a universal test is "probably an impossible task," said P.J. Bokhary in the *Kwong Mile Services Ltd.* case (FACV 29 of 2003). The facts, rather than the labels, are important in determining the source of profits.

- There is no legal basis to refuse apportionment, even for a business buying and selling goods, if operations that contribute to the profits are conducted outside Hong Kong, unless the operations are so minimal that apportionment cannot be justified. Also, there is no legal authority that apportionment, if due, must be 50-50 (see the board's decision in *Indosuez WI Carr Securities Ltd.* [16 IRBRD 1010] where the board apportioned a ratio of 60-40).

Conclusion

No doubt the IRD will appeal to the court against the board's decision in case D43/06. In my view, the board has properly applied the basic operations test and this case will open the way for taxpayers to claim apportionment in import processing cases. Because of Hong Kong taxpayers' extensive investment in mainland manufacturing, the impact of the case can be very significant, but whether the ratio of apportionment should be 50-50 remains to be determined by the court in the D43/06 appeal.

Ho Chi Ming is a barrister-at-law.