Task Force on Economic Challenges

Discussion Paper

How Can Hong Kong Help Manufacturers Facing Challenges from the Financial Tsunami?

Purpose

This paper proposes changes to the assessing practice and tax legislation to assist taxpayers engaged in manufacturing in the Mainland.

Executive summary

2. The manufacturing and trading sector forms a significant part of the Hong Kong economy. This sector is at present facing unprecedented challenges from the global financial tsunami and those engaged in contract processing are encouraged to transition to new operational modes in order to gain access to Mainland credit and markets. Requests have been made to Mainland authorities to assist Hong Kong manufacturers. In this regard, Hong Kong could also provide assistance by changing existing tax treatments to facilitate the operational changes.

3. Current tax practice only allows a 50% offshore profits claim for Hong Kong manufacturers engaged in contract processing arrangements (來料加工). This tax treatment is denied for Hong Kong manufacturers engaged in import processing arrangements (進料加工) despite the fact that in substance the operations are essentially the same as contract processing.

4. The current tax legislation also results in the costs incurred on plant and machinery used by processing units in the Mainland not being eligible for any tax deductions. As the costs involved are usually very significant, the current treatment could result in a huge negative impact for Hong Kong manufacturers.

5. There is therefore a case to review and amend the relevant tax practice and legislation to assist manufacturers to deal with challenges during this transition that is exacerbated by the global financial tsunami.

Discussion

6. There is often a misconception that manufacturing has long ceased to matter to Hong Kong's economy as much of it has relocated out of Hong Kong, notably to the Pearl River Delta, in search of lower-cost land and labour. However, a study conducted by the Hong Kong Trade and Development Council ("*Development and Contribution of Hong Kong's Manufacturing and Trading Sector*", November 2006) has shown that the manufacturing and trading sector accounts for about 25% of Hong Kong's GDP and total employment. Industrialists in fact remain active in Hong Kong, operating their local offices as trading companies and

business headquarters that support offshore production. The relocation of Hong Kong's manufacturing should thus be more appropriately viewed as an expansion of Hong Kong's industrial sector and as an element which has contributed to the upgrading of the services sector as it generates demand for management, shipping and logistics and financing etc.

7. Hong Kong manufacturers are at present facing unprecedented challenges. These include escalating production costs, a rising renminbi, the new labour law and changes regarding processing trade. Above all, the dramatic fall in export orders caused by the global economic crisis puts the fate of tens of thousands of Hong Kong-owned factories in jeopardy, with many having already gone out of business. The difficulties encountered by the Hong Kong-owned processing trade have also highlighted the importance of this sector to the Pearl River Delta economy and the Mainland society as a whole where tens of millions of migrant workers are at risk of becoming unemployed and dislocated.

8. Officials in the SAR and in the Mainland have encouraged Hong Kong manufacturers to restructure their operational mode in response to the challenges. In particular, they are encouraged to change from contract processing to other forms of operation so as to gain access to Mainland credit and markets. However, the existing Hong Kong tax assessing practice and legislation are not conducive to such operational restructurings.

50:50 apportionment

9. Hong Kong manufacturers in the Mainland usually operate in the form of contract manufacturing, namely contract processing (來料加工) and import processing (進料加工) arrangements.

10. In this connection, the Inland Revenue Department (IRD) has long accepted that, where a Hong Kong company manufactures goods partly in Hong Kong and partly outside Hong Kong, the part of the profits which relates to the manufacture of goods outside Hong Kong will not be regarded as arising in Hong Kong. In the interest of administrative convenience and to avoid protracted arguments on the basis of apportionment, the IRD generally adopts a 50:50 approach in apportioning these profits.

11. Although it is not clearly stated in the Departmental Interpretation and Practice Notes (no. 21), in practice the IRD only allows 50:50 apportionment for contract processing arrangements, but not for import processing arrangements, despite the fact that the substance of the two arrangements is very similar.

12. Under contract processing, legal title of the imported raw materials as well as the work-in-progress and finished goods remain with the Hong Kong company whilst the PRC factory charges a processing fee for its processing services. In an import processing arrangement, the legal title of the imported raw materials is transferred from the Hong Kong company to the Mainland factory and the legal documents indicate a sale of the raw materials. On completion of processing, the Mainland factory sells the finished goods back to the Hong Kong company.

13. In an import processing case, the IRD regards the Hong Kong company as a trader and not as a manufacturer. Hence in determining the source of its profits no account is taken of the manufacturing activities done in the Mainland. However, in reality, even though the transaction is documented as a buy-sell to satisfy Mainland regulatory requirements, the Hong Kong company is just as involved in the manufacturing process as it would be in a contract processing arrangement. Taking into account the substance of these arrangements, taxpayers have been calling on the IRD for many years to extend the 50:50 apportionment treatment to import processing. As more and more Hong Kong manufacturers are encouraged to change from contract processing to import processing to address the challenges of the financial crisis, the extension of the tax offshore claim to import processing has become all the more compelling.

14. It is also worth noting that in a recent decision made by the Court of First Instance (CFI), the CFI considered that the taxpayer which was engaged in import processing should be entitled to the 50:50 apportionment treatment. Although the IRD has lodged an appeal against the CFI decision (which is yet to be heard), the case indicates the technical merit of allowing 50:50 apportionment to import processing cases.

15. The alignment of the tax treatment for import processing with that for contract processing not only provides fairness to taxpayers, but also provides certainty to taxpayers on their tax affairs.

Manufacturing plant and machinery tax deductions

16. Under the Inland Revenue Ordinance (IRO), tax relief for manufacturing plant and machinery currently available includes:-

- 100% outright deduction (except where the plant and machinery is under a lease); or

- Depreciation allowances (initial allowance at 60% in the year the expenditure is incurred plus annual allowances at applicable rate of 10%, 20% or 30% on the tax written down value), <u>but</u> the allowances are denied where the plant and machinery is subject to a lease and is used outside Hong Kong.

"Lease" is broadly defined in the IRO and the IRD takes the view that plant and machinery provided free of charge by Hong Kong taxpayers to a Mainland processing unit constitutes a lease.

17. Under processing arrangements (both contract processing and import processing), Hong Kong manufacturers typically provide the Mainland processing units with plant and machinery for use, although legal title remains with the Hong Kong manufacturers.

18. Given the broad definition of "lease", no tax deductions are available for expenditure on such plant and machinery. As a concession for contract processing cases qualifying for 50:50 apportionment, the IRD allows 50% of the relevant depreciation allowances. However, this concession is not extended to import processing cases even though under the current practice (as mentioned above) 100% of profits generated from import processing

arrangements are treated as taxable. This means Hong Kong taxpayers engaged in import processing do not obtain any tax relief for their expenditure on plant and machinery used in the Mainland processing units.

19. In particular, given that moulds used in the manufacturing process often involve proprietary design and/or technology, it is very common for a Hong Kong company to continue to own moulds that are provided to the Mainland manufacturer. The usage of the moulds is strictly limited to the production of goods for the Hong Kong company. Denying tax deductions for the cost of moulds deviates from the basic principle of allowing taxpayers to get relief for costs incurred in generating revenue.

20. Coupled with the fact that no 50:50 offshore profits apportionment is allowed, taxpayers engaged in import processing are doubly disadvantaged.

21. In light of the abovementioned issues, appropriate amendments to the IRO should be considered to allow 100% outright deduction or capital allowances for plant and machinery used by processing units in the PRC (where the Hong Kong company retains the legal title) so as to remove the undesired tax consequences.

Ayesha Macpherson
January 2009