Profits Tax Treatments on Cross-border Manufacturing and Trading Businesses

There have recently been claims that the Inland Revenue Department ("the IRD") has changed its practice in assessing profits of Hong Kong companies from the sale of goods processed by Mainland entities. Many Hong Kong enterprises previously had their goods processed by Mainland entities through "contract processing" (來料加工) arrangements and were assessed only on 50% of their profits. They argue that this taxation treatment should continue to apply even though they have changed the mode of their operations and procured their products from Mainland entities which carry on an "import processing" (進料加工) trade.

The analysis below will show that it is the differences in taxpayers' operations, not any change in the IRD's practice, that give rise to disparity in taxation treatments.

The Territorial Source Basis of Taxation

As is well known, only profits that are "sourced" in Hong Kong are chargeable to profits tax. The broad guiding principle in determining the territorial source of profits, as established by case law, is that "one looks to see what the taxpayer has done to earn the profits in question and where he has done it". For this purpose, it is only the taxpayer's operations, not anybody else's, that are relevant. In certain situations, where gross profits from an individual transaction arise in different places, they can be apportioned as arising partly in and partly outside Hong Kong.

It follows from the broad guiding principle that in determining the territorial source of profits from businesses of different nature, different considerations will apply. For trading profits, an important factor to consider is the place where the contracts for purchase and sale were effected, but other factors must also be looked at. For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was the payment effected? On the other hand, profits from manufacturing of goods will have arisen from the place where the manufacturing processes and other services related to the production of the

manufacturing profits are performed. Such tax treatments are summarised in Departmental Interpretation and Practice Notes ("DIPN") No. 21: "Locality of Profits" issued by the IRD.

Contract Processing

In Contract Processing, the Hong Kong enterprise engages a Mainland entity to process goods on the Mainland on a cooperative basis. The processing agreement, which has to be approved by the relevant Mainland authorities, typically stipulates that the Hong Kong enterprise shall provide equipment and raw materials at no consideration, provide technical assistance, and pay a processing fee to the Mainland entity. The Mainland Entity is required, on the other hand, to provide factory premises and labour, to process the raw materials provided by the Hong Kong enterprise into finished goods and to handover the processed goods to the Hong Kong enterprise. Apart from the obligations under the processing agreement, the Hong Kong enterprise also has other activities in Hong Kong, such as arranging purchase and sale and carrying out design and technical know-how development.

Under Contract Processing arrangement the Mainland entity takes no ownership title to the raw materials and the processed goods throughout the course of processing. All processed goods have to be exported back to the Hong Kong enterprise. Recognising the involvement of the Hong Kong enterprise in the processing activities performed on the Mainland under this kind of arrangement, the IRD accepts, as stated in DIPN No. 21, that the profits on the sale of the goods in question can be apportioned on a 50:50 basis. However, the DIPN has made it clear that apportionment of profits does not apply to cases where the manufacturing process on the Mainland is contracted to a sub-contractor with minimal involvement of the Hong Kong business.

Import Processing

The Mainland entity that carries on an Import Processing trade is frequently a Foreign Investment Enterprise ("FIE") set up on the Mainland. It purchases raw materials from overseas, processes the goods on the Mainland and sells finished goods abroad on its own account. It takes ownership title to both the raw materials and finished goods. The buyer of finished goods may be a different person from the one who sold raw materials to the Mainland entity. The Hong Kong enterprise

purchases finished goods from the Mainland entity. It may also sell raw materials to the Mainland entity with a mark-up. The purchase and sale contracts between the Mainland entity and the Hong Kong enterprise are ordinary trading contracts.

Under such an arrangement the Mainland entity is simply a supplier of the goods sold by the Hong Kong enterprise, whether they are related companies or not. The processing activities conducted by the Mainland entity on the Mainland are not operations that give rise to the profits of the Hong Kong enterprise. The Hong Kong enterprise is a trader. It makes trading profits. Where the Hong Kong enterprise carries out its trading activities in Hong Kong, the whole of its profits must be assessed to Hong Kong profits tax.

Board of Review and Court Decisions

The source of a profit is always a question of fact. However, some recent Board of Review and court cases do provide guidance on the proper taxation treatments for the two different situations mentioned above.

In D132/99, 15 IRBRD 25, the Board held that the IRD was right in apportioning and bringing into charge 50% of the profits of a taxpayer which had entered into a typical processing agreement with a factory on the Mainland and which had operations both on the Mainland and in Hong Kong.

In D111/03, 19 IRBRD 51, the taxpayer, a toy trading company, sold raw materials to a FIE, which manufactured toy products on the Mainland, and then purchased finished products from the FIE with a mark-up. The Board decided that the taxpayer and the FIE, though belonging to the same group of companies, were in form and substance separate entities distinct from each other and that the FIE's manufacturing activities could not be treated as those of the taxpayer. The taxpayer's claim for an apportionment of its profits on a 50:50 basis was rejected. A similar decision was made in D56/04, 19 IRBRD 456.

In *Consco Trading Co v. CIR* [2004] 2 HKLRD 818, the court upheld the Board's conclusions that, on the evidence, a preponderance of the taxpayer's trading activities took place in Hong Kong and that the profits of the taxpayer from the purchase and sale of polysilicon were derived from Hong Kong. The court further held that the Board correctly excluded the processing activities of the Mainland entity as being irrelevant to determining the taxpayer's source of profits, which were derived through the sale of processed goods.

Form and substance

Some taxpayers argue that Contract Processing and Import Processing arrangements are only different in form and not in substance. This argument is not tenable. As can be clearly seen from the above analysis, they are different both in form and in substance, entailing different tax treatments.

Furthermore, there is no general rule of law that the form of a commercial transaction, which is consistent with the transaction, can be disregarded for tax purposes. "Form" does not simply mean the label but encompasses legal rights and liabilities created under a transaction. As Penlington J.A. stated in *Harley Development Inc. & Trillium Investment Ltd. v. CIR* 4 HKTC 91 at page 110:

> "*Here it may be said that the appellants could have achieved the same result by going about the transactions in a different way but they have not done so. The appellants are bound by the form of their transactions.*"

Conclusion

The IRD has all along adopted consistent practices, which are in accordance with established legal principles, in assessing profits from cross-border transactions. Where profits have been returned by taxpayers on a wrong basis (e.g. on a manufacturing basis rather than on a trading basis) and assessments were raised on such a wrong basis, assessors are duty-bound to raise additional assessments upon discovery of the true facts.

[The above is the IRD's contribution for the "IRD Feature" in the September 2005 issue of the Hong Kong Institute of Certified Public Accountant's journal, A Plus]