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Hong Kong Tax

Court of Appeal reaffirms denial of 50:50 apportionment of profits for import processing arrangement

The Hong Kong Court of Appeal ("CA") issued a decision on 7 March 2011, confirming that the "50:50 apportionment of profits concession" only applies to contract processing arrangements and not to import processing arrangements (Commissioner of Inland Revenue v CG Lighting Limited HCIA8/2009). The CA upheld the 2010 ruling of the Court of First Instance ("CFI") and reiterates that a taxpayer's profits derived from the sale of goods acquired under an import processing arrangement with a subsidiary in Mainland China are subject to Hong Kong profits tax in full. In essence, the decision reconfirms that legal form ultimately outweighs substance.

The 50:50 apportionment is a concession granted by the Inland Revenue Department (IRD) in Departmental Interpretation and Practice Notes No. 21 (DIPN21), which sets out the IRD's position on the source of various types of income. The concession is granted where a Hong Kong manufacturing business enters into a processing arrangement with a Chinese Mainland entity and the Hong Kong entity provides the raw materials, technical know-how, management, production skills, design, skilled labor, training and supervision for locally recruited labor. The IRD generally will allow the profits derived by the Hong Kong entity from the sale of the relevant manufactured goods to be apportioned and taxed on a 50:50 basis on the grounds that the sales activities are carried out in Hong Kong, but the manufacturing activities are carried out outside Hong Kong. In practice, the IRD only grants apportionment to situations where the underlying arrangement is a contract processing arrangement. Import processing arrangements are subject to different treatment: they are treated as trading profits (rather than manufactured profits) and are fully chargeable to tax in Hong Kong.

Background of the case

The taxpayer, CG Lighting Limited ("CG Lighting"), a Hong Kong company, is engaged in the manufacturing of lighting fixtures and has consistently lodged 50:50 apportionment of profits from the sale of lighting fixtures manufactured in the Mainland. The taxpayer's claim replicated the tax treatment conferred on taxpayers under contract processing arrangements.

In 1993, CG Lighting entered into a contract processing arrangement with a third party manufacturer in the Mainland, where the IRD initially agreed that 50:50 apportionment of profits would be applied to its profits from sales of the products produced in the Mainland. In 1994, CG Lighting set up a foreign investment enterprise, CG Electrical (Shenzhen) Limited ("CGES"), a wholly owned subsidiary, to carry on its business of producing lighting fixtures. With the approval of the relevant PRC authorities, CG Lighting changed the manufacturing arrangement with the third party manufacturer to CGES.

Despite the change in legal form, CG Lighting's mode of operations remained unchanged in substance from when it was under a contract processing arrangement. CG Lighting continued to provide raw materials, technical know-how, management staff, product design, manufacturing plant and machinery at no cost to CGES. CGES charged CG Lighting a monthly processing fee for the provision of the factory premises and production labor. The amount of the processing fee would not exceed CGES's operating costs and overhead. CGES prepared sales documents for goods provided to CG Lighting for the sole purpose of obtaining customs clearance by the Mainland authorities.

The Commissioner of Inland Revenue (CIR) was of the opinion that CG Lighting was a trader, not a manufacturer of lighting fixtures, and its trading transactions were carried out in Hong Kong and thus all of its profits should be assessable to Hong Kong profits tax. The CIR took the position that CG Lighting's profit-making activities were the purchase of finished goods and the on-selling of those goods to its customers for profit, both of which took place in Hong Kong. Additional assessments were issued for the years 1998/99 to 2004/05 and the 50:50 apportionment claims were rejected for those years of assessment. CG Lighting argued that profits tax should be assessed only on a portion of the profits because part were offshore sourced since CG Lighting was actively engaged in the manufacturing process in the Mainland and the profits could be attributed to the taxpayer's involvement. CG Lighting appealed to the BOR against the additional assessments.

Summary of Board of Review and CFI decisions

The BOR overruled the decision of the CIR, concluding that the taxpayer's substantial involvement in the production process in the Mainland should be regarded as part of its profit-generating transactions. In fact, the BOR held that CG Lighting's operations were multifaceted, with each part of its operations forming an integral part of the profit-producing process. The BOR held that since part of CG Lighting's profit-generating transactions was located in the Mainland, its assertion that part of its profits was sourced outside Hong Kong and not chargeable to profits tax was correct. The question as to the appropriate apportionment of profits to be taxed was remitted back to the CIR. The CIR then appealed the BOR decision to the CFI.

The CFI relied heavily on the authority of a previous case, CIR v Datatronic Limited CACV 275/2008, in which the CA ruled against the appellant, i.e. Datatronic Limited, on the apportionment of profits. The facts in Datatronic and CG Lighting are in many aspects identical, except for the fact that the BOR established that Datatronic was engaged in the buy-sell of raw materials and finished goods with its PRC subsidiary, whereas the BOR held that CG Lighting was not. The CA held in Datatronic that the taxpayer was a trader of finished goods, whereby the profit-generating transactions were the buying of goods from its PRC subsidiary and the resale of those goods at a profit. The participation of the taxpayer in the manufacturing process was merely ancillary and thus not relevant to the determination of the source of trading profits.

Therefore, referring to the Datatronic case, the CFI upheld the decision of the CIR by reaffirming that the core of CG Lighting's activities that produced its profits emerged from the arrangement of goods to be manufactured by, and subsequently transferred from, CGES to CG Lighting and the ensuing resale of the goods to customers for profit, all of which took place in Hong Kong. The involvement of CG Lighting in CGES' manufacturing process was taken to be only antecedent or incidental to its profit-producing transactions and, thus, ignored in determining the source of profits in question.

Decision of the CA

Adhering to the decision of the CFI, the CA was in agreement that the taxpayer's costs of acquiring the finished lighting products are reflected in the processing fee it paid to CGES, even though the fee was structured on a cost-recovery basis (i.e. the processing fee would not exceed the total of CGES' operating and overhead costs). In addition, although CGES, the manufacturer of the finished lighting products, was CG Lighting's wholly owned subsidiary, it does not change the fact that the cost of acquiring the finished lighting products was taken into account in arriving at the profits earned from the subsequent sales to CG Lighting's customers.

Consequently, the CA's decision coincided with that of the CIR and the CFI, unyielding to the possibility of an apportionment of profits under an import processing arrangement. The CA concluded that the CFI was correct, in that CG Lighting was a trader with no distinguishable difference from that of the taxpayer in Datatronic, who bought and sold goods, rather than being a manufacturer of lighting products that it sold at a profit. The relevant profits were derived from the profit-producing transactions in relation to the sale of the lighting products in Hong Kong.

Our observations and comments

The CA decision reiterates that the 50:50 tax concession applies only in the context of contract processing arrangements. To the dismay of taxpayers, this decision is consistent with Datatronic decision, and it seems unlikely that the courts will deviate from this interpretation in any similar case involving the apportionment of profits from an import processing arrangement. Even though according to the finding of the BOR that, in reality, there were no sales in CG Lighting, the CA did not agree with the implication of the taxpayer's case that all the raw materials supplied by CG Lighting to CGES and the finished products were belonged to the taxpayer throughout the process. The CA viewed that, what BOR referred to as the “reality of the situation,” only represented the subjective intention of the taxpayer since CG Lighting thought it would be advantageous from a Hong Kong tax liability perspective to be regarded as the owner of the raw materials and the finished products.

Nonetheless, since contract processing arrangements are no longer encouraged by the Mainland authorities, Hong Kong business moving more towards import processing arrangements to preserve their business operations in the PRC. Should the IRD and the courts continue to stand firm on their traditional interpretation, the 50:50 tax concession will have little particular application in the future.

With nearly identical outcomes, both Datatronic's and CG Lighting’s principal profit-generating transactions were regarded as the purchase and sale of goods manufactured by a Mainland entity and their involvement in the manufacturing operations of the Mainland entity were regarded as mere incidental activities. However, from a taxpayer’s point of view, involvement in the manufacturing activities is imperative to the operations and ultimately the profitability of the business as a whole. With that said, the IRD should consider developing a clear definition of profit-producing transactions in conjunction with practical tests to substantiate whether a transaction falls within the scope of the definition.

Concluding remarks

Given the decision handed down by the CA in Datatronic, the CA’s conclusions in CG Lighting are not surprising. Backed by these two coinciding judgments, the IRD likely will continue to sustain apparent differences between contract processing arrangements and import processing arrangements, and deny the 50:50 tax concession in the latter case.

If your company's operations are similar to those in Datatronic or CG Lighting and you have been pursuing the 50:50 offshore claim on profits for profits tax filing purposes for some years, we would recommend that the company revisit its tax position to ensure that it is well prepared (with supporting documentation) to defend its offshore claim.

For further information, or to discuss how Deloitte can assist your company, please feel free to contact our Hong Kong Business Tax team.

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