

How Can 50% Profits Of A HK Company Be Exempted From Corporate Tax?

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Over the past two decades, most manufacturers in Hong Kong have shifted their production plants to the Mainland China to take advantage of the relatively low manufacturing costs and favourable government policies there. These production plants have got the business licenses in China for doing processing trades with their Hong Kong related companies by entering into the processing agreements.

Under a typical processing agreement, the licensed factory in China ("China Factory") agrees to provide land, factory premise and workers for the purpose of processing or producing the required goods exclusively for Hong Kong company ("HKCo") whereas HKCo agrees to provide machinery, technical know-how, production skills and supervision to China Factory. HKCo actively solicits customers from overseas and negotiates with them about the terms of sales such as quantity, product type, selling price, delivery date and settlement basis etc. Upon finalizing the sales terms, HKCo issues production instruction sheets to China Factory listing out details of the products ordered by the customers. HKCo at the same time purchases the required raw materials from local suppliers and delivers them to the factory for processing. After the finished goods are produced, they are transported from the factory through HKCo to the customers. HKCo then issues sales invoices to the customers for settlement. China Factory also sends its service fee notes to HKCo to recover the production costs incurred.

It can be appreciated from the above that HKCo exercises substantial control over China Factory and heavily involves in its daily operations. HKCo holds the title to the factory machines, the raw materials and the processed goods throughout the production process. It bears the costs incurred by China Factory (e.g. workers' wages, raw materials, production overheads and general expenses etc.) and books the expenses in its own company accounts. In return, the company gets all the monetary rewards from selling the goods to its customers. HKCo effectively has treated China Factory as if it were the company's production department in China.

Substance-Over-Form Principle Applies

Strictly speaking, China Factory is a legal and taxing entity distinct from HKCo. It should not affect the corporate tax liability of HKCo in Hong Kong. Nevertheless the Hong Kong Inland Revenue Department ("IRD") recognizes the uniqueness of its operating modes and the fact that HKCo is the beneficial owner of China Factory. It applies the "substance-over-form" principle and views HKCo as a manufacturer and trader doing processing business in Hong Kong and China. Accordingly the chargeability of HKCo's profits is determined by the place where its manufacturing activities are carried out. If all the activities are conducted at overseas, the company's profits will be totally exempted from tax in Hong Kong.

However, please note that the IRD's definition of "manufacturing activities" cover the whole production process starting from initial negotiation with customers to final settlement of invoices. It does not simply focus on the location of production plant. The table below lists out the locality of each major activity conducted by HKCo:-

<u>An overview of the manufacturing activities conducted by HKCo</u>	<u>Place of the activity</u>
1. Solicit customers and finalize the terms of sales	HK
2. Purchase raw materials	HK / China
3. Arrange transportation of raw materials to China Factory	HK
4. Production of finished goods	China
5. Overall supervision of the production	China
6. Quality control of the produced goods	China
7. Pack and transport the finished goods to customers	China / HK
8. Issue sales invoices to customers	HK
9. Receive sales proceeds and settle suppliers' invoices	HK
10. Prepare and keep accounting records	HK

In view of the above, the IRD will not accept that the "manufacturing activities" of HKCo are completely offshore sourced. The IRD will consider HKCo as carrying on its manufacturing activities partly in and partly outside of Hong Kong. The company's profits generated from selling the goods made by China Factory have to be divided into taxable and non-taxable portions.

The next problem then arises – what is the correct percentage of non-taxable manufacturing profits? ... 40%, 60% or 90%? It will be a time consuming process to determine the appropriate percentage and get the unanimous consensus from the IRD and HKCo. To resolve this problem, the IRD currently adopts the so-called "broad-brush" approach. It will simply deem 50% of HKCo's gross profits from selling the goods made in China Factory as chargeable to corporate tax in Hong Kong and allows for deduction of its general expenses attributable to such taxable profits.

When HKCo applies for the first time that 50% of its manufacturing profits are tax exempted, the IRD will logically look for documentary evidence to support the application. It will issue a long enquiry letter to HKCo and ask for representative transactions for examination in order to ascertain its business operations. This examination process may take years before the IRD approves the application. Therefore, Hong Kong companies should consult their qualified advisors, particularly where unusual or complex situations are involved, before lodging the 50% tax exemption application with the IRD.

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