Tax alert

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Court of Appeal dismisses offshore claim by CG Lighting Ltd

In handing down its decision in *CG Lighting Ltd v CIR* (CACV 119/2010), the Court of Appeal has dealt a further blow to taxpayers claiming that arrangements, similar to contract processing arrangements, should enjoy equivalent tax treatment (i.e. only 50 percent of profits are subject to Profits Tax). The Court affirmed the decision of the Court of First Instance that the taxpayer was a trading company that bought and sold finished goods. The Court held that it was not a manufacturer of the lighting products which it sold for a profit.

Background

For the background to this case, please see Tax alert Issue 12 - May 2010. Broadly, the taxpayer claimed that only 50 percent of its profits should be subject to Profits Tax on the basis that its profits arose partly in Hong Kong and partly in the Mainland. The taxpayer's claim reflected the treatment afforded to "contract processing" arrangements, as detailed in Departmental Interpretation and Practice Note No. 21. Under a contract processing arrangement, only 50 percent of the profits are treated as assessable on the basis that they arise from a manufacturing activity undertaken in Hong Kong and partly in the Mainland.

The taxpayer previously manufactured goods in the Mainland under a contract processing arrangement, but subsequently set up a foreign investment enterprise through a wholly-owned Mainland subsidiary manufacturer.

The subsidiary carried on a business of manufacturing lighting fixtures in the Mainland. To facilitate the manufacturing process, the taxpayer provided raw materials, technical know-how, management staff, production skills, computer software, product designs, skilled labour, training, supervision and manufacturing plant and machinery to the subsidiary at no cost. The subsidiary provided factory premises and labour for the production of lighting fixtures in return for monthly processing fees paid by the Taxpayer. The monthly fees were equivalent to the subsidiary's operating costs and overheads.

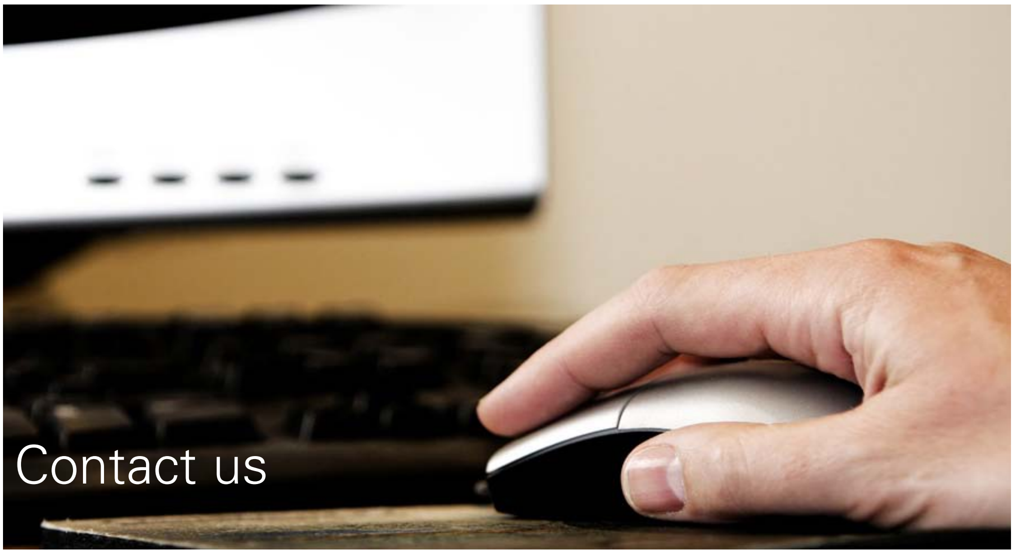
The taxpayer considered that the arrangement was, in substance, no different to the previous contract processing arrangement and claimed that 50 percent of its profits should not be subject to tax.

Comment

The Court of Appeal's decision is the second case to come before the courts that has gone against taxpayers claiming that, in substance, their trading arrangements were the same as a contract processing arrangement and therefore should be taxed on the same basis.

The Inland Revenue Department continues to take the position that substantive differences exist between contract processing and import processing arrangements. Contract processing arrangements will enjoy the 50 percent exemption on the grounds that profits arise partly from a manufacturing source in the Mainland. In contrast, however, import processing arrangements will be taxed as a trading arrangement, wherein profits will be subject to tax if sourced in Hong Kong.

The case illustrates that recourse to the Courts to obtain the same tax treatment as contract processing arrangements for arrangements that closely resemble such arrangements is unlikely to succeed.



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