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Tax alert

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Justice denied?

The Leave Committee of the Court of Final Appeal (CFA) recently refused CG Lighting Limited leave to appeal to the CFA on the basis that tax appeals do not have an automatic right to appeal.

Background

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 partly 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's business was to manufacture 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.

The taxpayer won before the Board of Review, but lost before both the Court of First Instance (CFI) and the Court of Appeal (COA).

The Taxpayer then sought leave to appeal to the CFA. First, it contended that, having regard to the amount involved, such an appeal lies as of right under section 22(1)(a) of the *Hong Kong Court of Final Appeal Ordinance* (the *Ordinance*). Secondly, in the Court's discretion, under section 22(1)(b) of the *Ordinance* as it involved a question of great general or public importance, or the Court otherwise believed it ought to be submitted to the Court for decision.

The Leave Committee held that monetary claims which require assessment – and are therefore unliquidated rather than liquidated – do not come within section 22(1)(a). As tax requires assessment, tax demands do not come within section 22(1)(a). Accordingly, the appeal which the taxpayer seeks to bring does not lie as of right.

As to section 22(1)(b), the Leave Committee was not persuaded that there was any question of legal principle to be resolved in the proposed appeal. In the absence of any question of legal principle to be resolved, there was no foundation for the grant of leave to appeal under the "question of law" limb of section 22(1)(b). As for the "or otherwise" limb of section 22(1)(b), the Leave Committee noted that it is only in rare and exceptional circumstances that leave to appeal would be granted there under. No such circumstances existed in the present case.

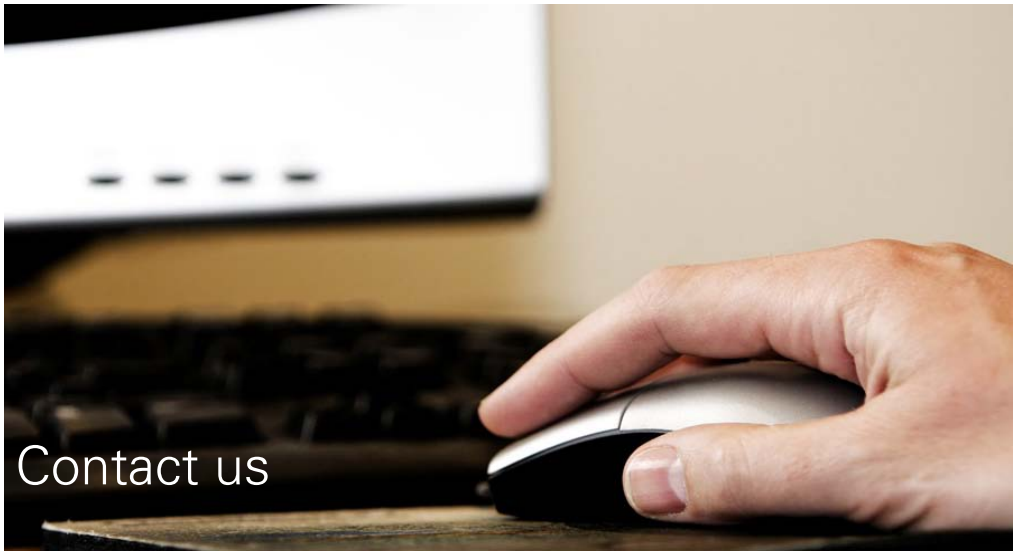
Comment

This decision involves a number of firsts. It is the first application by a taxpayer for leave to appeal to the CFA which the Commissioner of Inland Revenue has contested. The case is also the first application by a taxpayer that has been refused leave to appeal since the establishment of the CFA 14 years ago.

The Leave Committee's decision brings to an end CG Lighting's appeal and effectively ends claims for apportionment by taxpayers engaged in manufacturing in the Mainland in situations that are in substance equivalent to contact processing arrangements.

More worrying is the restriction placed by the CFA on applications for leave to appeal – prompted by its apparent policy to restrict the number of overall appeals it hears – 16 tax cases have been heard in the past 14 years!

Further, before the COA, the taxpayer had argued that the CFI had misapplied the offshore tax principles set out in the more recent cases on source of profits: *ING Barings Securities (Hong Kong) Ltd v CIR* and *Ngai Lik Electronics Co Ltd v CIR*. Arguably this brought CG Lighting's appeal within the "question of law" ground under section 22(1)(b) and should have been allowed to proceed as an appeal of great general or public importance.



Contact us

For more information, please contact:

Corporate Tax, KPMG China

Khoon Ming Ho
Partner in Charge, Tax
China and Hong Kong SAR
Tel: +86 10 8508 7082
khoonming.ho@kpmg.com

Vaughn Barber
Partner
Tel: +852 2826 7130
vaughn.barber@kpmg.com

Charles Kinsley
Principal
Tel: +852 2826 8070
charles.kinsley@kpmg.com

Jennifer Wong
Partner
Tel: +852 2978 8288
jennifer.wong@kpmg.com

Ayesha M. Lau
Partner in Charge, Tax – Hong Kong SAR
Tel: +852 2826 7165
ayesha.lau@kpmg.com

Darren Bowdern
Partner
Tel: +852 2826 7166
darren.bowdern@kpmg.com

Curtis Ng
Partner
Tel: +852 2143 8709
curtis.ng@kpmg.com

Garry Laird
Senior Tax Advisor
Tel: +852 2143 8795
garry.laird@kpmg.com

Chris Abbiss
Partner
Tel: +852 2826 7226
chris.abbiss@kpmg.com

Nigel Hobler
Partner
Tel: +852 2143 8784
nigel.hobler@kpmg.com

John Timpany
Partner
Tel: +852 2143 8790
john.timpany@kpmg.com

kpmg.com/cn