香港中華廠商聯合會
The Chinese Manufacturers' Association of Hong Kong

Suggestions to Amend Sections 39E and 16EC of the Inland Revenue Ordinance ("IRO")

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Contents

1 Abbreviations used in the report

ACCA	Association of Chartered Certified Accountants
B&R Initiative	Belt and Road Initiative
Consultation Report	Transfer pricing report issued by the Hong Kong Government on 31 July 2017
DIPN	Departmental Interpretation and Practice Notes
Equipment	Plant and machinery
FSTB	Financial Services and the Treasury Bureau
HKICPA	The Hong Kong Institute of Certified Public Accountants
IRD	Inland Revenue Department
IRO	Inland Revenue Ordinance
IPRs	Intellectual property rights
I&T	Innovation and technology
TP	Transfer pricing

2 Objective of this report

It has been a long recurring issue since the early 2000s within the business community that Hong Kong enterprises who incur capital expenditure for the acquisition of equipment are denied depreciation allowances when the assets are made available to factories or other outsourced manufacturers in the Mainland under import processing arrangements (進料加工). The IRD has taken the position that Section 39E of the IRO, which is an anti-avoidance provision, applies to such arrangements and therefore denies depreciation allowance claims.

The IRD's position has created numerous disputes with taxpayers and has increased the operating costs of Hong Kong enterprises who engage in offshore manufacturing. The profits of such enterprises are fully taxable for Profits Tax purposes; whilst the expenditure incurred on necessary equipment (which represents a major cost) is denied any tax relief.

A similar problem arises in respect of IPRs. As an incentive to step up technological innovation in local industries and promote wider application of IPRs by local enterprises, the Financial Secretary proposed in the 2010/11 Budget to extend the deduction for capital expenditure on IPRs to cover such items as copyrights, registered designs and registered trademarks under Section 16EA. This was in addition to the deduction that was already available for the purchase costs of patent and know-how rights under Section 16E.

Similarly to Section 39E, an anti-avoidance provision (Section 16EC) was introduced at the same time to deny a deduction for the cost of an IPR if the IPR was used wholly or principally outside Hong Kong by persons other than the Hong Kong owner.

In the 2017/18 Budget, the Financial Secretary announced that I&T was to become a new engine to power the sustainable and diversified economic development of Hong Kong. He noted that Hong Kong had experienced economic restructuring in recent years with the result that the contribution of the manufacturing industry to the economy had declined considerably since the early 2000s. The Government therefore adopted a policy whereby I&T would drive Hong Kong's re-industrialisation to facilitate the development of a high-end manufacturing industry in Hong Kong, which in turn would promote economic growth and create quality jobs.

The establishment of the Innovation and Technology Bureau in November 2015 was a key step in developing the I&T ecosystem in Hong Kong. In the 2017/18 Budget, the Financial Secretary also announced that a new committee on I&T development and re-industrialisation would be set up to co-ordinate the planned development. As part of this initiative, the Tax Policy Unit to be established within the FSTB would explore enhanced tax deductions for I&T expenditure.

While these developments with respect to I&T are positive steps to improve the competencies of local I&T enterprises under the re-industrialisation initiative, the existing limitations in Sections 39E and 16EC continue to undermine manufacturers' ability to expand their businesses by developing their manufacturing capabilities outside Hong Kong under the B&R Initiative. The denial of depreciation allowances under Section 39E and IPRs deductions under Section 16EC significantly increases their operating costs and limits their growth potential under the re-industrialisation initiative.

We set out in this report the relevant technical analyses, our observations on the IRD's interpretation and practice, as well as our suggestions for legislative changes to Sections 39E and 16EC of the IRO. We hope these will help to enable the relevant stakeholders including the government to discuss these issues and take this matter forward.

3 Brief history of Section 39E

Section 39E of the IRO was introduced in 1986 with the legislative intention of limiting opportunities for tax deferral and avoidance through sales and leasebacks of equipment (and through leveraged leasing arrangements)[1]. Where the section applies, an owner of equipment will be denied depreciation allowances (i.e. initial allowances and annual allowances) in respect of its purchase price.

When Section 39E was scrutinised and passed by the Legislative Council in 1986, the Hong Kong Government stated that the provision was intended to only strike down cases of tax avoidance under sale and leaseback (and leveraged leasing) arrangements. At the same time, the Government gave an assurance that general leasing transactions and normal commercial transactions would not be affected.

Notwithstanding this legislative intention and assurance, the IRD has taken the position since the early 2000s of denying depreciation allowance claims where a Hong Kong enterprise makes the relevant equipment available for use by factories or outsourced manufacturers in the Mainland under ordinary commercial arrangements (e.g. import processing arrangements). This was the case even if (i) the Hong Kong enterprise did not engage in any tax deferral or avoidance arrangement (through a sale and leaseback or leveraged leasing arrangements or other avoidance device), and (ii) the profits derived by the Hong Kong enterprise were fully subject to Profits Tax in Hong Kong.

Under the IRO, taxpayers are provided with tax relief for equipment costs as follows:-

- 100% outright deduction under Section 16G[2] of the IRO. However, this deduction does not apply if the plant or machinery is subject to a ***lease***; or
- depreciation allowances (initial allowance at 60% in the year the expenditure is incurred plus annual allowances at 10%, 20% or 30% on the tax written down value). However, depreciation allowances (both initial and annual allowances) do not apply under Section 39E(1) of the IRO if the equipment (not being a ship or an aircraft) is subject to a ***lease*** and is used wholly or principally outside Hong Kong.

The key issues under Sections 16G and 39E is whether the equipment is considered to be subject to a ***lease***. In general parlance, the word "lease" is not appropriate to describe the arrangement whereby a Hong Kong manufacturer makes equipment available to Mainland factories. However, Section 39E contains a statutory definition of "lease" which has given rise to the difficulties being faced by manufacturers.

3.1 Definition of "lease" under the IRO

Section 2 of the IRO defines a "lease" in respect of plant and machinery to include:-

(a) any arrangement under which a right to use the equipment is granted by the owner of the equipment to another person; and

[1] The relevant Budget Speech is enclosed as **Appendix 1**.
[2] As an incentive to invest more in high value manufacturing and modern business systems, in his 1998/99 Budget Speech, the then Financial Secretary proposed an immediate 100% write-off for new expenditure on plant and machinery specifically related to manufacturing plant and machinery, computer hardware and software. This proposal was subsequently approved and the relevant legislation was enacted under Section 16G of the IRO effective from the year of assessment 1998/99.

(b) any arrangement under which a right to use the equipment, being a right derived directly or indirectly from a right referred to in paragraph (a), is granted by another person, but does not include a hire-purchase agreement or a conditional sale agreement unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised.

The main concern is item (a) above which is a very broad definition. The IRD took the position that, irrespective of whether or not rent is charged, the grant of a right to use equipment to any other party constitutes a "lease". Hence, it applied Section 39E to taxpayers who made equipment available to Mainland factories for the purposes of assisting their production of the relevant goods. This was clearly not a case of tax avoidance and appeared to be inconsistent with the legislative intention behind Section 39E which was to attack only cases of tax avoidance involving sale and leaseback arrangements and leveraged leasing arrangements. Applying Section 39E to cases involving consignments by manufacturers to factories of equipment was inconsistent with the original legislative intention.

The IRD indicated its position in its 2006 and 2007 annual meetings with the HKICPA and in its DIPN[3] No. 15. Extracts from these meeting minutes and DIPN are enclosed as **Appendices 2 to 4**.

Because Section 39E is expressed in wide terms and literally applies to such consignment arrangements between manufacturers and Mainland factories, the hands of the courts were tied in subsequent litigation. The courts (including the Court of Final Appeal) therefore had no choice but to uphold the IRD's position in cases before them.

3.2 The undesirable tax consequences

The current operation of Section 39E has resulted in adverse impact to various businesses. There were numerous disputes between the IRD and taxpayers regarding depreciation allowance claims on plant and machinery provided by Hong Kong companies to Mainland subcontractors on a rent-free basis under import processing arrangements.

To illustrate the undesirable tax consequences of Section 39E (which are inconsistent with the original legislative intent behind the section), we set out an example of a typical manufacturing business scenario where the IRD will deny depreciation allowance claims with respect to equipment pursuant to Section 39E.

- Many Hong Kong manufacturers have relocated their manufacturing operations to the Mainland, but they remain active in Hong Kong by operating local offices. These Hong Kong companies operate as trading companies, but also provide substantial support to the manufacturing operations carried out in the Mainland;

- Hong Kong enterprises often structure their relationships with factories in the Mainland in the form of contract manufacturing, namely contract processing (來料加工) and import processing (進料加工) arrangements. Under these arrangements, the Hong Kong enterprise typically enters into a contract with a local factory in the Mainland for the production of goods. The Hong Kong enterprise sources raw materials, provides product design and

[3] DIPNs contain the IRD's interpretation and practices in relation to the law as it stood at the date of publication. They have no legally binding effect to either the IRD or the taxpayers. With that said, we notice that the IRD generally adheres to the positions stated in DIPNs.

technical know-how, and provides plant and machinery (e.g. moulds) to the Mainland factory.

- The Mainland factory produces the finished goods for the Hong Kong enterprise to sell into overseas markets;

    - Under a contract processing (來料加工) arrangement, legal title to the raw materials and finished goods remains with the Hong Kong enterprise at all times;

    - Under an import processing (進料加工) arrangement, the Hong Kong enterprise sells the raw materials to the Mainland factory.

- After import processing, the Mainland factory will sell the finished goods to the Hong Kong manufacturer. After contract processing, the goods automatically belong to the Hong Kong enterprise.

- Broadly speaking, the change of legal title to the raw materials and finished goods is the major difference between a contract processing and an import processing arrangement. That said, for all practical purposes, the roles played by the Hong Kong enterprises under these arrangements are very similar. In both cases, they provide all the plant and machinery free of charge, as well as substantial operational and administrative support, to the Mainland factories in the manufacturing process.

- For certain industries, given the proprietary nature of product designs, it is very common for Hong Kong companies to supply the necessary moulds to its overseas vendors. The moulds are usually used solely for the production of products that belong to (or are sold to) the Hong Kong enterprises. This mould loan arrangement is in place irrespective of whether a processing trade is involved.

  Because the relevant mould costs are not included as part of the processing factories' cost base, the processing fees charged by the factories to the Hong Kong companies would generally be lower than would otherwise be the case. However, this is because the Hong Kong enterprise is required to bear the cost of providing the mould.

- Because of the IRD's application of Section 39E, the Hong Kong enterprise is not entitled to **<u>any</u>** tax relief for its cost of providing the mould to the factory (other than for enterprises engaging in contract processing arrangements to which the IRD allows a concessionary 50% claim for the depreciation allowances[4]).

Considering capital expenditure for plant and machinery is a key cost component for most manufacturers, Section 39E has a hugely adverse impact on Hong Kong enterprises who engage in such activities.

[4] For Hong Kong manufacturers engaging in contract processing (來料加工) arrangements, the IRD is of the view that the Hong Kong manufacturers have operations in the Mainland factory such that they are regarded as using the plant and machinery there. Accordingly, Section 39E of the IRO had not been strictly applied in this context whereby the Hong Kong manufacturers are allowed as a concession to claim 50% of the relevant depreciation allowances as their profits are treated as 50% taxable (see **Appendix 5** for the relevant extract of minutes for the 2009 annual meeting between the IRD and HKICPA).

4 Brief history of Sections 16E, 16EA and 16EC

As an incentive to step up technological innovation in local industries, Section 16E of the IRO was introduced in 1983 to provide a deduction for the capital cost of acquiring patents, trademarks and designs. As a result of subsequent amendments, the current position is that only the purchase cost of ***patent rights*** and ***rights to any know-how*** are deductible under Section 16E.

To promote wider investment in IPRs by local enterprises and to facilitate the development of creative industries in Hong Kong, the Financial Secretary proposed in the 2010/11 Budget Speech that Profits Tax deductions should be extended to cover capital expenditure on the purchase of three types of commonly-used IPRs, namely, ***copyrights***, ***registered designs*** and ***registered trademarks***. As a result, Section 16EA of the IRO was enacted in December 2011.

Section 16EC(4)(b) of the IRO, an anti-avoidance provision, was introduced at the same time to prevent potential exploitation of the IPR deduction. A deduction is denied if an IPR is ***used*** wholly or principally outside Hong Kong by persons other than the taxpayer who owns the IPR.

4.1 The IRD's interpretation of Section 16EC

The IRD issued DIPN No. 49 in July 2012 setting out its interpretation of the provisions relating to the (i) deduction of capital expenditure on IPRs; and (ii) taxation of royalties derived from licensing of IPRs. In the DIPN, the IRD states that it is prepared to adopt a pragmatic approach in applying Section 16EC(4)(b) considering the peculiar nature of IPRs, the territorial registration system, the protection of the rights and the wide scope by which the IPRs can be used.

DIPN 49 sets out various examples which illustrate the circumstances in which the IRD will or will not apply Section 16EC(4)(b) to deny a deduction under Sections 16E or 16EA of the IRO. Based on these examples, if a taxpayer (i) incurs capital expenditure on the purchase of trademarks registered **outside** Hong Kong; and (ii) the relevant trademarks are used by a non-Hong Kong contract manufacturer for the production of goods outside Hong Kong, the purchase price will be non-deductible, even if all the profits of the taxpayer are taxable in Hong Kong.

4.2 The undesirable tax consequences

Unlike Section 39E, the concept of a "lease" is not relevant in the context of deductions for IPRs. Nevertheless, similar undesirable tax consequences arise in both cases where the (leased) equipment or the overseas registered IPRs are used outside Hong Kong by someone other than the taxpayer who owns the equipment or IPR. Specifically, Hong Kong enterprises who (i) purchase IPRs registered outside Hong Kong; and (ii) sub-contract production work to factories located outside Hong Kong which exploit the overseas registered IPRs in the manufacturing process will be denied a tax deduction for the relevant capital expenditure on the overseas registered IPRs, even though all the profits derived by the enterprise are fully taxable in Hong Kong.

5 Practical observations on Sections 39E and 16EC

5.1 Section 39E

In many cases, the IRD has refused deductions where equipment was made available by a Hong Kong taxpayer to a Mainland factory under an import processing arrangement, even in cases where the equipment was recorded as a fixed asset in the Hong Kong taxpayer's books, where the equipment was in fact wholly used by the Mainland factory. The IRD justified its position by asserting that such a scenario potentially gives rise to tax depreciation claims in both Hong Kong (by the Hong Kong taxpayer) and China (by the Mainland factory – which in our view should not be the case) on the capital expenditure incurred on the same piece of equipment.

The IRD initiated numerous field audit cases against Hong Kong taxpayers who were engaged in processing arrangements, with a particular focus on their tax depreciation allowance claims. From the business community's standpoint, this is unfair. The provision of equipment to Mainland factories under import processing arrangements is commercially driven and does not involve any tax avoidance motive (and in fact is no different from the provision of equipment under contract processing arrangements). As a result, there were many disagreements between the IRD and the taxpayers on the interpretation of "lease" and the application of Section 39E under the IRO.

Hong Kong taxpayers typically put forward the following arguments to pursue their claims for deductions and depreciation allowances in cases involving import processing arrangements.

- The equipment was provided by the Hong Kong enterprise to the Mainland factory pursuant to genuine commercial arrangements without any tax avoidance motive.

- The equipment was at all times owned by the Hong Kong enterprise, and was not injected into the Mainland factory as a capital contribution.

- The Mainland factory was not subject to tax in Hong Kong. Therefore, it was not possible for any other entity besides the Hong Kong taxpayer to claim tax allowances in Hong Kong in respect of the same item of equipment, and hence there would not be any loss of tax revenue to Hong Kong.

- The Hong Kong enterprise was merely claiming tax benefits that rightfully accrued to it in connection with its capital expenditure on equipment used exclusively for the production of its profits which were fully taxable in Hong Kong.

- The Mainland factory was not claiming any tax depreciation allowances in respect of the equipment provided by the Hong Kong enterprise. If a factory did so, this would be incorrect from both PRC accounting and tax perspectives. The Hong Kong enterprise should not be punished if the factory was indeed taking such an incorrect position.

- There was no attempt by the Hong Kong enterprise to exploit provisions contained in the IRO or seek to benefit from any tax deferral or tax avoidance opportunity.

Despite these arguments, the IRD continued to refuse Hong Kong taxpayers who engaged in non-contract processing arrangements outright deductions under Section 16G of the IRO and depreciation allowances under Section 39E of the IRO.

We are aware that some businesses have chosen to relocate to Singapore or Ireland in preference to Hong Kong largely because of the denial of tax depreciation allowances under Section 39E. These cases included activities relating to container leasing and asset based financing (aircraft leasing). As a result, operating lease financing activities were no longer structured through Hong Kong but through other locations, notably Ireland and Singapore. This represented a lost opportunity for Hong Kong to develop as a transport and logistics hub which is supposedly one of Hong Kong's "pillar industries". (More recent amendments to the IRO have introduced new tax incentives to make Hong Kong a favourable centre for aircraft operating leasing activities.)

The unsatisfactory nature of the current position is well known to the IRD. The IRD attempted to mitigate some of the harshness of these provisions with a statement made in the example set out in Paragraph 17 of DIPN No. 15. This provides that where, Section 39E(1)(b)(i) of the IRO denies depreciation allowances where equipment is used by a third party wholly outside Hong Kong, the lease income would, **as a practice**, be regarded as non-taxable. While commendable as an attempt to remedy some of the concerns, this is unsatisfactory because there is no legislative basis for treating income as non-taxable solely because deductions are being denied. In addition, DIPNs do not have any legally binding effect, so the IRD can refuse to apply this so-called practice in cases where it wishes to tax the leasing income. Hence, this example does not sufficiently address the issues of concern.

In any event, a Hong Kong manufacturer who consigns equipment to a Mainland factory does not charge rent to the factory. Hence, this concession is not relevant to a Hong Kong manufacturer.

5.2 Section 16EC

Before Section 16EC was enacted in December 2011, the ACCA made a submission dated 29 March 2011 (see **Appendix 6**) to the then Legislative Councillor (Accountancy), Hon Paul CHAN Mo-po, MH, JP, about its concern that the proposal would not be able to serve the purpose of "to promote the wider application of intellectual property by enterprises and the development of creative industries", and would cause concerns similar to those arising as a result of Section 39E. ACCA highlighted that, in the case of a taxpayer producing goods through sub-contractors outside Hong Kong using IPRs, Section 16EC(4)(b) would disallow a deduction for the cost of the IPRs on the ground that they were not being used by the owner but by the sub-contractor (under license) outside Hong Kong.

In response to ACCA, the FSTB issued a letter dated 6 April 2011 (see **Appendix 7**) explaining that, where a Hong Kong enterprise allows its overseas sub-contractor to use outside Hong Kong an IPR owned by the Hong Kong enterprise at no cost, the overseas production activities by the sub-contractor are generally not attributed to the Hong Kong enterprise. Accordingly, the IRD would not charge Profits Tax on the sub-contractor nor on the Hong Kong enterprise for the overseas production activities, by application of the "territorial source" principle.

The FSTB emphasised that, if it recognised the "no cost" arrangement for the use of IPRs outside Hong Kong and granted a tax deduction, the relevant overseas jurisdiction could query whether Hong Kong was violating established TP principles by not applying the "arm's length principle" advocated by the OECD and thus prejudicing the taxing rights of the overseas jurisdiction concerned.

When the Bills Committee in the Legislative Council deliberated the proposal (see **Appendix 8** for the Bills Committee report), there were a number of deputations who raised concerns about, and objected to, the proposed Section 16EC(4)(b). Their point was that it would result in a blanket denial of tax deductions for businesses engaged in cross-border activities involving the use of IPRs by a party other than the taxpayer, even where the relevant IPR was being used (outside Hong Kong) to produce goods to be sold solely to the taxpayer. Despite these concerns, the Government continued to insist that Section 16EC(4)(b) should be enacted, and LegCo ultimately endorsed the Government's position.

As a result, in practice, Hong Kong taxpayers cannot claim the benefits of Sections 16E / 16EA of the IRO when they incur capital expenditure on the acquisition of IPRs.

In a global economy where innovation and application of technology are no longer limited to any particular jurisdiction, limiting the deductibility of purchase costs for IPRs registered outside Hong Kong, especially in cases where the resulting profits are fully taxable in Hong Kong, creates a disparity in terms of the "tax symmetry" principle of matching revenue and costs of a taxpayer for the purpose of computing net taxable income. It also undercuts the Government's stated strategy of promoting Hong Kong as an intellectual property trading hub by disincentivising investment in IPRs.

The Government has an apparent initiative to promote I&T and re-industrialisation in Hong Kong, as evidenced by the recent announcement of a new tax incentive comprising enhanced tax deductions for I&T expenditure. The limitation on tax relief for expenditure on IPRs deduction under Section 16EC(4)(b) weakens this initiative and should be properly examined and addressed.

6 Arguments for amending Sections 39E and 16EC

Numerous parties have raised concerns about the unintended negative effects of Sections 39E and 16EC via different means over the years. The Hong Kong Government and the IRD have refused to consider legislative changes or adopt a more liberal approach in interpreting these provisions, even in cases of genuine commercial transactions involving no tax avoidance motive.

Despite the long standing position of the Hong Kong Government and the IRD, the recent developments under the B&R Initiative, the new aircraft leasing regime in Hong Kong and the coming introduction of comprehensive TP legislation, as well as the practical concerns and difficulties faced by the business community, combine to present an opportunity to revisit the possibility of lobbying for the introduction of legislative changes to Sections 39E and 16EC with the Government, the IRD and the newly-formed Tax Policy Unit within the FSTB.

We set out proposals below to amend Sections 39E and 16EC. We look forward to more in-depth discussions among the stakeholders to develop the arguments for these amendments further and to buttress them with appropriate statistics and estimates.

6.1 Section 39E: Amend the definition of "lease"

For Hong Kong manufacturers wrestling with Section 39E, the main problem is the broad definition of "lease" under Section 2 of the IRO. The statutory definition is so broad that it includes all situations where equipment is provided to another party, irrespective of whether or not rent is charged.

To rectify this problem, we suggest the definition of "lease" under Section 2 should be amended so that it does not apply in cases where equipment is provided by a Hong Kong taxpayer to a supplier to assist the supplier to produce goods for sale to the Hong Kong taxpayer or to the order of the Hong Kong taxpayer. The definition should be confined to cases involving a "normal" lease in consideration of rental income.

For example, we suggest that the definition of "lease" under Section 2 could be amended as follows:-

> *"lease, in relation to any machinery or plant, includes:-*
>
> *……*
>
> *but does not include:-*
>
> *(a) a hire-purchase agreement or conditional sale…..; and*
>
> *(b) any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person, who is engaged by the owner of the machinery or plant to manufacture goods for the owner of the machinery or plant, and the said machinery or plant is used by such another person solely for manufacturing goods for sale to the owner of the machinery or plant, or to the order of the owner of the machinery or plant."*

6.2 Section 16EC: Limit the concept of "use"

For Hong Kong manufacturers wrestling with Section 16EC(4)(b), the problem is the use by persons outside Hong Kong of the relevant IPR, irrespective of whether a royalty or other license fee is charged.

To avoid this problem, we suggest that Section 16EC(4)(b) be amended so that it does not apply in cases where IPR is provided by a Hong Kong taxpayer to a supplier to assist the supplier to produce goods for sale to the Hong Kong taxpayer or to the order of the Hong Kong taxpayer. The concept of "use" should be confined to cases involving a "normal" licensing agreement in consideration of royalty income.

For example, we suggest that Section 16EC(4)(b) could be amended as follows:-

"the relevant right is, while the licence is in force, used wholly and principally outside Hong Kong by a person other than the taxpayer, except where the relevant right is used by a person other than the taxpayer who is engaged by the taxpayer to use such right to manufacture goods solely for sale to the taxpayer or to the order of the taxpayer."

6.3 The introduction of comprehensive TP legislation

Following a public consultation exercise, the Hong Kong Government issued the Consultation Report[5] which indicated that it would seek to enact amendments to the IRO to implement a comprehensive TP regime in Hong Kong. The legislation is expected to be introduced into LegCo in early 2018.

The introduction of comprehensive TP rules in Hong Kong provides a basis to reopen discussions with the Government about amending Sections 39E and 16EC. This is because (as explained in part 4.2 above), the Government previously sought to justify its hard-line position by referring to TP concerns if the IRD were to relax its position under those sections. The introduction of a formal comprehensive TP regime means that any TP concerns and potential abuses can now be met by applying the new TP rules, in which case the strict position taken by the IRD under Sections 39E and 16EC can now be relaxed.

Specifically, from a TP perspective, transactions between related companies should be carried out on an arm's length basis, and the profits of related entities should be ascertained depending on the economic benefits, risks and functions assumed by them under the relevant transactions.

In the typical example of a Hong Kong taxpayer having ownership of equipment and/or IPRs which are provided to a contract manufacturer on the Mainland to use in its manufacturing processes, the Hong Kong taxpayer generally assumes the role of a principal in the integrated value chain, while the factory outside Hong Kong generally assumes the role of a limited risk contractor in producing the requisite products according to the specifications and instructions provided by the Hong Kong taxpayer. In most cases, the processing factory outside Hong Kong depends heavily on the Hong Kong taxpayer to provide equipment and IPRs for use in the production process.

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[5] The three-tier documentation requirement consisting of TP master file, local file and County by Country "CbyC report" provides the tax authorities with a risk assessment platform with greater visibility of taxpayers' global arrangements and help them to identify targets for tax and TP audits. The Consultation Report has specified the thresholds for triggering the preparation of master file and local file. Please refer to **Appendix 9** a publication issued by KPMG summarizing the key areas set out in the Consultation Report.

As a principal, the Hong Kong taxpayer bears most of the trading risks and undertakes most of the activities attributable to value creation in the value chain. For instance, the Hong Kong principal performs sales and marketing activities in identifying customers and securing orders, identifies the appropriate processing factories to assist with the production, and provides them with equipment and IPRs for no fee.

As a limited risk contractor, the processing factory outside Hong Kong generally provides the plant facilities and labour in producing the goods based on the specifications and instructions provided by the Hong Kong principal.

From a TP perspective, under this function and risk profile, the commercial value from the value chain cannot be realised and materialised without the principal's (i.e. the Hong Kong manufacturer's) activities and input (e.g. equipment and IPRs) The factory alone would not be able to realise the same value. For this reason, the principal, from a TP perspective, should presumably enjoy the residual profits from the entire value chain, whilst the limited risk contractor should only be entitled to a routine level of profits which remunerate its limited risks and functions. The level of profits calculated by adopting this approach should result in a reasonable level of profits being reported by the Hong Kong taxpayer for Profits Tax purposes.

Under the tax symmetry principle, the Hong Kong taxpayer, being the owner of the relevant equipment and IPRs and who has incurred the relevant capital expenditure, should be entitled to claim the corresponding tax deductions and capital allowances whether or not relevant equipment or IPRs is used by the factory outside Hong Kong. Under TP principles, the profits derived by the Hong Kong taxpayer will already have been calculated by taking into account the provision by the taxpayer of any equipment and IPR to the factory outside Hong Kong.

6.4 Commercial considerations when expanding business overseas

Under the B&R Initiative, the Hong Kong business community is being encouraged to set up business in the 60+ economies along the Belt & Road. While the business community embraces the opportunity and the drive for deeper regional development under the B&R Initiative, Hong Kong businesses will have reservations about investing in equipment and IPRs when deciding whether to establish factories or other production plants in those countries, in view of the unfavourable tax treatment that would apply if they incur expenditure on equipment and IPRs to be provided to overseas factories.

In addition, we would note that, for various reasons, principally related to protection of ownership rights in respect of equipment and intellectual property rights in respect of IPRs, Hong Kong taxpayers understandably prefer to retain ownership of their equipment and IPRs where they intend to subcontract manufacturing activities to a factory.

Finally, it is worth noting that, in some cases, if manufacturing equipment and IPRs were not provided free of charge to the overseas factories, from a practical standpoint, companies engaged in offshore manufacturing face difficulties in receiving remittances of rental income and royalties from certain overseas jurisdictions due to their foreign exchange control regulations.