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Tapping into new opportunities offered by CEPA: A practical guide for investors

Signed on 29 June 2003, the Closer Economic Partnership Arrangement (CEPA) has provoked vigorous discussions and debates in the Hong Kong community.

The agreement is the first bilateral Free Trade Agreement (FTA) signed between Hong Kong and the Chinese Mainland. Formulated within the ambit of the World Trade Organisation (WTO), the agreement aims to remove substantial trade and investment barriers between Hong Kong and the Chinese Mainland without affecting other countries' access to the two markets. As CEPA unleashes new opportunities for various industries and service sectors in Hong Kong, many local and overseas investors are eager to learn how they can capitalise on and to reap the benefits of the agreement.

The content of CEPA has been enhanced with the signing of six annexes on 29 September 2003. Although details of the agreement will be updated continuously via ongoing talks between the governments, the general framework and some major terms have already been set and can be leveraged on by investors.

CEPA covers three broad areas, namely trade in goods, trade in services and investment facilitation.

Leveraging on the opportunities in Trade in Goods

The Chinese Mainland will adopt a zero tariff policy for 273 types of imported goods of Hong Kong origin from 1 January 2004. These include electrical and electronic products, plastic articles, paper articles, textiles and clothing, chemical products, pharmaceutical products, clocks and watches, jewellery, cosmetics, meal products and other miscellaneous goods. The zero tariff policy will be extended to cover other products made in Hong Kong upon application by manufacturers and is subject to agreement on rules of origin no later than 1 January 2006.

In order to enjoy zero tariff, a Hong Kong manufacturer should apply for a Certificate of Hong Kong origin — CEPA, either from the Trade and Industry Department (TID) or one of the Government Approved Certification Organisations. The certificate should be



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passed to the Mainland importer, who will then present the certificate to the customs authorities upon lodgement of the import declaration.

Manufacturers who wish to take advantage of the zero tariff policy should make sure that their goods fulfil the rules of origin requirements. Among the 273 product codes, 68% will adopt Hong Kong's existing origin rules as CEPA origin rules. These include products such as textiles and clothing, jewellery, cosmetics, pharmaceutical products, and plastic and paper articles. 17% of the products, such as chemicals, metal products, some electronic products and electronic components, will use the "Change in Tariff Heading" approach as CEPA origin rules. 15% of the products, such as some electronic and optical components, watches and clocks, etc, will adopt a 30% value added requirement as CEPA origin rules. Product development costs, such as design, development, intellectual property rights, etc, will be taken into account in calculating the value-added percentage.

The zero tariff policy will not only enhance the price competitiveness of the products made in Hong Kong for export to the Mainland, but will also provide an option for manufacturers to expand their existing facilities or set up new production lines in Hong Kong. In order to justify new production in Hong Kong or the reengineering of existing production structures, manufacturers need to consider the following factors carefully:

- Whether the company is able to reap high savings in tariffs — exporters of high-end products to China will likely benefit as these products are previously subject to high import tariffs;
- Whether the company depends on imported raw materials or intermediate goods from overseas rather than sourcing from the Mainland — sourcing from the Mainland will likely affect the company's ability to meet the rules of origin requirements; manufacturers who previously had to pay high tariffs for importing parts and components from overseas for production in China may achieve savings by relocating production lines to Hong Kong;
- Whether the company can leverage on its strong or premium brand image and charge a higher price for the "made in Hong Kong" label for its products — companies that are adept in design and quality control and have the ability to develop upmarket brands or products will be more competitive in the Mainland market;
- Whether the value added components of the company's goods (such as brand, design, technology, etc) are higher than the labour input — given the higher average wage and rent in Hong Kong, manufacturers of goods that involve a higher labour input component may not benefit from the savings in tariffs;
- Whether the intellectual property input takes up a predominant share of the overall cost structure and hence requires strong IP protection — as Hong Kong offers high-standard and strong protection of the proprietary technology or invention, some investors may prefer investing in Hong Kong;
- Whether the goods are produced in limited quantity rather than mass production — setting up a mass production line in Hong Kong may not be feasible or profitable for large scale manufacturing activities due to the high land cost and scarcity of space in Hong Kong; an alternative for certain industries is to have research, design, development and production of the core and most high value-added components performed in Hong Kong, with mass production of the final products subcontracted to Mainland factories;
- Whether sufficiently skilled workers are readily available in Hong Kong, or whether they are able to adopt advanced technology in production.

As Hong Kong's advantages may offset lower cost levels in China, it will be worthwhile for certain niche and high value-added industries, such as pharmaceutical industries, high-end fashion, jewellery, watch and electronic industries, to consider using Hong Kong as their production or product development base for OBM (original brand manufacturing). Manufacturers who have



already established distribution networks on the Mainland may also find new opportunities of forming partnerships or negotiating licensing agreements with international brands to produce and distribute for the Mainland market.

Some manufacturers may consider changing their inter-company pricing strategy to take advantage of the benefits offered by CEPA. They may try to reduce the inbound transfer prices of materials or intermediate goods sourced from overseas associates and increase the relative value of inputs sourced in Hong Kong. **Before adjusting their inter-company pricing strategy, however, manufacturers should make sure that the change in strategy will not give rise to any transfer pricing problems.** They are recommended to seek professional advice if necessary.

Leveraging on the opportunities in Trade in Services

The Chinese Mainland has granted specific market concessions to Hong Kong enterprises trading in 18 service sectors. These include management consulting, convention and exhibition, advertising, accounting, real estate and construction, medical and dental, distribution, logistics, freight forwarding agency, storage and warehousing, transport, tourism, audiovisual, legal, banking, securities, insurance and telecommunication services. To qualify for the benefits guaranteed by CEPA, an enterprise must have substantive activity in Hong Kong. The general criteria for determination include:

- The nature and scope of its business in Hong Kong — it should include services it intends to provide on the Mainland;
- The years of operations in Hong Kong — for most services, the minimum period of the enterprise's business operations in Hong Kong is three years, but for construction, banking and insurance, the requirement is five years. There is no limitation in the years of operation for real estate services;
- Liable to pay profits tax in Hong Kong;
- Own or rent premises in Hong Kong — the scale of the business premises must be commensurate with the scope and scale of the enterprise's business;
- At least 50% of employees are residents staying in Hong Kong without limit of stay and people from the Mainland staying in Hong Kong on a One Way Permit.

The specific benefits offered by CEPA vary from industry to industry, but in general, CEPA offers Hong Kong firms earlier and wider accessibility to the Mainland market ahead of China's WTO commitments. For example, management and consulting firms in Hong Kong may set up wholly owned companies on the Mainland from January 2004, which is more than three years ahead of China's WTO commitment. Companies that engage in logistics and transport services, construction and related services, and distribution services may set

up wholly owned companies one year ahead of China's WTO timetable. CEPA also allows Hong Kong firms wider access to the various services markets, including construction and related services, logistics, and transportation services, distribution services, tourism, legal services and audiovisual services. Five telecom subsectors, including paging, messaging, Internet access, content services and data storage will also allow access from Hong Kong telecom companies.

To obtain the CEPA treatment, a Hong Kong firm should apply for a Certificate of Hong Kong Service Supplier (HKSS) from the Trade and Industry Department in order to establish its status as a "Hong Kong Service Supplier". Upon receipt of the certificate, the supplier can then apply to the relevant Mainland authorities for permission to supply the relevant services under CEPA.

CEPA also extends benefits to Hong Kong permanent residents, who as natural persons, may apply to the relevant authorities on the Mainland for the supply of services under CEPA. Such services include legal, accounting, medical, insurance and securities. CEPA also formalises the practice of allowing Hong Kong permanent residents to set up individually owned retail stores in the Guangdong Province for the provision of retailing services.

Foreign investors who intend to acquire a Hong Kong enterprise in order to capture the benefits offered by CEPA should take note of the rules on mergers and

acquisitions that govern the eligibility of the enterprise as a "Hong Kong Service Supplier". An enterprise being merged or acquired on or after 29 June 2003 will not qualify as a "Hong Kong Service Supplier" within the first year of the merger or acquisition.

It should also be noted that a Hong Kong firm that has changed the nature of its business operation in recent years may not qualify to enjoy the arrangements under CEPA, as the arrangement requires most service suppliers to engage in the same nature of substantive operation for a minimum period of three years or more. For example, a service supplier that has been in business operation since 1995 but has changed its operation from accounting to management consulting in 2002 will not qualify to set up a wholly owned management consulting operation in China under CEPA. Given the requirements on substantive business operation and the rules on mergers and acquisitions, foreign investors who intend to acquire Hong Kong firms should assess whether their acquisition target has fulfilled the substantive business operation requirements, and whether the

merger can still enable the firm to capture the first mover advantages despite a one-year delay.

Trade and Investment Facilitation

CEPA includes a range of measures to help facilitate trade and investment. These include simplifying procedures and strengthening cooperation between Hong Kong and the Mainland in seven areas, namely, trade and investment promotion, customs clearance facilitation, commodity inspection and quarantine, food safety, quality and standardisation, electronic business, transparency in laws and regulations, cooperation of small and medium enterprises and cooperation in the Chinese medicine industry.

To conclude, Hong Kong firms have to work hard and act fast in order to capitalise on the preferential tariff policy and other advantages offered by CEPA. Given the relative immaturity of the Mainland's service sectors and complex regulatory practices, however, Hong Kong firms may have to take on the risk of early exposure to the myriad of problems and complications on the Mainland.

"Winning entries of the Summer Holiday Competition"

Here are the winning entries. At least someone kept cool in the long hot summer.



Congratulations!

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