

**For meeting on
14 January 2002**

Legislative Council Panel on Commerce and Industry

Dutiable Commodities (Amendment) Bill 2002

PURPOSE

This paper seeks Members' views on the Administration's proposal to extend the Open Bond System (which is currently applied to bonded warehouses storing oil and to breweries) to all bonded warehouses in Hong Kong and on the contents of the Dutiable Commodities (Amendment) Bill 2002 which seeks to amend the existing legislation to enable the implementation of the new arrangements.

BACKGROUND AND ARGUMENT

Bonded Warehouse Arrangements: Closed Bond System Vs Open Bond System

2. Duty is imposed on liquor, tobacco, hydrocarbon oil and methyl alcohol used for local consumption (as opposed to export or re-export) in Hong Kong. The bonded warehouse is a duty-deferral facility. Owners of dutiable commodities may store their goods "under bond" in a Customs controlled warehouse until such time as they are ready to pay the duty or otherwise discharge the duty liability. Upon entry of dutiable goods into a bonded warehouse, the warehouse operator incurs a duty liability for the goods. This liability is discharged when the goods are duty paid, exported or transferred to another bonded warehouse. There are currently 60 warehouses storing dutiable commodities in Hong Kong. They are licensed and controlled by the Customs and Excise Department (C&ED) under either a closed bond system (CBS) or an Open Bond System (OBS). They are managed by either warehouse operators or the

importers/manufacturers of the dutiable commodities.

3. The majority of our bonded warehouses (51, which are mainly for storing liquor and tobacco) are controlled under the CBS, whereby to ensure compliance and protect government revenue, C&ED exercises full physical control over goods entering, leaving, being stored or processed in bonded warehouses. Officers of C&ED are stationed full-time at the warehouses to supervise the movement of dutiable commodities, exercise physical control over dutiable commodities held there and over the bonded warehouse itself, endorse the permits issued by C&ED for the removal, domestic sale and export of the goods, supervise all vanning (i.e. loading of dutiable goods into a cargo container for export) and devanning (i.e. unloading of dutiable goods from an imported cargo container), and supervise labelling, sampling, bottling, blending, denaturing, and other in-bond operations. In the absence of Customs officers, the warehouses are required to be closed under revenue locks. The warehouse operators/traders must meet government's charges in respect of C&ED officers in their role as warehouse officers. The fees range from \$60,000 to \$330,000 per warehouse per month (depending on the number of C&ED officers stationed in the warehouse). In addition, a fee of \$500 is charged for every vanning or devanning operation. Around \$70 million is expected to be paid to C&ED in 2001-02 for the service of about 150 Customs officers.

4. The oil companies and the breweries (nine in total) have been granted permission to operate under the OBS. Under this system, no Customs officer is stationed on the premises to provide physical supervision, and warehouse operators do not have to pay any attendance fee to the government. Control of dutiable commodities mainly relies on self-compliance by the licensee, and on risk-management and periodic inspections by Customs. Under the OBS, licensees are given full

autonomy in managing the stock inventory of raw materials, finished products or dutiable goods stored and in supervising releases of the goods for local consumption and export.

The Consultancy Study

5. The Administration commissioned a consultancy study in 1999 on the feasibility of extending the OBS to all bonded warehouses in Hong Kong, taking into account overseas experience and practices. The study confirmed the feasibility and benefits of introducing an OBS more widely in Hong Kong. It confirmed that extension of open bond arrangements to the liquor and tobacco industry would reduce traders' compliance costs, induce additional business opportunities and enhance Hong Kong's competitiveness in the international market. It pointed out that while in general, there would be an increase in revenue fraud, missing goods, thefts, mishandling of dutiable commodities, etc. upon the withdrawal of Customs officers, the risk of revenue loss would be manageable if we had in place a comprehensive audit and risk-management system. The consultancy further noted that Australia, Canada, New Zealand, Singapore, UK and USA had already moved to OBSs. It recommended the adoption of the Australian model (as the Australian duty system is the closest to Hong Kong's), and made suggestions for a structured audit method to check the compliance of warehouse owners and for the necessary legislative amendments.

The Pilot Scheme

6. We accepted the consultancy findings and launched a pilot scheme to test the implementation of an OBS for liquor and tobacco bonded warehouses and the auditing framework as recommended by the consultant. The pilot scheme was conducted from 1 January to 30 June 2001 on five bonded warehouses randomly selected. Feedback from the participants was highly positive. They found the operation of the OBS

very smooth and successful, and had no difficulty in complying with the new reporting and other obligations. The majority considered that the OBS had enhanced their management flexibility and had brought considerable savings in operating costs. The participants expressed strong support for the introduction of the OBS to their bonded warehouses on a permanent basis. From the revenue protection aspect, we observed no anomaly in the duty collected from the participating warehouses when compared to the trend over the same period in other bonded warehouses.

Implementation of OBS

7. We recommend to introduce the full implementation of the OBS in two phases. In the first phase, the OBS would be applied to all bonded warehouses, including warehouses storing tobacco and liquor, except distilleries (which are manufacturing cum storage places for liquor). C&ED would withdraw Customs officers' attendance at these warehouses, while conducting surprise checks on the riskier operations such as vanning and devanning. In the second phase to be implemented some six months after the first phase, the OBS would be extended to distilleries, which require a more comprehensive control system to be in place.

CONTENTS OF THE BILL

8. The existing Dutiable Commodities Ordinance is designed for the control of bonded warehouses under the CBS. For the oil companies and breweries where the OBS is in operation, C&ED control, especially the requirements to produce commercial documents for audit purposes, is achieved through administrative means. If the OBS is to be extended to all bonded warehouses in Hong Kong, a legal basis has to be provided for this to ensure its smooth operation and the effective protection of revenue. Also, as the CBS will be gradually phased out,

the provisions relating to that will become obsolete and need to be deleted.

Transitional arrangements for existing bonded warehouse licensees

9. The existing bonded warehouse licences are valid for one year. We intend that, after the Amendment Ordinance has come into effect, we should be prepared to allow licensees to operate according to the existing law and the terms and conditions of their existing licences until expiry, whereupon C&ED would assess their applications for renewal, based on the requirements of the Amendment Ordinance.

10. However, since some licensees might opt to operate under the OBS before their existing licences had expired, we also intend to allow them to surrender their existing licences to C&ED and apply for new licences under the terms of the Amendment Ordinance. C&ED would make a pro-rata refund of the licence fee paid for the unexpired period of validity of the existing licence.

Relaxing restrictions on the operation of bonded warehouses

11. As the need for Customs officers' full-time attendance would be removed under the OBS, we propose to delete the provisions in the Dutiable Commodities Regulations (the Regulations) that require C&ED's attendance for certain operations.

12. We intend to replace the regulation that prescribes the hours of opening for bonded warehouses, with a requirement for warehouse licensees to inform C&ED in advance of the opening of warehouses or changes in the reported opening hours. This will allow the operators to decide on the operating hours of their warehouses and at the same time, will facilitate the conduct of surprise checks by C&ED.

13. Without C&ED's attendance under the OBS, there could be more unintended mistakes in the stock account of the quantity and description of dutiable goods. We consider that it would be reasonable to subject such unintended mistakes to the compounding procedure where the deviation from the stock account does not exceed \$10,000 in terms of the duty value of the goods involved.

Tightening licensing, record-keeping and auditing requirements

14. To minimize the risk of duty evasion under an OBS, we would need to tighten the licensing, record-keeping and auditing requirements for warehouse owners.

15. Section 7 of the existing Ordinance empowers C&ED to grant and issue licences for operating bonded warehouses, to attach conditions to the licences and to revoke licences issued. For the sake of clarity, we propose to state in the Ordinance the factors that C&ED shall take into account when considering the grant or renewal of licences for operating bonded warehouses, including -

- (a) the financial status of the applicant;
- (b) the suitability of the documents that the applicant proposes to keep for C&ED's auditing, the systems and procedures in respect of inventory control, record-keeping and security of the warehouse; and
- (c) the fitness and propriety of the applicant and the persons who are or will be wholly or mainly responsible for managing the warehouse, including directors where the applicant is a body corporate.

16. As to record-keeping and auditing requirements, it is crucial under an OBS that warehouse-keeper should keep and produce the

documents that would allow C&ED to perform full and effective audit checks. We intend to expand the list of information required to be kept and produced by the warehouse-keeper to include all the movement and payment records, balance sheets and audit reports. These documents are necessary for C&ED to ascertain whether a stock account and record is genuine and trustworthy.

PUBLIC CONSULTATION

17. We have fully consulted bonded warehouse owners and traders in dutiable goods on the detailed arrangements and requirements under the OBS. In the first half of 2001, we conducted a pilot scheme on the OBS. Participants expressed strong support for the implementation of the OBS. We have also considered the trade's feedback on the detailed arrangements under the OBS and have duly reflected such suggestions in the Bill.

18. We have consulted the Business Advisory Group which strongly supported implementation of the OBS. The Group also gave an award to the OBS initiative under the Helping Business Awards Scheme 2001.

ADVICE SOUGHT

19. Members' views on the Administration's proposal to extend the OBS to all bonded warehouses in Hong Kong and on the contents of the Dutiable Commodities (Amendment) Bill 2002 are sought.

Finance Bureau
January 2002