Press release

LCQ1: Depreciation allowances

Wednesday, November 4, 2009

Following is a question by Dr the Hon Lam Tai-fai and a reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (November 4):

Question:

At the meeting of this Council on October 21, 2009, I raised a question regarding the initial allowances and annual allowances (depreciation allowances) on machinery and plants. In connection with the reply given by the Secretary for Financial Services and the Treasury to this question, will the Government inform this Council:

(a) given that section 39E of the Inland Revenue Ordinance (section 39E) aims at limiting tax avoidance opportunities in various forms of machinery or plant leasing arrangements, and the Government also agrees that under the import processing arrangement, Hong Kong enterprises may make their machinery or plants (mainly moulds) available for use by mainland enterprises free of charge for manufacturing goods which these Hong Kong enterprises will buy from the mainland enterprises, and not for the purpose of "tax avoidance", why the Government still considers such arrangements as leasing arrangements and applies section 39E to restrict the granting of depreciation allowances to Hong Kong enterprises to which they are entitled in respect of these machinery and plants;

(b) given that the Government has indicated that the practice notes of the Inland Revenue Ordinance have no legal binding force and can never change the legislative intent of the relevant provisions, why the authorities needed to amend the original practice notes in 2006 and extended the retrospective period of the amended notes to the previous years of assessment; how the Government fulfils the assurance it made upon the enactment of section 39E in 1986 that the provision only targeted at the two leasing arrangements of "sale and leaseback" and "leveraged leasing"; and

(c) given that the Government has indicated that there are practical difficulties in relaxing the relevant restriction in (a), including the difficulties in confirming if the machinery or plant was solely used on the Mainland for manufacturing goods sold to the Hong Kong enterprise concerned, if the machinery or plant has been sold and if the depreciation allowances concerned have been claimed by others, whereas there are provisions in the Inland Revenue Ordinance stipulating that under certain circumstances the burden of proof shall rest on the taxpayers, whether the Government will allow taxpayers to provide evidence in this respect to address such difficulties, so that the legislative intent of section 39E will not be violated when this section is enforced?

Reply:

President,

(a) As I pointed out in my reply to Dr the Hon Lam Tai-fai's written question on October 21 this year, section 39E of the Inland Revenue Ordinance (IRO) was enacted in 1986 and amended in 1992 to become the current version. The legislation aims at limiting tax avoidance opportunities in various forms of machinery or plant leasing arrangements. The relevant provision stipulates that a Hong Kong enterprise will be denied depreciation allowances if the machinery or plants owned by it are used wholly or principally outside Hong Kong by another enterprise.

Section 39E or any other specific anti-avoidance provision in the IRO will apply if a commercial arrangement is within the specific scope of the provision. The Inland Revenue Department (IRD) cannot exercise its power under the law selectively.

(b) Section 39E was indeed enacted in 1986 to target "sale and leaseback" and "leverage leasing" arrangements only. However, after the 1992 amendment, depreciation allowances will also be denied if the machinery or plants owned by a Hong Kong enterprise are used mainly by another enterprise outside Hong Kong. The IRD reflected this amendment to section 39E in its update on Departmental Interpretation and Practice Notes (DIPN) No. 15 in 1992. The further update on DIPN No. 15 in 2006 was only to provide more detailed explanations and real life examples. In no way did the update in 2006 change the scope of section 39E.

The time limit for raising additional assessments under the IRO is six years. The IRD has all along been issuing additional assessments in accordance with the provisions of the IRO. It has no authority to vary the statutory time limit to cater for different situations.

(c) I have already pointed out in my written reply on October 21 that there are practical difficulties in relaxing the restrictions of section 39E. Although the taxpayer has the onus of proof under the IRO, as the relevant machinery or plants are used by another enterprise outside Hong Kong and such an enterprise is usually a separate legal entity, it would be difficult for the IRD to check the actual usage of the relevant machinery or plants. Besides, the IRD does not have the statutory power to request such an overseas entity to provide supporting documents. If the relevant restriction is relaxed, the specific anti-avoidance provision can easily be exploited, resulting in tax deferral or loss and a large number of cases in dispute.

Ends