Press release

LCQ16: Section 39E of the Inland Revenue Ordinance

Wednesday, December 9, 2009

Following is a question by Dr the Hon Lam Tai-fai and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (December 9):

Question :

I raised questions regarding the depreciation allowances on machinery and plants under section 39E of the Inland Revenue Ordinance (section 39E) at the meetings of this Council on October 21, November 4 and November 25 of this year respectively. Regarding the replies given by the Secretary for Financial Services and the Treasury, will the Government inform this Council:

(a) whether the authorities have, on the basis of "balance of probabilities", which is the standard of proof generally adopted in civil litigation cases, assessed the feasibility of allowing taxpayers to provide their own proof to prove that section 39E does not apply to the activities involved; if they have assessed, of the results; if not, the reasons for that;

(b) given that the former Secretary for the Treasury indicated at the meeting of the former Legislative Council on March 11, 1992 that the amendment to Inland Revenue (Amendment) (No. 5) Bill 1991 aimed "to apply the new provisions relating to leveraged leasing to transactions entered into on or after November 15, 1990 only in respect of ships and aircraft", why the Government now states that since 1986, section 39E has already covered machinery or plants other than ships and aircraft;

(c) given that the Government has stated that it had noticed at that time many companies could technically circumvent the definition of "leveraged leasing", yet the Legislative Council Brief of 1991 did not mention such situations, of the justifications for the Government to make such a statement, whether there are any data indicating the number of companies involved in such arrangements at that time, and of the detailed explanation of "technically circumvent the definition";

(d) according to the Legislative Council Brief dated November 13, 1991, the taxation loophole at that time was that foreign operators who had acquired ships or aircraft through limited partnership in Hong Kong were granted depreciation allowances for profits tax in the capacity as Hong Kong operators, whether this situation is different from that of "technically circumvent the definition" raised by the Government at present;

(e) of the reasons for the Government to amend section 39E(1)(c)(i) from "(i) the person holding rights as lessee is not a person who is deemed by section 23B to be carrying on a business as the owner of ships in Hong Kong; and" to "(i) the person holding rights as lessee is not an operator of a Hong Kong ship or aircraft; or" when section 39E was amended in 1992;

(f) given that the former Secretary for the Treasury referred to the amended section 39E as "the new provisions relating to leveraged leasing" at the meeting of the former Legislative Council on March 11, 1992, why the Government now claims that the scope of application of section 39E has been extended beyond "sale and leaseback" and "leveraged leasing" arrangements to cover all kinds of leasing arrangements;

(g) given that the Government has stated that section 39E is an anti-avoidance provision, on what criteria the Government has based to decide that, for the activities of Hong Kong enterprises engaging in import processing, the provision would be applicable to those related to commercial arrangements falling within the "specific scope of the provision", and whether it has assessed if such criteria are still applicable to the current economic and social situations; as the Government has indicated that the provision would be applicable to any commercial arrangement falling within the specific scope of the provision, why the Government still assured the former Legislative Council in 1986 that the Ordinance concerned would only be used to strike down tax avoidance;

(h) given that the Government has stated that the assurance (only to be enforced in circumstances of actual necessity) given by the then Commissioner of Inland Revenue (the Commissioner) upon resumption of the Second Reading debate on the Inland Revenue (Amendment) Bill 1986 (the Bill) was a general assurance in respect of the Bill as a whole rather than a specific assurance in respect of section 39E, as the provision was included in the Bill, whether the assurance concerned covers section 39E;

(i) given that in the appeal case with decision number D51/08, the counsel representing the Commissioner pointed out that the Departmental Interpretation and Practice Notes No. 15 (P.N. 15) updated in 2006 was not applicable before January 2006, whether it has assessed his grounds; if it has, of the results; if not, the reasons for that;

(j) why the term "lease" was explained in the P.N. 15 updated in 2006 but not in the P.N. of 1986 and that of 1992;

(k) given that the Government has stated that section 39E is an anti-avoidance provision, the Board of Review, however, pointed out in the appeal case with decision number D61/08, 24 IRBRD 184 that it was not stipulated in section 39E that there should be "an intention to avoid tax" in order for the provision to apply; whether the authorities have assessed if the two arguments contradict each other, and what the effects are on its decision of the Board not considering the statutory setting of the Bill in 1986 when making such a decision; and

(l) given that the authorities have stated that as long as the machinery or plants are wholly or principally used outside Hong Kong, the taxpayer concerned would not be granted depreciation allowance, what the meaning of "principally used outside Hong Kong" is, whether there are any objective and quantifiable standards to define "principally", and whether the taxpayer concerned is allowed to explain the use of the machinery or plants outside Hong Kong; if he is not allowed to do so, of the reasons for that?

Reply:

President,

(a) The Inland Revenue Department (IRD) must deal with depreciation allowances claims it receives from taxpayers according to the law. While taxpayers may provide information to prove that relevant activities are not restricted by section 39E, it is the responsibility of the IRD to verify whether the information provided by taxpayers meets the statutory requirements.

(b) The main purpose of that speech made by the then Secretary for the Treasury was to clarify the retrospective effect of the part of the 1992 amendment bill concerning ships or aircrafts, rather than to indicate the applicability of the original section 39E. Section 39E has covered machinery or plants other than ships and aircrafts since its enactment in 1986.

(c) and (d) As mentioned in my reply to Dr the Hon Lam Tai-fai's written question on November 25 this year, the main purpose of amending section 39E in 1992 was to prevent companies from abusing the conjunction "and", which separated sub-paragraphs (i) and (ii) of both sections 39E(1)(b) and (1)(c). Such abuse enabled certain leasing arrangements to circumvent the scope of "leveraged leasing", even though the machinery or plants (including ships and aircrafts) under such arrangements were principally used by other persons outside Hong Kong. "Technically circumvent the definition" generally refers to any arrangement taking advantage of the loopholes of section 39E. The IRD has not kept records of the number of companies involved in such arrangements.

(e) Under the original section 39E(1)(c)(i) in 1986, it was relatively easy for overseas users of ships or aircrafts to technically satisfy the condition of "carrying on business in Hong Kong", thus circumventing section 39E. The amendment in 1992 was to plug this loophole by stipulating that a user of a ship or aircraft under the leasing arrangement must be an "operator of a Hong Kong aircraft" or an "operator of a Hong Kong ship".

(f) In my reply to Dr the Hon Lam Tai-fai's written question on November 25 this year, I explained in detail the evolution of section 39E from its enactment in 1986 to its amendment in 1992. The scope of application of the current section 39E indeed goes beyond "sale and leaseback" and "leveraged leasing" arrangements as targeted in 1986.

(g) and (h) Section 39E does not stipulate that the provision may only apply to leasing arrangements with "the intention to avoid tax". It is applicable to any commercial arrangement falling within the specific scope of the provision, irrespective of whether such arrangement is intended for tax avoidance. The IRD cannot enforce this provision selectively.

(i) The main issue in dispute in the Board of Review case D51/08 was the source of profits, not section 39E. In that case, the Board of Review decided that the Departmental Interpretation and Practice Notes No. 15 (DIPN No. 15) as revised in 2006 was issued after the relevant year of assessment and hence should not be applicable to that case. The decision was not related to the time limit set in the Inland Revenue Ordinance (IRO) for raising assessment.

(j) As mentioned in my reply to Dr the Hon Lam Tai-fai's written question on November 25 this year, the definition of "lease" has been provided in section 39E since its enactment in 1986. While the IRD updates the Departmental Interpretation and Practice Notes (DIPNs) as and when necessary to provide explanations and examples for individual provisions, such DIPNs cannot change any provision in the law.

(k) As mentioned in my reply to Dr the Hon Lam Tai-fai's written question on November 25 this year, section 39E of the IRO is a specific anti-avoidance provision. It is applicable to any commercial arrangement falling within the specific scope of the provision. It is not a factor for consideration whether there is "an intention to avoid tax". This point has been confirmed by the decision of the Board of Review case D61/08. There is no contradiction.

(l) Regarding the phrase "used wholly or principally outside Hong Kong", the IRD has given an explanation in paragraph 17 of DIPN No. 15 (2006 revised version). This is a question of fact, which has to be decided having regard to the circumstances of the case. Taxpayers can certainly provide explanations regarding their tax matters, but the IRD has the responsibility to verify the information provided by taxpayers.

Ends