

## **Press release**

### **LCQ17: Depreciation allowances**

Wednesday, October 27, 2010

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 (October 27):

Question:

Regarding the depreciation allowances on machinery and plants under section 39E of the Inland Revenue Ordinance (Cap. 112) (section 39E), will the Government inform this Council:

(a) given that in his reply to my question raised at the Chief Executive's Question and Answer Session on July 13 this year, the Chief Executive said that Hong Kong levies tax on a territorial basis, and once any capital or economic activity leaves Hong Kong, it will be dealt with in a different way, which must not contravene the territorial source principle of taxation, whether the authorities can explain this view in detail;

(b) why Hong Kong manufacturers are entitled to depreciation allowances on capital expenditure for their investments in commercial buildings or structures on the Mainland but the machinery or plants installed on the Mainland are not entitled to the same arrangement;

(c) given that in his reply to my question raised on November 25, 2009, the Secretary for Financial Services and the Treasury indicated that the Government considered that the implementation of section 39E by the Inland Revenue Department (IRD) was in accordance with the legislation and was supported by case law, whether the view was put forward by the Department of Justice (DoJ); if so, of the details, and whether section 39E is applicable to non-tax avoidance circumstances; if not, whether DoJ has been consulted on this, and of the details; apart from the Board of Review case, whether there are other related court cases; if so, of the details; if not, the reasons for that;

(d) given that according to the current taxation principles, in calculating taxable income or profits, taxpayers may apply for deductions on "outgoings and expenses, to the extent to which they have been incurred in the production of chargeable profits", and the relevant profits earned by Hong Kong manufacturers from using machinery or plants on the Mainland are regarded as taxable profits in Hong Kong, why Hong Kong manufacturers, under the same principle, are not entitled to depreciation allowances on the machinery or plants concerned;

(e) given that some members of the trade have pointed out that after section 39E was amended in 1992, IRD did not interpret the arrangement under which Hong Kong manufacturers made available their machinery facilities in Hong Kong for use by Mainland outsourced processors free of charge as equivalent to usages under "lease", and did not restrict such Hong Kong manufacturers from being entitled to depreciation allowances on the facilities concerned, and this situation went on until IRD suddenly changed the interpretation of the definition of "lease" in recent years, and withdrew those depreciation allowances granted and recovered taxes from the enterprises concerned, of the reasons for a sudden change in the position of IRD; of the annual number of cases and tax amount involved in the withdrawal by IRD of the depreciation allowances already granted since 2000 (list in table form);

(f) given that the authorities have indicated that in relaxing the restrictions of the anti-avoidance provisions in section 39E, there are practical difficulties in implementation and may lead to tax avoidance loopholes, whether the authorities have encountered difficulties in implementation and tax avoidance loopholes when levying taxes on international trade and economic activities of other nature; if they have, how they coped with such difficulties, and whether the practical difficulties encountered in relaxing section 39E may be coped with in similar ways; if not, of the reasons for that;

(g) given that the authorities have indicated that there are practical difficulties in relaxing the restrictions under section 39E, whether the authorities will explain specifically such practical difficulties in detail, and whether there is evidence to support such views; if so, of the details; if not, the reasons for that; and

(h) given that some members of the trade have pointed out that IRD has used difficulties in implementation to justify applying the unfair taxation arrangements to persons who have not avoided tax, which violates the legislative intent of section 39E, whether the Government has assessed if there is such an unfair situation at present; if an assessment has been conducted, of the outcome; if not, the reasons for that?

Reply:

President,

(a), (b) and (d) As indicated in our reply to the written question raised by Dr the Hon Lam Tai-fai on November 4, 2009, section 39E of the Inland Revenue Ordinance (IRO) aims at limiting tax avoidance opportunities in various forms of machinery or plant leasing arrangements. Capital expenditure on commercial buildings or structures is not restricted by section 39E.

In fact, if Hong Kong enterprises wish to claim depreciation allowances in Hong Kong for their capital expenditure on commercial buildings or structures constructed in the Mainland, they have to meet two prerequisites: (1) the commercial buildings or structures in the Mainland do not constitute the permanent establishments of the Hong Kong enterprises in the Mainland (e.g. factories and offices in the Mainland would not be qualified), otherwise, capital expenditure on such buildings or structures should be handled according to the Mainland tax laws; (2) the commercial buildings or structures in the Mainland are constructed for the purpose of producing chargeable profits in Hong Kong. Given the above two prerequisites, only rare cases are eligible for claiming depreciation allowances in Hong Kong for capital expenditure on commercial buildings or structures in the Mainland.

Moreover, under the "import processing" arrangements, the relevant Mainland enterprises are separate legal entities which make direct use of the machinery or plant to produce goods for sale to the Hong Kong enterprises or other buyers with a view to generating profits in the Mainland. Based on the territorial source principle of taxation, the profits of these Mainland enterprises are derived from the Mainland and hence not chargeable to Hong Kong profits tax. According to the same principle, since the Hong Kong enterprises engaging in "import processing" in the Mainland conduct merely product trading activities, only profits derived from their trading activities but not the profits earned by the above Mainland enterprises would be subject to Hong Kong profits tax. As such, the Hong Kong enterprises would not be granted depreciation allowances in relation to the production of profits by the Mainland enterprises.

(c) and (h) As indicated in our reply to the written question raised by Dr the Hon Lam Tai-fai on November 25, 2009, the written decision of the Board of Review (BoR) on the case with reference no. D61/08 (24 IRBRD 184) pointed out that section 39E had not stipulated that there should be "an intention to avoid tax" for the application of the provision. At the hearing of the above case, the Commissioner of Inland Revenue was represented by a barrister appointed by the Department of Justice. This demonstrates that the implementation of section 39E by the Inland Revenue Department (IRD) is in accordance with the legislation and is supported by case law.

Apart from the above BoR case, there is no other court cases related to section 39E.

(e) The definition of "lease" was provided in the IRO when section 39E was enacted in 1986. IRD takes enforcement actions in accordance with the relevant legislative provisions. IRD updated the Departmental Interpretation and Practice Note (DIPN) No. 15 in 2006 to include detailed explanations and examples so that it could more clearly reflect the real situation and the principles laid down by court cases. The said DIPN has not changed the definition of "lease". Since IRD normally adopts the "Assess First, Audit Later" mechanism in making tax assessments, if IRD confirms subsequently that the taxpayers are not eligible for claiming depreciation allowances, it will carry out back tax assessments and recover the profits tax from the relevant individuals/companies. IRD does not have data on the amount of back tax assessed in question.

(f) We would review from time to time the tax regime of Hong Kong, taking into account changes arising from the development of international economic and trading activities, business restructuring as well as operational enhancement. In drawing up and amending the tax laws, we would devise relevant anti-avoidance provisions to tackle possible loopholes or abuse in the course of implementation. In fact, the anti-avoidance provision of section 39E was enacted to tackle specifically the then tax avoidance cases emerged in the society.

(g) As indicated in our replies to the written questions raised by Dr the Hon Lam Tai-fai on October 21 and November 4, 2009, there are a lot of practical difficulties in relaxing the relevant restriction, including whether the machinery or plant used in the Mainland is producing profits chargeable to tax in Hong Kong; whether it is used solely for the manufacturing of goods sold to the Hong Kong enterprise; whether the machinery or plant has been sold; whether the goods so produced are wholly sold to the Hong Kong enterprise; whether depreciation allowances for the same machinery or plant have been claimed by other enterprises, etc. Although the taxpayer has the onus of proof under the IRO, as the relevant machinery or plant is used by another enterprise outside Hong Kong and such an enterprise is usually a separate legal entity, it would be difficult for IRD to check the actual usage of the relevant machinery or plant. IRD also does not have the statutory power to request such an overseas entity to provide supporting documents. Moreover, when examining individual tax cases, IRD has once discovered that the confirmation letters provided by the taxpayers were factually incorrect and there were inconsistencies between the financial statements of the Hong Kong enterprise and those of the Mainland enterprise. Hence, IRD could not rely solely on the proof or financial statements provided by the taxpayers to resolve the enforcement difficulties. 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.

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