Press release

LCQ15: Inland Revenue Ordinance section 39E

Wednesday, January 12, 2011

Following is a question by Dr 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 (January 12):

Question:

Regarding section 39E of the Inland Revenue Ordinance (IRO) (Cap. 112) (section 39E), will the Government inform this Council:

(a) given that the Secretary for Financial Services and the Treasury (SFST) indicated in his reply to my question on November 24, 2010 that "according to our understanding, in the course of upgrading and restructuring the processing trade in the Mainland, considerable Hong Kong enterprises have opted to transfer the title of their machinery and plant to the newly established Mainland enterprises as capital injection", and SFST also indicated on December 8 of the same year that the authorities learnt about this situation from the relevant authorities of the Guangdong Province, yet the relevant authorities of the Guangdong Province did not have data that indicated the number of "considerable Hong Kong enterprises", which Mainland authorities are actually referred to as "relevant authorities of the Guangdong Province", when SFST asked them for such information, together with copies of the relevant correspondences and information documents; in the absence of support by actual data, how the Government proves whether the views of the "relevant authorities of the Guangdong Province" are correct;

(b) given that the Joint Liaison Committee on Taxation (JLCT) recommended in its review report to amend the definition related to "lease" in section 2 of IRO, why the Government refuses to accept such recommendation;

(c) whether it has assessed if it is too loose an interpretation for the Inland Revenue Department (IRD) to indicate that the definition related to "lease" in section 2 of IRO covers the situation of Hong Kong enterprises making available their machinery and plant for use by Mainland enterprises free of charge under "import processing"; if it has, of the details; if not, the reasons for that, and whether it will make such an assessment;

(d) given that the review report of JLCT pointed out that when section 39E was amended in 1992, the situation in which Hong Kong enterprises made available their machinery and plant for use by Mainland enterprises free of charge under "import processing" was not prevalent, and therefore the amendments to section 39E at that time were not aimed at handling this situation, whether the Government has assessed if this view is substantiated; if it has assessed, of the details; if not, the reasons for that, and whether it will make such an assessment;

(e) given that SFST indicated on November 24, 2010 that JLCT had not proposed effective measures to plug possible tax avoidance loopholes, whether SFST is responsible for studying how possible tax avoidance loopholes can effectively be plugged; if so, why SFST has not proposed any measure; if not, of the work for which SFST is responsible in respect of section 39E;

(f) given that SFST also indicated on November 24, 2010 that "we are worried that if we accede to the request of some enterprises and provide depreciation allowances in Hong Kong for such machinery and plant, we may be perceived as encouraging transfer pricing...so as to avoid any perception that we are acting in violation of the 'arm's length principle', and that we are in a way encouraging transfer pricing arrangements disapproved by the tax authorities around the world", whether there were other commercial activities that had aroused similar concerns about transfer pricing in the past three years; if so, of such commercial activities, and how the Government handled them;

(g) whether it has assessed if there are similarities between the cost effectiveness resulting from the amendments to section 39E and losses in tax revenue claimed by the Government, and the cost effectiveness and losses in tax revenue resulting respectively from the abolition of estate duty and profits tax from offshore funds in 2006 and the abolition of duty on wine in 2008 by the Government; if it has assessed, of the details; if not, the reasons for that, and whether it will make such an assessment;

(h) given that the Government announced in the 2010-2011 Budget a series of measures to broaden tax relief and amend the tax legislation in order to develop the financial business, including the measures to "extend the stamp duty concession in respect of the trading of exchange traded funds", "amend the provisions under the Inland Revenue Ordinance that require such debt instruments to be issued to the public in Hong Kong" "to better meet market requirements", "further clarify the definition of 'central management and control' to address the industry's concern about the residency requirement for directors of the management committee of offshore funds in their applications for profits tax exemption" by the Commissioner of Inland Revenue (the Commissioner), and "update the lists of recognised stock exchanges and futures exchanges under IRO so as to extend the application of tax exemption for offshore funds engaged in futures trading", whether the Government has assessed if there are similarities between the cost effectiveness to commerce and industry generated by the amendments to section 39E and the cost effectiveness generated respectively by the aforesaid relief measures; if it has, of the details; if not, the reasons for that, and whether it will make such an assessment;

(i) given that SFST indicated in his reply to my question on October 27, 2010 that at the hearing of the case of the Board of Review (BoR) with reference no. D61/08, the Commissioner was represented by a barrister appointed by the Department of Justice (DoJ), demonstrating that the implementation of section 39E by IRD is in accordance with the legislation, whether the Government has assessed if the fact that the Commissioner was represented by a barrister appointed by DoJ at the hearing equals to the fact that the current interpretation of section 39E is recognised by the independent legal opinion of DoJ; if the outcome of the assessment is in the affirmative, of the reasons for that; if the outcome of the assessment is in the negative, why SFST made such a reply;

(j) given that SFST indicated on October 27, 2010 that BoR had pointed out in its written decision on the case with reference no. D61/08 that section 39E had not stipulated that there should be "an intention to avoid tax" for the application of the provision, however, according to section 19 of the Interpretation and General Clauses Ordinance (Cap. 1), an Ordinance "shall receive such fair, large and liberal construction and interpretation as will best ensure the attainment of the object of the Ordinance according to its true intent, meaning and spirit", whether the Government has assessed if the aforesaid interpretation of section 39E by BoR is inconsistent with the principle adopted by the court in the construction of legislation; if it has assessed, of the details; if not, the reasons for that, and whether it will make such an assessment; and

(k) given that the Chief Executive indicated at the Question and Answer Session of this Council on July 13, 2010 that he expected me to follow up the issue of section 39E with SFST and the Financial Secretary (FS), whether SFST has discussed this issue with FS and consulted his opinion; if SFST has done so, of the details; if not, the reasons for that?

Reply:

President,

(a) to (e), (g), (h) and (k) We have completed our review on whether the restriction in section 39E of the Inland Revenue Ordinance should be relaxed. We have also reported timely to the Financial Secretary on the outcome of our review. In our reply to the oral question raised by Dr Hon Lam Tai-fai on November 24, 2010, we have already pointed out clearly that our review has come to a conclusion that there are no justifiable grounds to relax the existing restriction in section 39E and explained in detail the reasons for not relaxing the relevant restriction. Hence, we do not see the need to assess the economic benefits that the relaxation of section 39E would bring about.

During the course of deliberations, we have already taken into consideration the views of the industrial and commercial sector, the accounting sector and tax experts. We have also communicated with the relevant Mainland authorities with a view to understanding the operation and related taxation matters of the processing trade in the Mainland.

(f) In our reply to the oral question raised by Dr Hon Lam Tai-fai on November 24, 2010, we have clearly pointed out the concern of the international community about the transfer pricing issue involved in cross-border trading activities between associated enterprises, and the stance taken by the tax authorities around the world on this issue. Given that the Hong Kong enterprises and the Mainland enterprises are associated parties in many cases, we have to examine the proposal relating to depreciation allowance comprehensively from the perspective of transfer pricing. To address the transfer pricing issue, in the course of negotiating comprehensive avoidance of double taxation agreements (CDTAs), Hong Kong will discuss with negotiation partners the inclusion of provisions stipulating the taxing rights of the two contracting parties for transactions between associated enterprises of the two places according to the "arm's length principle" advocated by the Organisation for Economic Co-operation and Development. As a responsible tax jurisdiction, Hong Kong has to comply with all the provisions in the CDTAs. As such, we should not ignore the possibility of transfer pricing arrangements in the transactions between Hong Kong enterprises and their associated enterprises in the Mainland.

(i) and (j) As the legal representative of the Commissioner of Inland Revenue (the Commissioner), the Department of Justice (DoJ) has to consider thoroughly the legal points of view involved in a case, and to give appropriate instructions to the barrister who will represent the Commissioner at the hearing. Similarly, in the Board of Review (the Board) case with reference number D61/08, the barrister appointed by DoJ to represent the Commissioner at the hearing has already examined the legal points of view involved. The decision of the Board, which could be downloaded from the Board's website, has already covered the legal grounds submitted by the two parties to the case for the Board's consideration as well as the reasons and relevant legal principles adopted by the Board in concluding that section 39E does not stipulate that there should be "an intention to avoid tax" for the application of the provision. The Board is an independent statutory body to determine tax appeals. We respect the Board's decision on the above-mentioned case.

Ends