Press release

LCQ16: Section 39E of the Inland Revenue Ordinance

Wednesday, November 25, 2009

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 (November 25):

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 and November 4 of this year respectively. Regarding the replies given by the Secretary for Financial Services and the Treasury (the Secretary), will the Government inform this Council:

(a) given that according to the explanatory memorandum of the Inland Revenue (Amendment) (No. 5) Bill 1991 (the Bill), the purpose of amending section 39E was to "remove the allowances that may be claimed in certain 'leveraged leasing' transactions", why the Government stated that the amended section 39E no longer targeted merely the two arrangements of "sale and leaseback" and "leveraged leasing";

(b) given that it was pointed out both in the Legislative Council Brief issued by the former Finance Branch in 1991 and by former Secretary for the Treasury during the Second Reading of the Bill in the former Legislative Council on November 27 of the same year that the 1992 amendment aimed at "denying depreciation allowances to all foreign operators of ships and aircraft", of the justifications for the Government to interpret this amendment as restricting the granting of depreciation allowances to owners of machinery or plants other than aircraft or ships;

(c) given that the 1992 amendment only changed the word "and" to the word "or" between section 39E(1)(b)(i) and (ii), why the Government interpreted this amendment as extending the application of section 39E (i.e. not only targeting the two arrangements of "sale and leaseback" and "leveraged leasing"); given that the Secretary stated that "the legislation aims at limiting tax avoidance opportunities in various forms of machinery or plant leasing arrangements machinery or plants", what forms are being referred to by "various forms";

(d) given that the Legislative Council Brief issued in 1991 by the former Finance Branch, the speech delivered by the former Secretary for the Treasury during the Second Reading of the Bill in 1991, as well as the speech delivered in 1992 during the resumption of Second Reading of the Bill by the convenor of the ad hoc group of the former Legislative Council formed to study the Bill had all reflected that the leasing as referred to in section 39E at that time meant "acquiring ships and aircraft through leveraged leasing", whether the "leasing arrangements" referred to in the replies given by the Government at present are equivalent to the "leveraged leasing" referred to at that time; if they are, of the definition of "leveraged leasing"; if not, of the difference between the definitions of the two kinds of leasing;

(e) why the Government defines the arrangements concerned referred to in section 39E as those "within the specific scope of the provision", and considers that relaxing the relevant restrictions will lead to the situation where "the specific anti-avoidance provision can easily be exploited, resulting in tax deferral or loss and a large number of cases in dispute";

(f) given that the former Commissioner of Inland Revenue (the Commissioner) gave an assurance upon the enactment of section 39E in 1986 that the provision would only be enforced in circumstances of actual necessity, why the Government stated that it "cannot exercise its power under the law selectively", hence activities with no tax avoidance intention are subject to regulation under the provision, and whether the Government has abandoned the assurance given in the past;

(g) whether the Inland Revenue Department (IRD) had considered that the original intent of the legislation is to target "leveraged leasing" when it updated the Departmental Interpretation and Practice Notes No. 15 (P.N. 15) in 2006 to categorise the provision of moulds for machinery by Hong Kong enterprises to mainland processors as "leasing";

(h) given that the Government indicated that the time limit for raising additional assessments under section 39E is six years, yet, in the appeal case with decision number D51/08, the counsel representing the Commissioner pointed out that the P.N. 15 updated in 2006 was not applicable before January 2006, whether the authorities have assessed if the two arguments contradict each other, and whether the Government should refrain from applying this section retrospectively to cases assessed prior to the updating of the Notes; if not, of the reasons for that;

(i) given that under the processing trade arrangements at present, Hong Kong companies strictly restrict mainland manufacturing units to use the moulds provided to them only for manufacturing goods which the companies require and to return the moulds to the companies once the manufacturing process is completed, whether the Government, in not granting the depreciation allowances concerned, is violating the taxation principle under which costs arising from Hong Kong companies' taxable profits in Hong Kong are eligible for tax allowances;

(j) given that the legislative intent of section 39E is to strike down tax avoidance by businesses, whether the Government has assessed if it is lawful to invoke section 39E to recover tax from Hong Kong enterprises which have not avoided tax, and whether it has sought the advice of the Department of Justice on the enforcement actions concerned; if it has, of the details; if not, the reasons for that; and

(k) whether the Government can provide information on the number of companies from which tax has been recovered by the authorities by invoking section 39E (including tracing back the cases which had already been assessed before IRD updated the P.N. 15 in 2006) in each of the past 10 years, the amount of tax involved as well as the number of companies which went bankrupt because of the recovery action?

Reply :

President,

(a) to (c) When section 39E of the Inland Revenue Ordinance (IRO) was enacted in 1986, sub-paragraph (1)(a) targeted "sale and leaseback" arrangements of all machinery or plants (including ships and aircrafts). Sub-paragraphs (1)(b) and (1)(c) of section 39E targeted "leverage leasing" arrangements, the former being applicable to machinery or plants not being ships or aircrafts while the latter being applicable to ships or aircrafts. It is evident that upon enactment in 1986, section 39E already covered machinery or plants other than ships and aircrafts. Since ships and aircrafts were most commonly involved in such leasing arrangements for tax avoidance, the papers submitted by the Administration to the Legislative Council at that time specifically mentioned these two items.

Section 39E was indeed enacted in 1986 to target "sale and leaseback" and "leverage leasing" arrangements only. At that time, only "leverage leasing" arrangements involving machinery or plants used outside Hong Kong by other persons were restricted by section 39E. However, the Administration noticed that many companies could technically circumvent the definition of "leverage leasing" and made arrangements which were in substance similar to "leverage leasing" arrangements, whereby machinery or plants (mainly involving ships and aircrafts) were made available for use by other persons outside Hong Kong. Such arrangements were not caught by section 39E and tax avoidance was achieved. To plug the loophole, the Administration amended section 39E in 1992. The amendment was mainly to replace the word "and" which separated sub-paragraphs (i) and (ii) of both sections 39E(1)(b) and (1)(c) by "or". After the amendment, so long as the machinery or plants (including ships and aircrafts) under a leasing arrangement is principally used by another person outside Hong Kong, section 39E will apply. Thus the scope of application of section 39E has been extended beyond "sale and leaseback" and "leverage leasing" arrangements to cover all kinds of leasing arrangements.

(d) As pointed out above, section 39E was amended in 1992 to target those companies which technically circumvented the definition of "leverage leasing". "Leasing arrangement" in my replies refers to any arrangement within the definition of "lease" under the IRO, and is not limited to "leverage leasing".

(e) 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. As pointed out in my replies of October 21 and November 4, there are practical difficulties in relaxing the restriction on "being used outside Hong Kong". Thus, 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.

(f) Upon resumption of the Second Reading debate on the Inland Revenue (Amendment) Bill 1986, a legislator mentioned such assurance by the Commissioner of Inland Revenue. However, it was a general assurance in respect of the Bill as a whole rather than a specific assurance in respect of section 39E. In fact, apart from section 39E, the Bill contained many anti-avoidance provisions, including sections 61A and 61B. Sections 61A and 61B specifically provided that they applied to transactions with tax avoidance purposes. During the Second Reading debate, the former Financial Secretary stated that sections 61A and 61B would only be used to strike down tax avoidance schemes. The Commissioner of Inland Revenue also made similar assurance in respect of sections 61A and 61B in his Departmental Interpretation and Practice Notes (DIPN) No. 15.

(g) The definition of "lease" was provided in the IRO when section 39E was enacted in 1986. The Inland Revenue Department updated 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".

(h) Neither the statutory power of section 39E nor the six-year time limit for raising additional assessments under the IRO will be affected by any DIPN. The DIPNs have no legal binding force.

(i) As mentioned in the reply to question (e) above, 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. Under the provisions of section 39E, it is not a factor for consideration whether the machinery or plants are solely used for producing profits for the Hong Kong enterprise. As long as the machinery or plants are wholly or principally used by another person outside Hong Kong, the Hong Kong enterprise owning them will not be granted depreciation allowance.

(j) We consider that the implementation of section 39E by the Inland Revenue Department is in accordance with the legislation and is supported by case law. For example, the Board of Review made a decision on a case (D61/08, 24 IRBRD 184) relating to depreciation allowance in March 2009. In the written decision, the Board pointed out that section 39E had not stipulated that there should be "an intention to avoid tax" for the application of the provision.

(k) The Inland Revenue Department does not keep such data.

Ends