Press release

LCQ1: Review of Inland Revenue Ordinance section 39E

Wednesday, November 24, 2010

Following is a question by Dr 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 24):

Question:

The Secretary for Financial Services and the Treasury (SFST) indicated in February this year that a review of the implementation of section 39E of the Inland Revenue Ordinance (section 39E) would be conducted through the Joint Liaison Committee on Taxation (JLCT). It has been learnt that JLCT had completed the review months ago and submitted its review report and recommendations to the Bureau, but time and again in his replies to the questions raised by Members of this Council, SFST only indicated that the authorities would complete the study as soon as practicable. In this connection, will the Government inform this Council:

(a) of the exact date of receipt of the aforesaid JLCT report by the authorities, the reasons for not disclosing the receipt of the report and not publicising its contents all along, and when they will publicise the contents of the report to the public;

(b) of the meaning of the word "practicable" used by SFST as referred above; and

(c) whether it has assessed the negative impact on the commerce and industry sector if there is delay in or mishandling of the review of section 39E, and how SFST, as a principal official under the accountability system, should be held responsible; if it has, of the details; if it has not, the reasons for that?

Reply:

President,

(a), (b) and (c) Over the past year, Dr the Hon Lam Tai-fai proposed on a number of occasions at the Legislative Council to relax section 39E of the Inland Revenue Ordinance (IRO) in order to allow Hong Kong enterprises engaging in "import processing" arrangements to claim depreciation allowances for machinery and plant made available for use by the Mainland enterprises rent-free. We have repeatedly reiterated that since section 39E is an anti-avoidance provision, relaxing the relevant restriction would affect the completeness of the anti-avoidance provisions in the IRO. There are also practical difficulties in implementation and the provision could easily be abused.

Nevertheless, we are pleased to explore further whether there is room to relax section 39E of the IRO. Hence, in March this year, we invited the Joint Liaison Committee on Taxation (JLCT) to study the relevant issue so as to see if at the technical level, there are practical and feasible options that could comply with the taxation principles while relaxing section 39E. Subsequently, in June this year, the JLCT submitted its advice on the matter to the Administration. We are grateful for the JLCT's views.

After due consideration, we find that the JLCT's proposal in respect of some of the traders' request for relaxing section 39E is not in line with Hong Kong's established taxation principles of "territorial source" and "tax symmetry". Besides, the JLCT has not proposed effective measures to plug possible tax avoidance loopholes. The JLCT also recommends that when there is an adjustment to the rental charge of the machinery and plant involved in a rent-free leasing arrangement of a Hong Kong enterprise, the Inland Revenue Department (IRD) of Hong Kong should not claw back the proposed depreciation allowances as a result of such adjustment. We have grave concerns about this. I shall now explain in detail why we could not accept the proposal.

All along, Hong Kong enterprises point out that there is no fundamental change in operation after they have upgraded and restructured their processing trade in the Mainland from "contract processing" to "import processing". From the taxation perspective, we do not agree to such a view. Under "contract processing", Hong Kong enterprises have to participate in the production activities in the Mainland in various ways, and are responsible for supplying all necessary raw materials and production equipment. The "contract processing factories" of the Mainland are basically responsible for processing the raw materials according to the instructions and requirements of the Hong Kong enterprises. The finished products so produced belong to the Hong Kong enterprises. The Mainland authorities strictly require that the finished products under "contract processing" should all be exported. The expenses incurred by the Hong Kong enterprises in conducting the production activities under "contract processing" in the Mainland, and the profits derived from such production activities are all reflected in the accounts of the Hong Kong enterprises. Based on the "territorial source" and "tax symmetry" principles, we allow the Hong Kong enterprises engaging in "contract processing" to apportion their profits on a 50:50 basis for assessment of Hong Kong profits tax. Accordingly, we allow 50% deduction of expenses incurred by these Hong Kong enterprises, including depreciation for machinery and plant used in the Mainland, for generating the above taxable profits.

However, under "import processing", the Mainland enterprises, which are responsible for the Mainland production activities, are independent legal entities. These Mainland enterprises have to pay for importing raw materials and to install production equipment as needed. The finished products belong to the Mainland enterprises and it is their responsibility to arrange for domestic sale or export of their finished products. The Hong Kong enterprises maintain the buyer/seller relationship with their Mainland counterparts. The taxable profits of the Hong Kong enterprises in Hong Kong are derived from their trading transactions. Since the profits derived from the production activities in the Mainland do not belong to the Hong Kong enterprises, such profits would not be reflected in the accounts of the Hong Kong enterprises. As a result, the IRD would not charge profits tax on the Hong Kong enterprises in relation to the Mainland production activities. Based on the "tax symmetry" principle, depreciation allowances for the machinery and plant solely used in the production activities would not be granted. According to the "territorial source" principle, we could not apportion part of the profits of the Mainland enterprises derived from the production activities and transfer such to the Hong Kong enterprises for assessment of Hong Kong profits tax.

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. For some Hong Kong enterprises which have provided machinery and plant to the newly established Mainland enterprises at a rent, they have to pay business tax and income tax in the Mainland as their rental income is taxable profits in the Mainland.

As for machinery and plant provided for use by the Mainland enterprises rent-free, 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 which would affect the taxing rights of Hong Kong and other tax jurisdictions (including the Mainland). This would violate the international principles and guidelines for handling transfer pricing and Hong Kong would be regarded as a harmful tax competitor. The so-called transfer pricing refers to the arrangement where Party A provides Party B with raw materials or equipment at a price lower than the market level and in return Party A procures finished products from Party B at a price below market level. Such arrangement would transfer Party B's profits to Party A, thereby reducing the taxable profits of Party B. In other words, the tax authorities of Party B would suffer tax loss as a result of such arrangement.

On this score, I have to point out that with the globalisation of world economy in recent years, cross-border economic activities have increased significantly. The Organisation for Economic Co-operation and Development and the tax authorities around the world are all increasingly concerned about the transfer pricing issue arising from cross-border trading activities between associated enterprises. These transactions, which do not reflect market price, would affect the taxing rights of the tax authorities. There is consensus among the tax authorities to prevent transfer pricing arrangements as far as possible in order to protect their respective tax revenue.

Given that the Hong Kong enterprises and the Mainland enterprises are associated parties in many cases, we have to be extremely careful in considering the request for relaxing section 39E 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.

In fact, for transfer pricing arrangements between associated enterprises of the Mainland and Hong Kong, according to the comprehensive avoidance of double taxation agreement (CDTA) between Hong Kong and the Mainland, the Mainland tax authorities can make adjustments to the amount of tax payable according to the "arm's length principle" and the IRD has an obligation to make corresponding adjustments to the amount of tax charged in Hong Kong.

If the Administration were to relax section 39E to allow the Hong Kong enterprises to claim depreciation allowances for machinery and plant provided to the Mainland enterprises rent-free, once the Mainland tax authorities detect transfer pricing arrangements and make adjustments to the tax payable by the Mainland enterprises according to the "arm's length principle" as it is considered that the Mainland enterprises should pay rent for such machinery and plant to the relevant Hong Kong enterprises, Hong Kong would end up suffer tax loss in two ways: on the one hand, as suggested by the JLCT, the IRD should not claw back the proposed depreciation allowances because of any rent deemed by the Mainland tax authorities; whereas under the CDTA between Hong Kong and the Mainland, IRD has an obligation to make adjustments to the tax amount of the Hong Kong enterprises correspondingly.

President, as officials responsible for Hong Kong tax policy, we have to take into account the overall interests of all the taxpayers in making each and every policy decision. Based on the above considerations (particularly our long-held taxation principles), our review has come to a conclusion that there are no justifiable grounds to relax the existing restriction in section 39E.

Ends