

## **Press release**

### **LCQ1: Inland Revenue Ordinance section 39E**

Wednesday, January 19, 2011

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 (January 19):

Question:

Some members of the trade have pointed out that although the interpretation and enforcement of section 39E of the Inland Revenue Ordinance (section 39E) by the Inland Revenue Department have profound implications on the operation of industrial and commercial enterprises, the Secretary for Financial Services and the Treasury (SFST) has refused to amend the provision and has not arranged any meeting with me to discuss the issue of section 39E. In this connection, will the Government inform this Council:

(a) given that despite my letters to SFST on November 8 and 22 and December 1, 2010 respectively, as well as the several phone calls from my office to his, to request for a meeting to discuss the issue of section 39E, I have never succeeded in securing the arrangement of such a meeting with SFST, of the reasons for SFST not meeting with me and whether the authorities have assessed if this approach of SFST is appropriate and effective for maintaining good communication with Legislative Council Members; if they have assessed, of the conclusion; if not, the reasons for that, and whether they will make such an assessment;

(b) given that SFST indicated in his reply to the supplementary question of a Member of this Council on November 24, 2010 that he had conducted a lot of communication in great detail with the sectors through different opportunities and had conducted face-to-face communication with the sectors numerous times, yet he has not made any arrangement to meet with me, as the representative of the industrial sector (Industrial (Second)) in the Legislative Council, whether the authorities have assessed if the speech of SFST on November 24 has misled Members and was unfair to me; if they have assessed, of the details; if not, the reasons for that; and

(c) whether the Government of the current term will consider invoking other mechanisms to review the issue of section 39E so as to develop the local economy and continuously enhance the competitiveness of the small and medium enterprises; if it will, of the details; if not, whether it is going to pass the review exercise to the Government of the next term?

Reply:

President,

My replies to parts (a) to (c) of the question are as follows:

In the past year or so, Dr Hon Lam Tai-fai and other Members of the Legislative Council (LegCo) raised repeatedly questions about relaxation of section 39E of the Inland Revenue Ordinance (IRO). I gave replies to these questions on a number of occasions, setting out clearly the position of the Administration. In response to the oral question raised by Dr Hon Lam Tai-fai on November 24, 2010, I have given a very detailed reply, stating categorically that we have already reviewed the relevant issue and our conclusion is that there are no justifiable grounds to relax the current restriction in section 39E. We have also explained the reasons for not relaxing the restriction. 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.

All along, the Administration attaches great importance to maintaining good relationship between the executive authorities and the legislature. We are very pleased to present to the LegCo the Administration's policies in various areas and their respective objectives so as to gauge the valuable views of the LegCo Members. Indeed, we have had several rounds of discussions at the LegCo Chamber on the proposal of Dr Hon Lam Tai-fai to relax section 39E of the IRO. Regarding the meeting request of Dr Hon Lam Tai-fai, apart from issuing a written reply on November 26, 2010, I also communicated further with Dr Hon Lam Tai-fai upon receipt of his letter dated December 1, 2010 and explained once again our position on section 39E.

In response to the concerns of Dr Hon Lam Tai-fai on this issue, I hereby reiterate that there are no justifiable grounds to relax the existing restriction in section 39E, in the light of the established fundamental principles of Hong Kong's tax system such as "territorial source" principle and "tax symmetry" principle. From the taxation perspective, there are substantive differences between "contract processing" and "import processing" in terms of mode of operation, status of legal person, ownership of goods, manufacturing equipment as well as level of involvement in the manufacturing activities in the Mainland.

Under the "import processing" mode, Hong Kong enterprises engaging in "import processing" only involve in trading activities. As such, they would only be liable to profits tax in Hong Kong for taxable profits derived from their trading activities. The machinery or plant is solely used by the Mainland enterprises (being separate legal entities) in their manufacturing activities and the profits thus generated are wholly derived from the Mainland and liable to the Mainland tax. Since the Hong Kong enterprises do not take part in the manufacturing activities of the Mainland and have not derived any chargeable profits from the manufacturing activities in the Mainland, the Hong Kong Inland Revenue Department would not charge profits tax on the Hong Kong enterprises in relation to the manufacturing activities in the Mainland and would not grant depreciation allowances for the machinery and plant which are solely related to the manufacturing activities. If we were to provide depreciation allowances for such machinery and plant in Hong Kong, 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 may be regarded as a harmful tax competitor.

Ends