

## **Press release**

### **LCQ15: Inland Revenue Ordinance Section 39E**

Wednesday, October 31, 2012

Following is a question by the Dr Hon Lam Tai-fai and a written reply by the Acting Secretary for Financial Services and the Treasury, Ms Julia Leung, in the Legislative Council today (October 31):

Question:

The Chief Executive (CE) has indicated in his election manifesto that "[w]e will support Hong Kong manufacturers in restructuring their business model to tap the domestic market on the Mainland", and "will actively consult with Mainland authorities to help Hong Kong enterprises on the Mainland to resolve the problem of increased taxation costs arising from business restructuring". In the Inauguration Ceremony of the Government held on July 1, 2012, CE also said that "[w]e fully recognise the contribution to our economy by Hong Kong businesses operating on the Mainland and will continue to support their restructuring and upgrading". In this connection, will the Government inform this Council:

- (a) of the specific measures or plans to honour CE's aforesaid pledges;
- (b) whether the problems of increased taxation costs arising from the restructuring of Hong Kong businesses on the Mainland include the problem of Hong Kong enterprises engaged in import processing trade not being able to obtain depreciation allowance in Hong Kong for machinery and plants made available for use by mainland enterprises because of section 39E of the Inland Revenue Ordinance (Cap 112) (section 39E); if so, how this problem can be solved; if not, of the reasons for that;
- (c) as the authorities have said that there are practical difficulties in relaxing the restriction imposed by section 39E, which include whether the machinery or plant used on the Mainland was producing profits chargeable to tax in Hong Kong, whether it is used for the manufacturing of goods sold solely to the Hong Kong enterprise, whether the machinery or plant has been sold, and whether depreciation allowances of the same machinery or plant have been claimed by other enterprises, etc, whether the Government will discuss with the relevant mainland authorities to resolve such practical difficulties; if it will, of the details; if not, the reasons for that;

(d) as both the Secretary for Financial Services and the Treasury and the Secretary for Commerce and Economic Development of the Government of the last term indicated that there were no justifiable grounds to relax section 39E, whether the Government of the current term will review afresh section 39E; if it will, of the details; if not, the reasons for that;

(e) given that the Government of the last term refused to accept the recommendation put forward by the Joint Liaison Committee on Taxation on section 39E, whether the Government of the current term will consider accepting the recommendation; if it will, of the details; if not, the reasons for that;

(f) whether CE has made enquiries to or followed up with any government department on issues involving section 39E; if he has, of the details; if not, the reasons for that;

(g) whether the government departments concerned have relayed truthfully and objectively to CE the views on section 39E of the local industrial and commercial sectors, the accounting trade and tax experts; if they have, of CE's response; if not, the reasons for that;

(h) whether the government departments concerned have truthfully explained to CE why the authorities have all along not consulted the Department of Justice or other members of the legal profession on the interpretation of section 39E; if they have, of CE's response; if not, the reasons for that;

(i) as the authorities have indicated that relaxation of section 39E might lead to tax avoidance loopholes, whether the Government of the current term has carefully assessed the possibility of the emergence of the so-called tax avoidance loopholes and their impact; if it has, of the details; if not, why the authorities have said so; and

(j) as the authorities have indicated that they have to take into account the overall interests of Hong Kong and all the taxpayers in making each and every policy decision, whether the Government has assessed the contribution to be brought to the overall interests of Hong Kong by amending section 39E; if it has, of the details; if not, the reasons for that?

Reply:

President,

My reply to the various parts of the question is as follows -

(a) To assist Hong Kong enterprises in upgrading and restructuring their operations and promoting domestic sales in the Mainland, the Commerce and Economic Development Bureau has been implementing the following measures -

(i) We maintain close liaison with the relevant Mainland authorities at central, provincial and municipal levels to convey the views of the trade on the Mainland's business environment, laws and regulations, and measures to support the trade. We also organise activities such as symposiums and seminars to keep the trade abreast of various new policies and regulations and the latest business environment in the Mainland;

(ii) Through organisations such as the Hong Kong Trade Development Council and Hong Kong Productivity Council, we provide Hong Kong enterprises with support services on technological upgrading, management improvement, branding and market development, etc;

(iii) Our offices in the Mainland would collaborate with trade associations or other organisations to organise "Hong Kong Week" in second-tier cities under their respective coverage, in order to assist Hong Kong enterprises in building up their brand image and brand awareness in the Mainland market. The first and second "Hong Kong Week" projects had been held in Chongqing and Wuhan of Hubei Province in January and April to May this year respectively. The next "Hong Kong Week" project would be held in Xiamen of Fujian Province in April to May 2013; and

(iv) Through the existing funding schemes, including the various funding schemes for small and medium enterprises (SMEs) as administered by the Trade and Industry Department, we provide financial support to SMEs in order to assist them in market promotion, acquisition of equipment, upgrading of operational and technical skills, and business restructuring or relocation. In addition, to further assist Hong Kong enterprises in enhancing their competitiveness in the Mainland market, we introduced a \$1 billion dedicated fund in end June 2012 to assist Hong Kong enterprises in developing brands, upgrading and restructuring operations, and promoting domestic sales in the Mainland. As at end September 2012, the first batch of 104 applications received under the Enterprise Support Programme of the dedicated fund had been vetted. Twelve applications were approved with the average funding amount of about \$325,000. Another 43 applications were approved with conditions. On the other hand, the first batch of 19 applications received under the Organisation Support Programme had also

been vetted. Twelve applications were approved with an average funding amount of around \$3.8 million.

(b) to (e) In the last term of the Legislative Council, the Administration had already conducted an in-depth study on section 39E of the Inland Revenue Ordinance (IRO). Section 39E of the IRO is a specific anti-avoidance provision, which aims at limiting tax avoidance opportunities in various forms of machinery or plant leasing arrangements. According to that provision, taxpayers will be denied depreciation allowance if the machinery or plant owned by them is used outside Hong Kong by other parties. There were views suggesting that the restriction in the relevant provision should be relaxed such that Hong Kong enterprises would be allowed to obtain depreciation allowance in Hong Kong for their machinery and plant provided for use by Mainland enterprises on a rent-free basis under the "import processing" arrangement. In reviewing that provision, we have seriously considered such essential factors as whether the suggested change would be consistent with the taxation principles of Hong Kong and whether there would be any possible tax avoidance loopholes.

After examining the relevant taxation principles in relation to the processing activities carried out by Hong Kong enterprises in the Mainland, and taking into consideration the views of the industrial and commercial sector, the accounting sector and tax experts on the matter, we already conducted a review on the relevant matter in 2010. In view of Hong Kong's established taxation principles of "territorial source" and "tax symmetry", we have concluded that there are no justifiable grounds to relax the restriction in section 39E of the IRO. The Administration has already made known the above stance in replying to an oral question raised by Dr Hon Lam Tai-fai on November 24, 2010.

The reason underlying our conclusion that the relevant restriction should not be relaxed is that under the "import processing" mode, Hong Kong enterprises engaging in "import processing" merely involve in trading activities in buying/selling of goods, and 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. In other words, the profits generated from the Mainland manufacturing activities as stated above are not derived from Hong Kong. Based on the established "territorial source" principle of Hong Kong's tax regime, the Hong Kong Inland Revenue Department (IRD) would not charge profits tax on such profits which are not derived from Hong Kong. At the same time, based on the "tax symmetry" principle, IRD would

not grant depreciation allowance for the machinery and plant solely used in the production activities in the Mainland. If we were to relax section 39E of the IRO such that depreciation allowance in Hong Kong would be provided to such machinery and plant, we would not only violate the above taxation principles but may also be perceived as encouraging transfer pricing, which would affect the taxing rights of Hong Kong and other tax jurisdictions (including the Mainland). This would not be in line with the international principles and guidelines for handling transfer pricing and Hong Kong may be regarded as a harmful tax competitor.

As a matter of fact, on the issue of transfer pricing, the State Administration of Taxation has confirmed that if a Hong Kong enterprise provides some machinery and plant (including moulds) to its associated enterprise in the Mainland rent-free for production of finished products which would be sold to the Hong Kong enterprise at a price below normal price, such arrangement may constitute an "offsetting transaction" under the "Implementation Measures of Special Tax Adjustments (Provisional)" (Guoshuifa [2009] No.2) of the Mainland. In the course of conducting transfer pricing investigations, the Mainland tax authorities will make transfer pricing adjustments to restore the offsetting transactions.

It follows that if we accede to the request of some of the enterprises and relax the existing restriction in section 39E so as to provide depreciation allowance in Hong Kong to those machinery and plant, this would be perceived as encouraging transfer pricing and affect the taxing rights of Hong Kong and the Mainland. As a result, Hong Kong would be regarded as a harmful tax competitor. In the course of conducting the review in 2010, we have already taken into account the views of the Joint Liaison Committee on Taxation (JLCT). However, we are of the view that JLCT has not proposed effective measures to plug the possible tax avoidance loopholes.

(f) to (j) Since the completion of our review on section 39E of the IRO in 2010, we note that the industry has raised requests relating to the matter from time to time. In this regard, we would be pleased to keep explaining to the industry the Administration's stance.

At this stage, we have no plan to assess the economic benefits arising from relaxation of the restriction in section 39E. If there is a need to conduct relevant assessment in future, we would endeavour to strike a balance among the needs of all relevant parties and the overall interest of Hong Kong.

Ends