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Your Ref: CB1/PI/FA

**CB(1)601/09-10(01)**

4 December 2009

Chairman of the Panel on Financial Affairs  
Legislative Council  
Legislation Council Building  
8 Jackson Road  
Central, Hong Kong

Attention: Mr. Chan Kam-lam

Dear Mr. Chan,

**PANEL ON FINANCIAL AFFAIRS - SPECIAL MEETING  
DEPRECIATION ALLOWANCES FOR PROFITS TAX IN RESPECT OF  
MACHINERY OR PLANT UNDER INLAND REVENUE ORDINANCE (CAP.112)**

We refer to your letter dated 12 November 2009 and are pleased to provide below our views on the existing provision under section 39E of the Inland Revenue Ordinance (Cap. 112) ("IRO"):

Existing provision section 39E of the IRO

In broad terms section 39E operates to deny an owner initial and annual allowances ("depreciation allowances") in respect of machinery or plant under certain leased arrangements. In particular, where a leased machinery or plant, not being a ship or aircraft, is used wholly or principally outside Hong Kong by a person other than the taxpayer, depreciation allowances are denied.

Original intent of section 39E

Technically speaking, section 39E is an anti-tax avoidance provision. The provision aims to limit the opportunities for tax deferral or avoidance through sale and leaseback and leveraged leasing arrangements. When the provision was introduced and passed by the former Legislative Council in 1986, the Government had stated that the provision was only targeted at two types of leasing arrangements, namely sale and leaseback and leveraged leasing. We cannot see any reason that the provision is aimed at denying depreciation allowances for genuine businesses.

Our concerns

The current legislation could be subject to different interpretations. It is clear that the Inland Revenue Department ("IRD") is currently taking the position such that genuine businesses with profits fully taxable and fixed assets physically located outside Hong Kong could be denied of depreciation allowances.

It is not uncommon for taxpayers involved in trading or manufacturing businesses to have their manufacturing operations conducted or subcontracted to entities outside Hong Kong (e.g. in the Chinese Mainland) and their machinery and plant are used outside Hong Kong. Under this circumstance, very often the machinery and plant are legally owned by the Hong Kong company but relocated and used by a factory/sub-contractor in the Chinese Mainland. Taxpayers in import processing arrangement have been heavily affected as section 39E is applied to them to deny the depreciation allowances of the assets they own and put in the Chinese Mainland. As the costs of machinery and plant usually form a substantial part of their operational costs, this would inevitably increase their overall costs of doing business. It is also in contradiction to the basic principle of allowing taxpayers to get relief for costs incurred in generating taxable revenue.

We are of the view that the way the IRD is currently taking to apply section 39E to genuine businesses will result in an unfair treatment. We hope it can be rectified as soon as possible.

Proposed change in legislation

To be fair to taxpayers in import processing arrangement owning assets in the Chinese Mainland and to promote a friendly business environment, we trust it is necessary for the Government to revisit the existing provisions in the IRO and propose a change in legislation, such that taxpayers engaged in genuine businesses would not be affected and denied of depreciation allowances under section 39E.

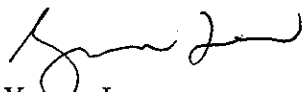
We propose the change in legislation should be retrospective back to the year of assessment 2003/04. We appreciate that a legislation change will take time. Therefore, pending the completion of the process and to remove the uncertainty, the IRD could provide a concession by way of Departmental Interpretation and Practice Note. This concession should also have retrospective effect back to the year of assessment 2003/04.

We understand that the IRD may have concerns about the validity of the claim of depreciation allowances for plant and machinery used outside Hong Kong. Some of the concerns may include the proof of ownership, the actual usage for other purposes and the plant and machinery being double booked in the accounts of both the Hong Kong and Chinese Mainland entities. However, we trust the confirmation and declaration by taxpayers should overcome these concerns and we believe that the current anti-avoidance and penalty provisions of the IRO can counteract any abuse or incorrect claim of depreciation allowances.

To conclude, we would suggest an amendment to the tax law and have it applied retrospectively from the year of assessment 2003/04 so that section 39E should not affect genuine businesses.

If you have any questions on the above, please do not hesitate to contact Davy Yun, our Tax Director at 2852 6538 or the undersigned at 2852 1667.

Yours sincerely,  
For and on behalf of  
Deloitte Touche Tohmatsu



Yvonne Law  
National Chief Knowledge Officer & Partner

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