For discussion on
14 December 2009

Legislative Council
Panel on Financial Affairs

Depreciation Allowances in respect of Machinery or Plants under "Import Processing" Arrangements

Purpose

Some Members have expressed concerns on the denial of depreciation allowances pursuant to section 39E of the Inland Revenue Ordinance ("IRO") in respect of the machinery or plants that Hong Kong enterprises provide to Mainland enterprises for use under "import processing" arrangements. This paper briefs Members on the background and scope of section 39E, and addresses Members' concerns.

Legislative background of section 39E

2. Section 39E was enacted in 1986 and amended in 1992 to become the current version. The legislation aims at limiting the opportunities to obtain depreciation allowances in respect of machinery or plants through various forms of leasing arrangements for the purposes of tax avoidance. The 1986 version and the current version of section 39E are enclosed at Appendices 1 and 2 respectively.

3. When section 39E was enacted in 1986, it targeted "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 then noticed that many companies could technically circumvent the definition of "leverage leasing" and made substantially similar arrangements, whereby machinery or plants (mainly 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 could be achieved. To plug the loophole, the Administration amended section 39E in 1992. After the amendment, so long as

the machinery or plants under a leasing arrangement are used wholly or principally outside Hong Kong by another person, section 39E will apply and the relevant depreciation allowances will be denied, even if the arrangement is not a "leverage leasing" arrangement.

The scope of section 39E

4. Although leasing arrangements for tax avoidance purposes most commonly involve ships and aircrafts, they may also involve other types of machinery or plants. Therefore, section 39E has covered all types of machinery or plants since its enactment in 1986.

5. After the amendment in 1992, any leasing arrangement of machinery or plants belonging to one of the following three types would be subject to the restriction under section 39E:-

(a) sale and leaseback arrangements;
(b) leverage leasing arrangements; or
(c) arrangements under which machinery or plants are used wholly or principally outside Hong Kong by another person.

In implementing section 39E, whether an enterprise has a tax avoidance intent is not a factor to be considered by the Inland Revenue Department ("IRD"), and IRD cannot enforce this provision selectively. This interpretation of section 39E has been accepted by the Board of Review. Leasing arrangements also include cases of rent-free transfer of the right to use the machinery or plants.

Denial of depreciation allowances in respect of machinery or plants under "import processing" arrangements

6. Under "import processing" arrangements, a Hong Kong enterprise usually injects machinery or plants into a Mainland enterprise to fulfill the former's capital commitment and such machinery or plants become the latter's asset. As the ownership of the machinery or plants has been transferred to the Mainland enterprise, the Hong Kong enterprise is no longer the owner and should not enjoy the depreciation allowances. Such denial of depreciation allowances is not because of section 39E.

7. We understand that under "import processing" arrangements, Hong Kong enterprises may sometimes make their machinery or plants (mainly moulds) available for use by Mainland enterprises free of charge. As this falls into the arrangement as described in paragraph 5(c) above, section 39E will apply and the depreciation allowances of the relevant machinery or plants will be denied.

8. We appreciate that the industry would like to enjoy the deduction of depreciation allowances in Hong Kong under the circumstance as described in paragraph 7 above. However, because the machinery or plants are used by another person outside Hong Kong, we consider that it is a rather complicated matter involving various issues, including whether the machinery or plants are producing profits chargeable to tax in Hong Kong; whether they are used for the manufacturing of goods sold solely to the Hong Kong enterprise; whether they have been sold; and whether depreciation allowances of the same machinery or plants have been claimed by another enterprise, etc. The IRD does not have the statutory power to request an overseas entity who is not a Hong Kong taxpayer to provide supporting documents, or to carry out a field audit on the operations of an overseas entity. Therefore, IRD would have difficulties in regulating such claims for depreciation allowances.

9. For the above reasons, we consider that if the "used outside Hong Kong" restriction under section 39E is relaxed, this specific anti-avoidance provision would easily be abused by all sorts of new tax avoidance schemes, resulting in deferral or loss of tax revenue and a large number of disputed cases. This will lead to inconvenience and uncertainty of tax liability for taxpayers, and increase administrative cost. The IRD will continue to communicate with professional and business organizations regarding the implementation of section 39E.

10. Dr Hon Lam Tai-fai raised questions on section 39E in the Legislative Council on 21 October, 4 November and 25 November this year. The Administration's replies to these questions are enclosed at Appendix 3.

Financial Services and the Treasury Bureau
December 2009

(5) If a person sells any machinery or plant referred to in subsection (4) within 12 months of the date of cessation he may claim the adjustment of any balancing allowance or balancing charge which may have been made to or on him as if such sale had taken place immediately prior to the date of cessation and notwithstanding section 70 an assessor shall make any necessary correction to any assessment.

(6) Notwithstanding anything contained in this section, where the aggregate of any sale, insurance, salvage or compensation moneys in respect of any machinery or plant exceeds the capital expenditure incurred on the provision of that machinery or plant, the aggregate of such moneys shall—

(*a*) for the purposes of calculating a balancing charge under subsection (2)(*b*); and

(*b*) in calculating the reducing value of the class of machinery or plant under section 39B(4),

not exceed the capital expenditure incurred on the provision of that machinery or plant.

(7) For the purposes of subsection (6), the capital expenditure incurred on the provision of the machinery or plant shall be taken as— *(Amended, 7 of 1986, s. 6)*

(*a*) in a case where section 37(2A) applies, the "cost of the asset" computed in accordance with that section;

(*b*) in a case where section 39B(6) applies, the capital expenditure computed in accordance with that section; or

(*c*) in any other case, the aggregate capital expenditure incurred by the person in question on the provision of the machinery or plant for the purposes of producing profits chargeable to tax under Part IV.

(Added, 63 of 1980, s. 3)

Allowances under this Part in respect of capital expenditure on leased machinery and plant.
(7 of 1986.)
[*14.3.86.]

39E. (1) Notwithstanding anything to the contrary in this Part, a person (in this section referred to as "the taxpayer") who incurs capital expenditure on the provision of machinery or plant, being machinery or plant acquired by the taxpayer under a contract entered into after the commencement* of the Inland Revenue (Amendment) Ordinance 1986, for the purpose of producing profits chargeable to tax under Part IV shall not have made to him the initial or annual allowances prescribed in section 37, 37A or 39B if, at a time when the machinery or plant is owned by the taxpayer, a person holds rights as lessee under a lease of the machinery or plant, and—

(*a*) the machinery or plant was, prior to its acquisition by the taxpayer, owned and used by that person (whether alone or with others), or any associate of that person (which person or any such associate is hereinafter referred to as "the end-user"); or

(*b*) the machinery or plant, not being a ship or aircraft or any part thereof, is while the lease is in force—

(i) used wholly or principally outside Hong Kong by a person other than the taxpayer; and

(ii) the whole or a predominant part of the cost of the acquisition or construction of the machinery or plant was financed directly or indirectly by a non-recourse debt; or

(*c*) the machinery or plant is a ship or aircraft or any part thereof and --

(i) the person holding rights as lessee is not a person who is deemed by section 23B to be carrying on a business as the owner of ships in Hong Kong; and

(ii) the whole or a predominant part of the cost of the acquisition or construction of the ship or aircraft or the part thereof was financed directly or indirectly by a non-recourse debt.

(2) Subsection (1)(*a*) shall not apply where—

(*a*) the machinery or plant was acquired by the taxpayer on payment from the end-user at not more than the price which the end-user paid to the supplier (not being a supplier who is himself an end-user); and

(*b*) no initial or annual allowances have at any time prior to the acquisition of the machinery or plant by the taxpayer been made under section 37, 37A or 39B to the end-user in respect of such machinery or plant.

(3) For the purposes of subsection (2) an allowance shall be deemed not to have been made if the end-user, by notice in writing to the Commissioner within 3 months of the date on which the capital expenditure on the provision of machinery or plant giving rise to the allowance is incurred, or within such further time as the Commissioner may, in any particular case, permit, disclaims such allowance.

(4) For the purposes of this section machinery or plant owned or leased by a trustee shall be deemed to be owned or leased both by the trustee and the beneficiary under the trust or, in the case of a discretionary trust, both by the trustee and by such beneficiary as the Commissioner may, in his discretion, determine to be the beneficiary during the relevant basis period.

(5) In this section—

"acquisition" means acquisition by a person as owner and includes holding or hiring under a hire-purchase agreement or, if the hire-purchase agreement is a conditional sale agreement, holding as purchaser;

"arrangement" includes—

(*a*) any agreement, arrangement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable, or intended to be enforceable, by legal proceedings; and

(*b*) any scheme, plan, proposal, action or course of action or course of conduct;

"associate", in relation to a person holding rights as lessee under any lease of machinery or plant, means—

(*a*) where the person holding such rights is a natural person—

(i) a relative of the person holding such rights;

(ii) a partner of the person holding such rights and any relative of that partner;

(iii) a partnership in which the person holding such rights is a partner;

(iv) any corporation controlled by the person holding such rights, by a partner of the person holding such rights or by a partnership in which the person holding such rights is a partner;

(v) any director or principal officer of any such corporation as is referred to in sub-paragraph (iv);

(*b*) where the person holding such rights is a corporation—

(i) any associated corporation;

(ii) any person who controls the corporation and any partner of such person, and, where either such person is a natural person, any relative of such person;

(iii) any director or principal officer of that corporation or of any associated corporation and any relative of any such director or officer;

(iv) any partner of the corporation and, where such partner is a natural person, any relative of such partner;

(*c*) where the person holding such rights is a partnership –

(i) any member of the partnership and, where such member is a natural person, any relative of such member;

(ii) any partner of the partnership and, where such partner is a natural person, any relative of such partner and, where such partner is a partnership, any relative of any member of that partnership who is a natural person;

(iii) any corporation controlled by the partnership or by any partner thereof or, where such a partner is a natural person, any relative of such partner;

(iv) any corporation of which any partner is a director or principal officer;

(v) any director or principal officer of a corporation referred to in sub-paragraph (iii);

"associated corporation" means—

(*a*) a corporation over which the person holding rights under any lease of machinery or plant has control;

(*b*) a corporation which has control over such person holding rights, being a corporation;

(*c*) a corporation which is under the control of the same person as such person holding rights, being a corporation;

"beneficiary under the trust" means, where the trustee holds machinery or plant on behalf of a beneficiary who is himself a trustee in respect of that machinery or plant, the beneficiary for whom such machinery or plant is ultimately held, being the person who has the use of, or the right to use, such machinery or plant for his own benefit;

"conditional sale agreement" means an agreement for the sale of goods under which the purchase price or part of it is payable by instalments, and the property in the goods remains in the seller (notwithstanding that the buyer is to be in possession of the goods) until such conditions as to the payment of instalments or otherwise as may be specified in the agreement are fulfilled;

"control", in relation to a corporation, means the power of a person to secure—

(*a*) by means of the holding of shares or the possession of voting power in or in relation to that or any other corporation; or

(*b*) by virtue of any powers conferred by the articles of association or other document regulating that or any other corporation,

that the affairs of the first-mentioned corporation are conducted in accordance with the wishes of that person;

"end-user" means any person (whether alone or with others) holding rights as lessee under a lease of machinery or plant or any associate of such person;

"held for use" includes installed ready for use and held in reserve;

"lease" includes—

(*a*) any arrangement under which a right to use machinery or plant is granted by the owner of the machinery or plant to another person; and

(*b*) any arrangement under which a right to use machinery or plant, being a right derived directly or indirectly from a right referred to in paragraph (*a*), is granted by a person to another person,

but does not include a hire-purchase agreement or a conditional sale agreement unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised;

"non-recourse debt", in relation to the financing of the whole or a predominant part of the cost of the acquisition or construction of any machinery or plant, means a debt where the rights of the creditor in the event of default in the repayment of principal or payment of interest—

(*a*) are limited wholly or predominantly to any or all of the following—

(i) rights (including a right to moneys payable) in relation to the machinery or plant or the use of the machinery or plant;

(ii) rights (including rights to moneys payable) in relation to goods produced, supplied, carried, transmitted or delivered, or services provided, by means of the machinery or plant;

(iii) rights (including a right to moneys payable) in relation to the loss or disposal of the whole or a part of the machinery or plant or of the taxpayer's interest in the machinery or plant;

(iv) any conjunction of such rights as are referred to in sub-paragraphs (i), (ii) and (iii);

(v) rights in respect of a mortgage or other security over the machinery or plant; or

(vi) rights arising out of any arrangement relating to the financial obligations of the end-user of the machinery or plant towards the taxpayer, being financial obligations in relation to the machinery or plant;

(*b*) are in the opinion of the Commissioner capable of being limited as described in paragraph (*a*), having regard to either or both of the following—

(i) the assets of the taxpayer;

(ii) any arrangement to which the taxpayer is a party; or

(*c*) where paragraphs (*a*) and (*b*) do not apply, are limited by reason that not all of the assets of the taxpayer (not being assets that are security for a debt of the taxpayer other than a debt arising in relation to the financing of the whole or part of the cost of the acquisition of the machinery or plant) would be available for the purpose of the discharge of the whole of the debt so arising (including the payment of interest) in the event of any action or actions by the creditor or creditors against the taxpayer arising out of the debt;

"principal officer" means—

(*a*) a person employed by a corporation who, either alone or jointly with one or more other persons, is responsible under the immediate authority of the directors for the conduct of the business of the corporation; or

(*b*) a person so employed who, under the immediate authority of a director of the body corporate or a person to whom paragraph (*a*) applies, exercises managerial functions in respect of the body corporate;

"relative" means the spouse, parent, child, brother or sister of the relevant person, and, in deducing such a relationship, an adopted child shall be deemed to be a child both of the natural parents and the adopting parent and a step child to be the child of both the natural parents and of any step parent;

"used" includes held for use.

(Added, 7 of 1986, s. 7)

Interpretation.

40. (1) In this Part—

"basis period" has the meaning assigned to it by section 2 except that—

(*a*) where 2 basis periods overlap the period common to both shall be deemed to fall in the first basis period only, and

(*b*) where there is an interval between the end of the basis period for one year of assessment and the beginning of the basis period for the next year of assessment the interval shall be deemed to fall in the second basis period but where, in respect of salaries tax, the interval is the year ending on 31 March 1973, that interval shall not be deemed to fall in the second basis period; *(Replaced, 49 of 1956, s. 28. Amended, 8 of 1973, s. 8)*

"capital expenditure"—

(*a*) includes interest paid and commitment fees incurred in respect of a loan made for the sole purpose of financing the provision of an industrial building or structure or commercial building or structure or machinery or plant; but

(*b*) does not include expenditure which is reimbursed by way of or attributable to any grant, subsidy or similar financial assistance and in relation to the person incurring the expenditure does not include any expenditure which is allowed to be deducted in ascertaining for the purpose of Part IV the profits of a trade or business carried on by that person; *(Replaced, 30 of 1981, s. 7)*

"capital expenditure on the provision of machinery or plant" includes capital expenditure on alterations to an existing building incidental to the installation of that machinery or plant for the purposes of the trade, profession or business;

"class of machinery or plant" means the items of machinery or plant for which the same rate of depreciation is prescribed by the Board of Inland Revenue; *(Added, 63 of 1980, s. 4)*

compensation moneys in respect of any machinery or plant exceeds the capital expenditure incurred on the provision of that machinery or plant, the aggregate of such moneys shall-

(a) for the purposes of calculating a balancing charge under subsection (2)(b); and

(b) in calculating the reducing value of the class of machinery or plant under section 39B(4),

not exceed the capital expenditure incurred on the provision of that machinery or plant.

(7) For the purposes of subsection (6), the capital expenditure incurred on the provision of the machinery or plant shall be taken as- (Amended 7 of 1986 s. 6)

(a) in a case where section 37(2A) applies, the "cost of the asset" computed in accordance with that section;

(b) in a case where section 39B(6) applies, the capital expenditure computed in accordance with that section; or

(c) in any other case, the aggregate capital expenditure incurred by the person in question on the provision of the machinery or plant for the purposes of producing profits chargeable to tax under Part IV.

(Added 63 of 1980 s. 3)

Section:	39E	Allowances under this Part in respect of capital expenditure on leased machinery and plant	32 of 1998	17/04/1998

Remarks:
Adaptation amendments retroactively made - see 12 of 1999 s. 3

(1) Notwithstanding anything to the contrary in this Part, a person (in this section referred to as "the taxpayer") who incurs capital expenditure on the provision of machinery or plant, being machinery or plant acquired by the taxpayer under a contract entered into after the commencement of the Inland Revenue (Amendment) Ordinance 1986 (7 of 1986), for the purpose of producing profits chargeable to tax under Part IV shall not have made to him the initial or annual allowances prescribed in section 37, 37A or 39B if, at a time when the machinery or plant is owned by the taxpayer, a person holds rights as lessee under a lease of the machinery or plant, and-

(a) the machinery or plant was, prior to its acquisition by the taxpayer, owned and used by that person (whether alone or with others), or any associate of that person (which person or any such associate is hereinafter referred to as "the end-user"); or

(b) the machinery or plant, not being a ship or aircraft or any part thereof, is while the lease is in force-

(i) used wholly or principally outside Hong Kong by a person other than the taxpayer; or (Amended 15 of 1992 s. 4)

(ii) the whole or a predominant part of the cost of the acquisition or construction of the machinery or plant was financed directly or indirectly by a non-recourse debt; or

(c) the machinery or plant is a ship or aircraft or any part thereof and-

(i) the person holding rights as lessee is not an operator of a Hong Kong ship or aircraft; or

(ii) the whole or a predominant part of the cost of acquisition or construction of the ship or aircraft or the part thereof was financed directly or indirectly by a non-recourse debt. (Replaced 15 of 1992 s. 4)

(2) Subsection (1)(a) shall not apply where-

(a) the machinery or plant was acquired by the taxpayer on payment from the end-user at not more than the price which the end-user paid to the supplier (not being a supplier who is himself an end-user); and

(b) no initial or annual allowances have at any time prior to the acquisition of the machinery or plant by the taxpayer been made under section 37, 37A or 39B to the end-user in respect of such machinery or plant.

(3) For the purposes of subsection (2) an allowance shall be deemed not to have been made if the end-user, by notice in writing to the Commissioner within 3 months of the date on which the capital expenditure on the provision of machinery or plant giving rise to the allowance is incurred, or within such further time as the Commissioner may, in any particular case, permit, disclaims such allowance.

(4) For the purposes of this section, where a trustee of a trust estate or a corporation controlled by such a trustee owns machinery or plant or holds rights as a lessee under a lease of machinery or plant, the trustee, the corporation and the beneficiary under the trust shall each be deemed to be the owner or holder, as the case may be, of rights as a lessee of the machinery or plant. (Replaced 15 of 1992 s. 4)

(5) In this section-

"acquisition" (取得) means acquisition by a person as owner and includes holding or hiring under a hire-purchase agreement or, if the hire-purchase agreement is a conditional sale agreement, holding as purchaser;

"associate" (相聯者), in relation to a person holding rights as lessee under any lease of machinery or plant (including a person who is deemed to be holding such rights), means- (Amended 15 of 1992 s. 4)

(a) where the person holding such rights is a natural person-
  (i) a relative of the person holding such rights;
  (ii) a partner of the person holding such rights and any relative of that partner;
  (iii) a partnership in which the person holding such rights is a partner;
  (iv) any corporation controlled by the person holding such rights, by a partner of the person holding such rights or by a partnership in which the person holding such rights is a partner;
  (v) any director or principal officer of any such corporation as is referred to in subparagraph (iv);
(b) where the person holding such rights is a corporation-
  (i) any associated corporation;
  (ii) any person who controls the corporation and any partner of such person, and, where either such person is a natural person, any relative of such person;
  (iii) any director or principal officer of that corporation or of any associated corporation and any relative of any such director or officer;
  (iv) any partner of the corporation and, where such partner is a natural person, any relative of such partner;
(c) where the person holding such rights is a partnership-
  (i) any partner of the partnership and where such partner is a partnership any partner of that partnership, any partner with the partnership in any other partnership and where such partner is a partnership any partner of that partnership and where any partner of, or with, or in any of the partnerships mentioned in this subparagraph is a natural person, any relative of such partner; (Replaced 65 of 1993 s. 4)
  (ii) (Repealed 65 of 1993 s. 4)
  (iii) any corporation controlled by the partnership or by any partner thereof or, where such a partner is a natural person, any relative of such partner;
  (iv) any corporation of which any partner is a director or principal officer;
  (v) any director or principal officer of a corporation referred to in subparagraph (iii);

"associated corporation" (相聯法團) means-

(a) a corporation over which the person holding rights under any lease of machinery or plant (including a person who is deemed to be holding such rights) has control; (Amended 15 of 1992 s. 4)
(b) a corporation which has control over such person holding rights, being a corporation;
(c) a corporation which is under the control of the same person as such person holding rights, being a corporation;

"beneficiary under the trust" (信託的受益人) means any person who benefits or is capable (whether by the exercise of a power of appointment or otherwise) of benefiting under a trust estate, either directly or through any interposed person, or who is able or might reasonably be expected to be able, whether directly or indirectly, to control the activities of the trust estate or the application of its corpus or income; (Replaced 15 of 1992 s. 4)

"control" (控制), in relation to a corporation, means the power of a person to secure-

(a) by means of the holding of shares or the possession of voting power in or in relation to that or any other corporation; or
(b) by virtue of any powers conferred by the articles of association or other document regulating that or any other corporation,

that the affairs of the first-mentioned corporation are conducted in accordance with the wishes of that person;

"end-user" (最終使用者) means any person (whether alone or with others) holding rights as lessee under a lease of machinery or plant or any associate of such person;

"held for use" (持有以供使用) includes installed ready for use and held in reserve;

"non-recourse debt" (無追索權債項), in relation to the financing of the whole or a predominant part of the cost of the acquisition or construction of any machinery or plant, means a debt where the rights of the creditor in the event of default in the repayment of principal or payment of interest-

(a) are limited wholly or predominantly to any or all of the following-

(i) rights (including a right to moneys payable) in relation to the machinery or plant or the use of the machinery or plant;
(ii) rights (including rights to moneys payable) in relation to goods produced, supplied, carried, transmitted or delivered, or services provided, by means of the machinery or plant;
(iii) rights (including a right to moneys payable) in relation to the loss or disposal of the whole or a part of the machinery or plant or of the taxpayer's interest in the machinery or plant;
(iv) any conjunction of such rights as are referred to in subparagraphs (i), (ii) and (iii);
(v) rights in respect of a mortgage or other security over the machinery or plant; or
(vi) rights arising out of any arrangement relating to the financial obligations of the end-user of the machinery or plant towards the taxpayer, being financial obligations in relation to the machinery or plant;

(b) are in the opinion of the Commissioner capable of being limited as described in paragraph (a), having regard to either or both of the following-
(i) the assets of the taxpayer;
(ii) any arrangement to which the taxpayer is a party; or

(c) where paragraphs (a) and (b) do not apply, are limited by reason that not all of the assets of the taxpayer (not being assets that are security for a debt of the taxpayer other than a debt arising in relation to the financing of the whole or part of the cost of the acquisition of the machinery or plant) would be available for the purpose of the discharge of the whole of the debt so arising (including the payment of interest) in the event of any action or actions by the creditor or creditors against the taxpayer arising out of the debt;

"operator of a Hong Kong aircraft" (香港飛機的經營者) means a person who-

(a) holds an air operators' certificate issued under the Air Navigation (Hong Kong) Order 1995 (Cap 448 sub. leg. C); and (Amended 12 of 1999 s. 3)
(b) carries on business as an operator of aircraft and the business is controlled and managed in Hong Kong; (Amended 15 of 1992 s. 4)

"operator of a Hong Kong ship" (香港船舶的經營者) means a person who-

(a) is responsible for defraying all or a substantial portion of the expenses of operating the ship and the ship operates mainly in the waters of Hong Kong or between the waters of Hong Kong and waters within the river trade limits; and
(b) carries on business as an operator of ships and the business is controlled and managed in Hong Kong; (Added 15 of 1992 s. 4)

"principal officer" (主要職員) means-

(a) a person employed by a corporation who, either alone or jointly with one or more other persons, is responsible under the immediate authority of the directors for the conduct of the business of the corporation; or
(b) a person so employed who, under the immediate authority of a director of the body corporate or a person to whom paragraph (a) applies, exercises managerial functions in respect of the body corporate;

"relative" (親屬) means the spouse, parent, child, brother or sister of the relevant person, and, in deducing such a relationship, an adopted child shall be deemed to be a child both of the natural parents and the adopting parent and a step child to be the child of both the natural parents and of any step parent;

"used" (使用) includes held for use. (Amended 32 of 1998 s. 24)

(6) The amendments made to this section by section 4(b) and (d)(iv) of the Inland Revenue (Amendment) Ordinance 1992 (15 of 1992) apply to capital expenditure on the provision of machinery or plant under a transaction entered into on or after 15 November 1990 except expenditure under a transaction which was the subject of an application for advance clearance made to the Commissioner before 15 November 1990 and the Commissioner before or after that date expressed the opinion that the transaction would not fall within the terms of section 61A or, where no such application was made in respect of a transaction entered into before 15 November 1990 under which expenditure was incurred on or after 15 November 1990, the transaction under which the expenditure was made is, in the Commissioner's opinion, of the same type as any for which, in the circumstances prevailing as at 14 November 1990, he would have expressed the opinion that the transaction would not fall within the terms of section 61A. (Added 15 of 1992 s. 4)

(Added 7 of 1986 s. 7)

Appendix 3

LCQ16: Depreciation allowances

****

Following is a question by Dr the 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 on October 21.

Question :

The Inland Revenue (Amendment) Ordinance 1986 added section 39E to the Inland Revenue Ordinance (Cap. 112). The provision aims to limit the opportunities for tax deferral or avoidance through sale and leaseback and leveraged leasing arrangements. In making such relevant arrangements, an owner of machinery or plants will be denied initial allowances and annual allowances (depreciation allowances) in respect of the capital expenditure incurred on the provision of such machinery or plants. When the provision was scrutinised and passed by the former Legislative Council in 1986, the Government had stated that the provision was intended to strike down such acts of tax avoidance, and specifically stated that the provision only targeted at the two leasing arrangements of sale and leaseback and leveraged leasing. At the same time, it assured that general leasing transactions and normal commercial transactions would not be affected. Upon passage of the Bill, the Commissioner of Inland Revenue issued the Departmental Interpretation and Practice Notes No. 15, which stated clearly that the Notes only apply to the two leasing arrangements of sale and leaseback and leveraged leasing. In this connection, will the Government inform this Council:

(a) given that members of the trade are of the view that the original Notes No. 15 already reflected clearly the legislative intent of section 39E, and no problem has arisen from the enforcement of the relevant legislation, yet the Government amended in January 2006 the Notes relating to the enforcement of the Ordinance, of the reasons for that;

(b) given that the Government had assured the former Legislative Council in 1986 that the departmental guidelines issued by the Commissioner of Inland Revenue in respect of section 39E would reflect the literal meaning and the legislative spirit of the legislation, whether the assurance was fulfilled when the Government amended the Notes concerned in 2006; if it was, how the new Notes reflect the legislative spirit of the legislation; if not, of the reasons for that;

(c) given that the legislative intent of the above provision is to strike down acts of tax avoidance, and it has been especially stated that the provision only targets at the two leasing arrangements of sale and leaseback and leveraged leasing, why Hong Kong enterprises are denied depreciation allowances, even if they have not committed or intended to commit the above acts of tax avoidance, and have absolutely not involved in the above two leasing arrangements, but have merely made the machinery and plants available for use by factories or their outsourced manufacturers on the Mainland in accordance with general commercial arrangements (e.g. import processing arrangement), so as to manufacture commodities for sale by Hong Kong enterprises, and the profits of these Hong Kong enterprises are all subject to taxes in Hong Kong;

(d) given that the Government had assured the former Legislative Council in 1986 that general leasing transactions and normal commercial transactions would not be affected by the provision, whether the relevant assurance is still valid today; if so, how it ensures that the assurance is complied with; if not, of the reasons for that;

(e) whether it has assessed the actual impact of implementing the new Notes on normal economic activities; if it has, of the details; if not, the reasons for that;

(f) whether, in implementing the new Notes, it has taken into consideration the situation of the northern migration of industries and regional economic integration in the Pearl River Delta at present; if it has, of the details; if not, the reasons for that;

(g) whether it has taken into consideration that the new Notes have rendered Hong Kong enterprises unable to tie with the Mainland policy of requiring enterprises to upgrade and restructure, and have dealt a severe blow to the productivity and competitiveness of the manufacturing industry; if it has, of the details; if not, the reasons for that; and

(h) whether it has plans to review the above Notes and related legislation; if it has, of the details; if not, the reasons for that?

Reply :

President,

(a) to (e) Section 39E of the Inland Revenue Ordinance was enacted in 1986 and amended in 1992 to become the current version. The legislation aims at limiting tax avoidance opportunities in various forms of machinery or plant leasing arrangements. As many of such tax avoidance arrangements involve machinery or plant owned by a Hong Kong enterprise being used by an enterprise outside Hong Kong for a long period of time, section 39E stipulates that the Hong Kong enterprise will not be granted depreciation allowances for the relevant machinery or plant under such circumstances.

Section 39E is not intended to have any impact on normal commercial leasing transactions. As we explained to the Legislative Council when we proposed the amendment to section 39E in 1992, if a Hong Kong enterprise leases its machinery or plant to another enterprise outside Hong Kong through a normal leasing arrangement, although the Hong Kong enterprise will no longer be granted depreciation allowance for the relevant machinery or plant, its rental income derived from outside of Hong Kong will not be subject to Hong Kong tax. Therefore, section 39E should not have impact on such transactions.

The Inland Revenue Department issues and updates departmental interpretation and practice notes from time to time for the implementation of various provisions of the Inland Revenue Ordinance (including section 39E). The notes provide detailed explanations and realistic examples so as to facilitate taxpayers' understanding of and compliance with the relevant provisions. However, the notes have no legal binding force and cannot change the legislative intent of any provision.

(f) to (h) We have noticed the restructuring of Hong Kong enterprises in the Pearl River Delta in recent years. We understand that under the import processing arrangement they may make their machinery or plant (mainly moulds) available for use by Mainland enterprises free of charge. In such circumstances, they would neither receive any rental income nor enjoy the relevant depreciation allowances because of section 39E.

We appreciate that the industry would like to continue to enjoy the deduction of depreciation allowances in Hong Kong under the above-mentioned circumstances. However, we consider that it is a rather complicated matter involving various issues, including whether the machinery or plant used in Mainland China is 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; whether depreciation allowances of the same machinery or plant have been claimed by other enterprises, etc. There are practical difficulties in relaxing the relevant restriction.

LCQ1: Depreciation allowances
****

Following is a question by Dr the Hon Lam Tai-fai and a reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council on November 4.

Question:

At the meeting of this Council on October 21, 2009, I raised a question regarding the initial allowances and annual allowances (depreciation allowances) on machinery and plants. In connection with the reply given by the Secretary for Financial Services and the Treasury to this question, will the Government inform this Council:

(a) given that section 39E of the Inland Revenue Ordinance (section 39E) aims at limiting tax avoidance opportunities in various forms of machinery or plant leasing arrangements, and the Government also agrees that under the import processing arrangement, Hong Kong enterprises may make their machinery or plants (mainly moulds) available for use by mainland enterprises free of charge for manufacturing goods which these Hong Kong enterprises will buy from the mainland enterprises, and not for the purpose of "tax avoidance", why the Government still considers such arrangements as leasing arrangements and applies section 39E to restrict the granting of depreciation allowances to Hong Kong enterprises to which they are entitled in respect of these machinery and plants;

(b) given that the Government has indicated that the practice notes of the Inland Revenue Ordinance have no legal binding force and can never change the legislative intent of the relevant provisions, why the authorities needed to amend the original practice notes in 2006 and extended the retrospective period of the amended notes to the previous years of assessment; how the Government fulfils the assurance it made upon the enactment of section 39E in 1986 that the provision only targeted at the two leasing arrangements of "sale and leaseback" and "leveraged leasing"; and

(c) given that the Government has indicated that there are practical difficulties in

relaxing the relevant restriction in (a), including the difficulties in confirming if the machinery or plant was solely used on the Mainland for manufacturing goods sold to the Hong Kong enterprise concerned, if the machinery or plant has been sold and if the depreciation allowances concerned have been claimed by others, whereas there are provisions in the Inland Revenue Ordinance stipulating that under certain circumstances the burden of proof shall rest on the taxpayers, whether the Government will allow taxpayers to provide evidence in this respect to address such difficulties, so that the legislative intent of section 39E will not be violated when this section is enforced?

Reply:

President,

(a) As I pointed out in my reply to Dr the Hon Lam Tai-fai's written question on October 21 this year, section 39E of the Inland Revenue Ordinance (IRO) was enacted in 1986 and amended in 1992 to become the current version. The legislation aims at limiting tax avoidance opportunities in various forms of machinery or plant leasing arrangements. The relevant provision stipulates that a Hong Kong enterprise will be denied depreciation allowances if the machinery or plants owned by it are used wholly or principally outside Hong Kong by another enterprise.

Section 39E or any other specific anti-avoidance provision in the IRO will apply if a commercial arrangement is within the specific scope of the provision. The Inland Revenue Department (IRD) cannot exercise its power under the law selectively.

(b) Section 39E was indeed enacted in 1986 to target "sale and leaseback" and "leverage leasing" arrangements only. However, after the 1992 amendment, depreciation allowances will also be denied if the machinery or plants owned by a Hong Kong enterprise are used mainly by another enterprise outside Hong Kong. The IRD reflected this amendment to section 39E in its update on Departmental Interpretation and Practice Notes (DIPN) No. 15 in 1992. The further update on DIPN No. 15 in 2006 was only to provide more detailed explanations and real life examples. In no way did the update in 2006 change the scope of section 39E.

The time limit for raising additional assessments under the IRO is six years. The IRD has all along been issuing additional assessments in accordance with the provisions of the IRO. It has no authority to vary the statutory time limit to cater for

different situations.

(c) I have already pointed out in my written reply on October 21 that there are practical difficulties in relaxing the restrictions of section 39E. Although the taxpayer has the onus of proof under the IRO, as the relevant machinery or plants are used by another enterprise outside Hong Kong and such an enterprise is usually a separate legal entity, it would be difficult for the IRD to check the actual usage of the relevant machinery or plants. Besides, the IRD does not have the statutory power to request such an overseas entity to provide supporting documents. 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.

LCQ16: Section 39E of the Inland Revenue Ordinance
****

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 on 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.