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The Honorable Chan Kam-lam
Chairman of the LegCo's Panel on Financial Affairs
Legislative Council Building
8 Jackson Road
Central
Hong Kong

The Honorable Chan Kam-lam,

Re: Panel on Financial Affairs - Special meeting on 14 December 2009
Tax depreciation allowances for profits tax in respect of machinery or plant used outside Hong Kong under a processing arrangement

Thank you for the letter dated 12 November 2009 inviting us to make a submission on taxpayers' concerns as regards the denial of tax depreciation allowances under section 39E of the Inland Revenue Ordinance (IRO) for plant and machinery used wholly or principally outside Hong Kong.

The concerns are particularly relevant in the light of the recent decision by the Board of Review (BOR) in case D61/08. In this case, the BOR endorsed the Revenue's current strict interpretation of section 39E, in its denial of tax depreciation allowances to taxpayers who provide plant and machinery to manufacturing entities in mainland China under import processing arrangements[1].

Given the decision in D61/08 and for reasons stated below, we consider that there is a strong case to grant an extra-statutory concessionary tax treatment to import processing arrangements or, if necessary, amend the terms of section 39E so as to achieve this result.

[1] An "import processing arrangement" is an arrangement where a mainland entity purchases raw materials for processing or manufacturing and then sells finished goods for its own account.

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A strong case for granting an extra-statutory concessionary tax treatment to import processing arrangements or, if necessary, amending section 39E

To put the issue in perspective, we would like to quote below what the Secretary for Financial Services and the Treasury, Professor K C Chan said in the Legislative Council on 25 November 2009, in response to questions raised on the issue, as regards the legislative intent of section 39E:

> *"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....*
>
> *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...*
>
> *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".*
>
> *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..."*

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The above quoted passages indicate that when section 39E was enacted in 1986, it was intended to function as a specific anti-avoidance provision, targeting only certain "sale and leaseback" and "leverage leasing" arrangements. The amendment made to section 39E in 1992 was apparently technical in nature, i.e., to thwart attempts by some taxpayers to *"technically circumvent the definition of "leverage leasing" and made arrangements which were in substance similar to "leverage leasing" arrangement."* If so, one can hardly say that the provision of plant and machinery by a Hong Kong company to its mainland subcontractor under a processing agreement for the production of goods ordered by the Hong Kong company, as part of a normal commercial arrangement, falls within the target of the 1992 amendment.

Another point that can be made about the application of section 39E is that it depends on there being a "leasing arrangement". In this regard, we believe it may be fair to say that at the time of the 1992 amendment, despite the wide definition for the term "lease", few people thought that it would cover the provision of plant and machinery under a processing arrangement as described above.

If it were indeed the intent of the Administration that the 1992 amendment was to deny tax depreciation allowances of plant and machinery used outside Hong Kong under any types of processing arrangements, the Administration did not appear to have made this intent known in any technical briefings when the LegCo considered the amendment.

We believe that, apart from attacking certain blatant tax avoidance arrangements which have no place in normal commercial transactions, a major rationale for enacting section 39E appears to be that if the use of assets outside Hong Kong does not bring significant economic benefits to the Hong Kong economy[2], taxpayers should not be able to enjoy the tax depreciation allowances normally provided for in the IRO.

For import processing arrangements, plant and machinery are used outside Hong Kong by a mainland subcontractor to produce goods ordered by a Hong Kong company. On the basis that the sale of the goods by the Hong Kong company will create employment in Hong Kong, and any

[2] Paragraph 16 of Departmental Interpretation and Practice Notes No. 15 (DIPN 15) states that *"The "used wholly or principally outside Hong Kong" condition in section 39E(1)(b)(i) aims to encourage the generation of economic benefits in Hong Kong by the use of the machinery or plant in Hong Kong."*

profits so generated are wholly chargeable to tax in Hong Kong, the use of the assets outside Hong Kong by the subcontractor under such arrangements will bring significant economic benefits to the Hong Kong economy. Indeed, the vibrancy and well-being of the Hong Kong economy depends very much on such arrangements.

On the basis of the above, we consider that, subject to the Revenue's relevant concerns being adequately addressed, there is a strong case to grant an extra-statutory concessionary tax treatment to import processing arrangements, i.e., section 39E would not be strictly interpreted to deny tax depreciation allowances for plant and machinery used outside Hong Kong under import processing arrangements.

Revenue's concerns on granting or extending an extra-statutory concessionary tax treatment to import processing arrangements can be adequately addressed

At present, the Revenue has adopted an extra-statutory concessionary tax treatment of granting 50% tax depreciation allowances on plant and machinery where a taxpayer (whose relevant profits are 50% chargeable to tax in Hong Kong) provides said equipment to an entity in mainland China under a contract processing arrangement[3], even though a strict interpretation of section 39E would deny the same.

The reasons given by the Revenue for not extending the concessionary tax treatment to import processing arrangements include difficulties encountered in verifying (i) a Hong Kong taxpayer's continued ownership of the assets when a related mainland manufacturing entity is involved; (ii) the actual usage of the assets outside Hong Kong, especially when the mainland entity does not produce goods solely for the Hong Kong taxpayer; and (iii) that claims for tax depreciation

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3 A "contract processing arrangement" is an arrangement where a mainland processing enterprise does not take title to the raw materials that are imported for processing and assembly. Under such an arrangement, the materials enter the mainland on a consignment basis and title to all raw materials and finished product remains with a non-mainland entity.

Paragraph 19 of DIPN 15 states that *"Under contract processing arrangement ... Even though the machinery or plant is not used wholly or principally in Hong Kong, the Department as a concession is prepared to allow 50 per cent of the depreciation allowances on the leased machinery or plant on the condition that the profits from manufacturing activities of the Hong Kong company are assessed on a 50:50 basis..."*.

allowances are not sought by both the Hong Kong taxpayer and the mainland entity in respect of the same assets.

Furthermore, the Revenue is apparently of the view that, unlike contract processing arrangements, taxpayers under import processing arrangements should or could provide the relevant plant and machinery to mainland manufacturing entities by way of a capital contribution. Or alternatively, such taxpayers could charge mainland manufacturing entities rentals for the use of the plant and machinery, such rentals being generally regarded as offshore income not chargeable to tax in Hong Kong.

While the concerns raised by the Revenue as regards the verification of ownership of such assets, the actual usage of same and the potential for the allowances to be claimed twice may be understandable, we believe that such concerns can be adequately addressed by way of the Revenue imposing certain administrative safeguards and documentary requirements in its processing of allowance claims.

As regards the possible alternatives of providing plant and machinery to mainland manufacturing entities as a capital contribution, or charging rentals for the use of the assets, these approaches could possibly pose a hindrance to how taxpayers would wish to arrange their business affairs, and may not be commercially feasible in some cases, e.g., where moulds and tools must be provided free of charge to an unrelated third party sub-contractor as part of a sub-contracting arrangement.

Amending section 39E, if necessary

If ultimately the Revenue is not convinced to change its stance and extend the concessionary tax treatment, we consider that there is a strong case to amend the terms of section 39E such that tax depreciation allowances for plant and machinery used outside Hong Kong under both import and contract processing arrangements are not denied, thus rendering the section less of a hindrance to cross-border commercial activities.

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Amending the terms of section 39E on the above basis would also place the current practice of granting 50% tax deprecation allowances to taxpayers under contract processing arrangements on a firmer legal footing.

Should you wish us to clarify any of the above points, please feel free to contact the undersigned at 2846 9921 or Patrick Kwong at 2846 9810.

Yours sincerely,
For and on behalf of
Ernst & Young Tax Services Limited

Agnes Chan
Partner