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Profession K C Chan
Secretary for Financial Services and the Treasury
Central Government Offices
Lower Albert Road
Hong Kong

Dear Professor Chan,

Depreciation Allowances for Plant & Machinery used outside Hong Kong

The Hong Kong General Chamber of Commerce would like to draw your attention to the adverse impact of Section 39E(1)(b) of the Inland Revenue Ordinance (IRO) on our members. While this provision has been in place for some time, lately the Inland Revenue Department has been reversing previous decisions, to the detriment of Hong Kong SMEs engaged in cross-border import processing manufacturing. We believe this is unwarranted.

Background. To off-set high labour and land cost in Hong Kong, manufacturers moved production to factories in the Mainland of China. In the initial stage, they had to work with a Chinese party by way of contract processing arrangements whereby the Mainland entity was responsible for manufacturing goods sold by the Hong Kong entity, and paid a processing fee. Under the arrangement, the Mainland entity would provide the factory premises, land and labour while the Hong Kong entity would provide, *inter alia*, manufacturing plant and machinery (P&M) free of charge.

In Departmental Interpretation and Practice Note (DIPN) No. 21, the IRD allows the taxpayers to apportion the chargeable profits under this arrangement on a 50:50 basis.

Recent developments. As investment restrictions eased, Hong Kong manufacturers established wholly-owned subsidiaries in the Mainland for the manufacture of their products under the import processing arrangement. Very often, unrelated factories were also engaged in production under similar arrangement. The P&M, including moulds and tooling used by the Mainland factories, were also provided by Hong Kong entities free of charge. Such P&M were booked as the fixed assets, and the goods manufactured by the factories were booked as purchases in the books of the Hong Kong entities. The profits of

the Hong Kong companies on sales of the goods manufactured by the Mainland factories were fully assessable to Hong Kong Profits Tax.

In the past years, depreciation allowances on P&M used by the Mainland entities under import processing arrangement have been claimed, and allowed, by the IRD. In some cases, the Assessors allowed the claim after making enquiries. On the premise that their legitimate claim was accepted by the IRD, taxpayers would not have made any provision on the depreciation allowances. Now, the IRD has begun revisiting these claims, raising additional assessments for past years by withdrawing the deprecation allowances allowed.

The problem. Under the IRO, a taxpayer is entitled to deprecation allowances on the P&M used in the production of his assessable profits. However, under S. 39E(i)(b) of the IRO, an anti-avoidance provision, depreciation allowances would be denied if the P&M were used wholly or principally outside Hong Kong by a person other than the taxpayer under a lease. Under Section 2 of the IRO, the provision of P&M to others at no consideration would fall within the definition of 'lease'. In the case of contract processing, following the concession on assessable profits, the depreciation allowances on the P&M used by the PRC factories rent free are allowed on the same 50:50 basis.

This concession is not extended to the P&M used in an import processing arrangement. Thus, while the profits from the sales of the goods produced by the Mainland factories are subject to Hong Kong Profits Tax, no corresponding depreciation allowances on the P&M used in the production of these taxable profits are granted by virtue of S.39E(i)(b) of the IRO resulting in an apparently unfair treatment.

The law and its intent. S.39E is an anti-avoidance provision introduced in 1986. When moving the second reading of the relevant Bill, the then Financial Secretary said it was:-

> *" to limit the opportunities for tax deferral through use of certain machinery or plant under leasing arrangements by denying to a lessor initial and annual allowances where machinery or plant was acquired by him under a sale and leaseback arrangement, or, being other than ship or an aircraft, was acquired by him through a 'leverage lease' transaction* ***and*** (emphasis added) *is used wholly or principally outside Hong Kong."*

S. 39E was amended in 1992. In proposing the amendment, the then Financial Secretary advised the Legislative Council that:-

> *".... In 1986 legislation was introduced with the intention of denying depreciation allowances where ships or aircraft had been acquired through leverage lease transactions and the lessee, referred to the end-user, was not a Hong Kong ship or aircraft operator. However, more and more examples of schemes are being encountered where the end-user of ships and aircraft acquired through a Hong Kong limited partnership is a foreign operator. Nonetheless, under the existing legislation depreciation allowances cannot be denied to these schemes.*

Subject to the advice of the Executive Council, amendments will be introduced in the coming year to ensure that foreign operators do not get the benefit of such depreciation allowances...."

Unintended consequences. S.39E was amended to give effect to the above recommendation. It should be noted that in the original version of S.39E, the condition of "used wholly and principally outside Hong Kong by a person other than the taxpayer" must be met with other conditions before depreciation allowances were denied. By replacing the word "and" with "or" after "used wholly and principally outside Hong Kong by a person other than the taxpayer" in the amended S.39E(1)(b), even though the P&M were used for the production of Hong Kong taxable profits, deprecation allowances would not be granted solely for the reason that the P&M were used by others outside Hong Kong.

From the speeches of the two Financial Secretaries, it is clear that *S.39E was intended to tackle tax avoidance schemes involving aircraft or ship leasing.* It was not meant to restrict the use of P&M by Hong Kong manufacturers in the ordinary course of their business. Unfortunately, the letter of law results in the denial of depreciation allowances apparently not intended by the legislation.

This situation is clearly against the spirit of the law, and in violation of the basic principle of allowing taxpayers to deduct the costs incurred in the production of income. Moreover, it is prejudice against manufacturers who have no intention of avoiding Hong Kong tax by means of the production arrangement. Finally, denying this depreciation allowance amounts to charging a higher tax on our own companies.

Conclusion and recommendations. It has always been the SAR Government's policy to encourage Hong Kong companies to invest in the PRC. To deny a legitimate depreciation based on a misinterpretation of the law is not in line with such a policy. To rectify the undesired effect of S.39E, the IRD should extend the concession it granted to *contract* processing arrangement to *import* processing arrangement. If the profits under import processing arrangement are 100% taxable, 100% of the depreciation allowances on the P&M used in the manufacturer of the goods should be allowed. Alternatively, the IRO may be amended to release manufacturers from the unintended effects of S.39E on P&M used for the production of Hong Kong taxable profits.

As the concession granted by the IRD has no legal binding effect, amendment of the IRO would be the best solution. Since it will take some time to complete the legislative process, the IRD should immediately grant similar concession to import processing arrangement so as to give immediate relief to the Hong Kong companies.

Due to the global financial crisis and the acute liquidity crisis facing manufacturers, we recommend that measures taken by the government either to amend the law or to extend the concession should be retroactive to the year of assessment 2003/04.

In view of the seriousness of the impact of S.39E on the Hong Kong manufacturers, your immediate attention to this matter is highly appreciated.

Yours sincerely

Alex Fong,
CEO

c.c. John Tsang JP, Financial Secretary