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Hon CHAN Kam-lam, SBS, JP
 Panel Chairman
 Panel on Financial Affairs
 Legislative Council Building
 8 Jackson Road
 Central
 Hong Kong

1 December 2009

Dear Mr Chan

**Panel on Financial Affairs
 Depreciation Allowances for Profits Tax in respect of Machinery or Plant under
 the Inland Revenue Ordinance (Cap.112)**

Thank you for your letter dated 12 November 2009 inviting ACCA Hong Kong's views on the captioned subject.

Original legislative intent of section 39E

ACCA Hong Kong understands that the legislative intent of section 39E of the Inland Revenue Ordinance is to combat abusive tax avoidance schemes such as "sale and leaseback" and "leverage leasing" arrangements. Hence, the current interpretation of section 39E by the Inland Revenue Department (IRD) to deny depreciation allowances on costs of plant and machinery provided by Hong Kong business enterprises to their sub-contractors located outside Hong Kong is not in accordance to the original legislative intent. Since the profits of these Hong Kong business enterprises are subject to Hong Kong Profits Tax, the denial of depreciation allowances is not in line with the general tax principle of taxation of allowing deductions of expenses incurred in the production of chargeable profits.

Commercial reality

It should be noted that under the current business models, it is very common for a Hong Kong company to purchase plant and machinery, especially moulds, and to provide the same to third party manufacturers / subsidiaries outside Hong Kong (normally in the Mainland) for the production of goods. All the goods produced will be purchased by the Hong Kong company for further resale

to customers in and outside Hong Kong. The purchase price of the goods is determined with due consideration of the fact that the plant and machinery are provided by the Hong Kong company free of charge.

Under this circumstance, the legal ownership of the plant and machinery belongs to the Hong Kong company which records the moulds as its fixed assets for accounting purposes. Depreciation is charged according to the Hong Kong company's accounting policy. As these assets are legally owned by the Hong Kong company, the Hong Kong company will be able to relocate these assets to another third party manufacturers where required, for instance, to seek for further capacity of production. It could also be understood that the Hong Kong company would prefer to own these assets legally due to some commercial risk reasons such as to ensure compliance with design and product specifications.

As the Hong Kong company is operating its trading business in Hong Kong, its profits from sale of these goods are fully subject to Hong Kong Profits Tax. However, under the current interpretation of section 39E and the prevailing practice of the IRD, depreciation allowances on the costs of these assets under this scenario are disallowed even though the arrangement is obviously for a genuine commercial purpose.

This treatment is not in line with the principle of taxation given these business enterprises are engaged in genuine commercial transactions. It also adds further financial burden onto those struggling businesses, especially small and medium businesses, in particular when the global demands have been weakened and access to finance is difficult.

ACCA Hong Kong viewpoint

Whilst we note in a few occasions, including a series of replies to the Legislative Council, that the IRD found it difficult in practice to confirm whether the plant and machinery is solely used in the Mainland for manufacturing goods sold solely to the Hong Kong company concerned, or whether depreciation allowances of the same plant and machinery have been claimed by other enterprises, we do not consider it a justified rationale to penalize those businesses which conduct genuine businesses by means of reasonable commercial practices and pay their fair share of tax. We strongly believe that the current general anti-avoidance and penalty provisions in the Inland Revenue Ordinance can adequately counteract any fictitious arrangements which abuse the claim of depreciation allowances.

To recognize the fact that the capital expenditure on the plant and machinery used in the manufacturing is an integral and material cost of producing the taxable profits in Hong Kong, and disallowing the depreciation allowances of these equipment not only deviate from the general principle of taxation as



mentioned above, but also create a burden on the striving business, ACCA Hong Kong strongly recommends these practices be revisited.

ACCA Hong Kong suggestion

The current practice and interpretation of section 39E by the IRD to the situations described above have created many difficulties to the Hong Kong companies, and in many cases, have caused disputes between the IRD and the taxpayers. Some of these disputes have to be sorted out by higher authorities such as the Board of Review or even in courts. For practical reasons and in line with our observations as explained above, we urge the Government to consider actions to resolve the difference in opinion. This can be done by issuing a Departmental Interpretation and Practice Note by the IRD to change their view on the subject matter. Alternatively the Hong Kong government can make legislative changes to the Inland Revenue Ordinance to achieve the same result where necessary. In either option, the new treatment should be applicable with retrospective effect, but not to re-open assessments issued based on prevailing practice.

Should you wish to discuss any of the above issues in detail, kindly please contact the co-chairmen of our Tax sub committee, Mr Fergus Wong and Mr Davy Yun, at 2524 4988.

Yours sincerely

A handwritten signature in black ink, appearing to read "Judy Wong", is positioned above the typed name and title.

Judy Wong
President