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4 December 2009

Mr Noel Sung
Clerk to the Panel
Legislative Council Secretariat
3/F, Citibank Tower
3 Garden Road
Central

CB(1)601/09-10(07)

Dear Sir / Madam,

RE: DEPRECIATION ALLOWANCES FOR PROFITS TAX IN RESPECT OF MACHINERY OR PLANT UNDER THE INLAND REVENUE ORDINANCE (CAP.112)

CPA Australia welcomes the opportunity to respond to your invitation to provide comments on the existing provision under section 39E of the Inland Revenue Ordinance (IRO) in respect of the granting of depreciation allowances.

Section 39E(1)(b) provides that depreciation allowances shall not be granted to a taxpayer 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 the machinery or plant was wholly or principally used outside Hong Kong by a person other than the taxpayer.

We believe that Section 39E was introduced to counter tax avoidance schemes and was not intended to catch bona fide commercial arrangements. Accordingly, we suggest the Inland Revenue Department (IRD) revisit the applicability of Section 39E as regards taxpayers involved under import processing arrangements for the following reasons:

1. ***The legislative intent***

   In the 2006 annual meeting between the IRD and the Hong Kong Institute of Certified Public Accountants ("HKICPA"), reference was made to Section 39E being, in effect, an anti-avoidance provision with the purpose and spirit of defeating tax deferral or avoidance through sale and leaseback, offshore equipment leasing and leveraged leasing arrangements. However, where the provision of machinery or plant by a taxpayer to a subcontractor is a commercial necessity and there is no tax scheme involving tax deferral or avoidance through sale and leaseback, offshore equipment leasing and leveraged leasing arrangements, a purposive approach should perhaps be taken when interpreting Section 39E to give effect to the real intention of the legislation.

2. *Definition of "use"*

A taxpayer should not be precluded from claiming the depreciation allowances under 39E because the machinery or plant were used "wholly or principally" outside Hong Kong by a person other than the taxpayer.

Section 39E should not restrict itself to considerations only to the physical use of the machinery or plant. Instead, relevance should also be given to the beneficial or economic "*use*" of the same. In most cases, the machinery or plant is actually used wholly by the taxpayer, through its subcontractor, the subcontractor's physical use of the machinery or plant, being for the purpose of producing the chargeable profits of the taxpayer in Hong Kong according to the very specific instructions of the taxpayer. The denial of the allowance claimed under such situations will cause exceptional hardship to taxpayers.

3. *Departmental practices*

Paragraph 19 of the Departmental Interpretation and Practice Notes No. 15(Revised) on Leasing Arrangements stated that the IRD allows depreciation allowances on assets used outside Hong Kong as a concession in the case of contract processing arrangements. Even though the machinery or plant is not used wholly or principally in Hong Kong, the IRD is prepared to allow 50% of the depreciation allowances on the leased machinery or plant as a concession on the condition that the profits from the manufacturing activities of the Hong Kong company are assessed on a 50:50 basis. If the IRD allows 50% of the depreciation allowances under contract processing arrangements where only 50% of the profits are taxable, we believe a taxpayer under an import processing arrangement, which returns 100% of its sales profits as chargeable, should not be precluded from claiming similar depreciation allowances. We do not believe it is IRD's intention to adopt a policy which denies the allowances claimed by this group of taxpayers who have acquired and used the relevant assets for the production of their taxable profits under bona fide commercial arrangement.

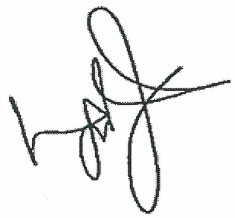
4. *2006 Annual Meeting between the IRD and the HKICPA*

As mentioned above, the implications and applicability of Section 39E of the IRO were discussed during the 2006 annual meeting held between the IRD and HKICPA.

According to the CIR, the Section 39E issue was to be resolved by considering two factors – whether the plant and machinery were owned by the Hong Kong entity and whether the assets were used by the Hong Kong entity in the production of its profits chargeable to be tax under the IRO. The CIR said that if, in a particular case, the two factors applied, then the matter could be considered further. From these comments, it appears that the CIR is prepared not to apply this anti-avoidance provision on a strict basis where the plant and machinery have to be used outside Hong Kong by necessity and not for tax avoidance purposes.

We would be pleased to address any questions you may have on the above comments. Meanwhile, if you require any further information, please contact Ms Deborah Leung, General Manager - Greater China, CPA Australia by phone at 2202-2710, by fax to 2832-9167 or by email to deborah.leung@cpaaustralia.com.au.

Yours sincerely,



Loretta Shuen FCPA (Aust.)
President - Hong Kong China Division
CPA AUSTRALIA

cc Hon Paul CHAN, MH, JP, Chairman of the Bills Committee