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Dear Mr Chan

Depreciation allowances for Profits Tax in respect of machinery or plant under the Inland Revenue Ordinance (Cap. 112)("IRO")

Thank you for your letter of 12 November 2009 inviting KPMG's views on Section 39E of the IRO.

Introduction

At the outset, we would like to express our support for the initiative of the Panel to raise this issue for discussion. The impact of Section 39E of the IRO has been a serious concern for some time for various businesses in Hong Kong. Specifically, while the legislative intent of Section 39E was to limit opportunities for tax deferral or avoidance through various leasing arrangements, its operation is so wide that it also catches genuine, commercial transactions. The result, which may not have been fully appreciated at the time of implementation, has been that businesses have suffered higher tax costs (than they should have been) and lost opportunities for Hong Kong to attract investment and develop its position as a leading financial and business centre.

We believe these unintended consequences are undesirable, and consider that the Administration should make legislative changes to the IRO so that it only applies to specified tax avoidance transactions in a more targeted manner.

The legislation

Section 39E of the IRO

The IRO provides taxpayers with tax relief for plant and machinery as follows:-

- 100% outright deduction under Section 16G[1] of the IRO. However, this deduction would not be allowed if the plant or machinery is subject to a ***lease***; or

- Depreciation allowances (initial allowance at 60% in the year the expenditure is incurred plus annual allowances at applicable rate of 10%, 20% or 30% on the tax written down value). However, depreciation allowances (both initial and annual allowances) would be denied under the relatively complex provisions of Section 39E(1) of the IRO, where:-

  i) the plant and machinery is purchased from and leased back to the same person or an associate;

  ii) the plant or machinery (not being a ship or an aircraft) is subject to a ***lease*** and is used wholly or principally outside Hong Kong; or

  iii) the plant or machinery (being a ship or an aircraft) is subject to a lease where the lessee is not an operator of a Hong Kong ship or aircraft.

We note the key operative requirement is that the plant and machinery are considered as being subject to a ***lease***.

Definition of "lease"

Section 2 of the IRO defines a "lease" in respect of plant and machinery to include:-

"(a) any arrangement under which a right to use the 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 the 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,..."

This is a very broad definition and the Inland Revenue Department ("IRD") is of the view[2] that, irrespective of whether or not rent is charged, the grant of a right to use plant and machinery to any other party constitutes a "lease".

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[1] As an incentive to invest more in high value manufacture and modern business systems, in his 1998/99 Budget Speech, the then Financial Secretary proposed an immediate 100% write-off for new expenditure on plant and machinery specifically related to manufacturing, and computer hardware and software. This proposal was subsequently approved and the relevant legislation was enacted under Section 16G of the IRO.

[2] The minutes of the 2006 and 2007 annual meetings between the IRD and the Hong Kong Institute of Certified Public Accountants ("HKICPA") and the Departmental Interpretation and Practice Notes No. 15 refer.

The (undesired) consequences

The current legislation and its interpretation have resulted in adverse impacts to various businesses. To illustrate the negative and in our view clearly unintended, impact of Section 39E of the IRO we use the example of a typical manufacturing business below.

Notwithstanding that many manufacturers have relocated their manufacturing operations to the Mainland, they remain active in Hong Kong, operating their local offices not only as trading companies but in support of their offshore manufacturing operations. Hong Kong manufacturers in the Mainland usually operate in the form of contract manufacturing, namely contract processing (來料加工) and import processing (進料加工) arrangements. Under these arrangements, the Hong Kong manufacturers typically enter into a contract with a local factory in the Mainland for the production of goods. Specifically, the Hong Kong manufacturers would source the raw materials, provide product design and technical know-how, and provide plant and machinery to the Mainland factory. The Mainland factory would produce the finished goods for the Hong Kong manufacturers to sell to the overseas markets.

Under a contract processing arrangement, legal title to the raw materials and finished goods remain with the Hong Kong manufacturers at all times. On the other hand, under an import processing arrangement, the raw materials are sold by the Hong Kong manufacturer to the Mainland factory. After processing, the Mainland factory will sell the finished goods to the Hong Kong manufacturer. Broadly speaking, this is the major difference between a contract processing and an import processing arrangement notwithstanding that to all practical effects, the roles played by the Hong Kong manufacturers under these arrangements are very similar.

For certain industries (e.g. toys), given the proprietary nature of product designs, it is very common for Hong Kong companies to supply the necessary moulds to its overseas vendors. The moulds are usually used solely for the production of products that belong to (or are sold to) the Hong Kong manufacturers. It is worth noting that this mould loan arrangement is in place irrespective of whether a processing trade is involved.

Although the Hong Kong manufacturers incur expenditure on the purchase of manufacturing plant and machinery and the moulds, as noted above the current tax legislation does not provide the Hong Kong manufacturers (other than those engaging in contract processing arrangements) with <u>any</u> tax relief for such expenditure. As the costs involved are significant, the current treatment has a huge negative impact for these Hong Kong manufacturers.

The IRD's interpretation of the current tax legislation is that manufacturing plant and machinery (including moulds) provided free of charge by Hong Kong manufacturers to Mainland/overseas factories constitutes a lease.

For Hong Kong manufacturers engaging in contract processing arrangements, the IRD is of the view[3] that the Hong Kong manufacturers have operations in the Mainland factory such that they are regarded as using the plant and machinery there. Accordingly, Section 39E of the IRO does not apply and, hence, the Hong Kong manufacturers are allowed as a concession 50% of the relevant depreciation allowances as their profits are treated as 50% offshore sourced.

However, in the case of non-contract processing arrangements, the IRD is of the view that the manufacturing plant and machinery (and moulds) are provided to the overseas factory/vendor for its use. Hence, this constitutes a lease under its definition in Section 2 of the IRO. As a result, Hong Kong manufacturers engaging in non-contract processing arrangements, whose profits are wholly subject to Profits Tax, are neither allowed to claim an outright deduction under Section 16G of the IRO nor a deduction for depreciation allowances under Section 39E of the IRO.

Wide impact

At KPMG we have seen businesses being based in Singapore or Ireland in preference to Hong Kong largely because of the operation of Section 39E of the IRO. The particular cases include container leasing and asset based financing such as aircraft. By way of example of the possible business opportunities that we believe may be missed by Hong Kong, we note that the Boeing Company forecasts that[4]:

> *"To accommodate the phenomenal growth in demand for air travel, China will need to more than triple the size of its fleet to 4,610 airplanes by 2028. China will take delivery of 3,770 new airplanes, which is 42 percent of the entire Asia Pacific market and valued at US$400 billion dollars."*

A significant source of financing new aircraft globally is leases. In our experience where operating lease finance is used, this will not be structured through Hong Kong as other locations, notably Ireland and Singapore, are much more attractive[5]. We consider this represents a lost opportunity for Hong Kong to develop its pillar industries in a manner that also supports its role as a transport and logistics hub. As noted by the Financial Secretary in his 2009/10 Budget Speech, financial services are high value-added industries which create significant jobs in finance and other support industries.

The unsatisfactory nature of the current arrangements is, in our view, well known to the IRD, which has attempted to mitigate some of the harshness of this provision with the statement in Paragraph 20 of Departmental Interpretation and Practice Note 21. This provides that where Section 39E(1)(b)(i) of the IRO applies the lease income will generally be regarded as non

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[3] The minutes of the 2009 annual meeting between the IRD and the HKICPA refer.

[4] See Current Market Outlook on www.boeing.com

[5] Lease financing using "Hire Purchase" arrangements is not impacted by Section 39E of the IRO

taxable. While commendable as an attempt to remedy some of the issues, we submit this is unsatisfactory as there is no legislative basis for treating income as non-taxable solely because deductions would be denied. Further, since the practice note does not have any legally binding effect, we consider that this does not sufficiently address the issues.

The legislative intent

It is understood that Section 39E of the IRO was enacted to limit opportunities for tax deferral or avoidance through various leasing arrangements. The particular mischief that the provision is aimed at is the use of Hong Kong's relatively generous capital allowance system, the benefit of which is transferred to a financer and used to create a shelter for the profits tax payable on other Hong Kong sourced profits. This is particularly a concern where the asset is used outside the Hong Kong tax base and Hong Kong does not necessarily directly benefit from the use of the asset by the lessee.

However, it is not intended to cast inhibitions on general leasing transactions or on normal commercial transactions. In our view, the effect of Section 39E of the IRO goes far beyond what is necessary to counteract the perceived problem. As explained above, the current legislation and its interpretation result in the denial of tax relief for Hong Kong manufacturers who provide manufacturing plant and machinery to overseas third party under genuine, commercial circumstances. We believe that as well as the negative impact on our local businesses Section 39E of the IRO is also unnecessarily inhibiting the growth and development of Hong Kong as an international finance and business centre. This can only be an unintended result of Section 39E of the IRO and, therefore, legislative changes should be made to correct this situation which is negatively impacting Hong Kong.

Possible solutions

Based on the foregoing, we hope that the Panel appreciates that Section 39E of the IRO, as currently drafted, has had unintended negative impacts on Hong Kong businesses. Accordingly, legislative changes are needed to ensure that Section 39E of the IRO (or its replacement) only attacks those tax avoidance transactions which it is intended to catch.

<u>Change the definition of lease</u>

In respect of the issue faced by Hong Kong manufacturers, in our view, the main cause of the problem is the broad definition of "lease" under the IRO. Specifically, the definition is so broad that it includes all situations where plant and machinery are provided to another party, irrespective of whether or not rent is charged. Therefore, to rectify this situation, we consider that the definition of "lease" under the IRO should be amended so that it does not catch situations where plant and machinery are provided to a vendor for the production of goods for the Hong Kong taxpayers (and not in return for rental income under a normal lease arrangement), in situations illustrated above.

Alternative solution

While the change to the definition of lease assists with the issue faced by many Hong Kong manufacturers, we submit that there is an opportunity to consider a wider reform which potentially simplifies the IRO, reduces unwarranted inhibitions on business and maintains the integrity of the Hong Kong tax base with a more targeted anti-avoidance measure. We note that other jurisdictions have faced similar issues of tax arbitrage arising from the use of offshore assets. We consider that measures, such as those in Ireland which "ring fence" deductions and losses from a leasing business to the income arising from that business, could provide a useful model in the case of assets used predominately offshore.

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In closing, we would like to thank the Panel again for giving us the opportunity to provide our comments and suggestions.

Yours sincerely

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cc:
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