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財經事務及庫務局
（庫務科）
香港下亞厘畢道
中區政府合署

FINANCIAL SERVICES AND THE TREASURY BUREAU
(The Treasury Branch)
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7 December 2010

Ms Anita Sit
Clerk to Panel
Panel on Financial Affairs
Legislative Council Secretariat
Legislative Council Building
8 Jackson Road, Central
Hong Kong
(Fax: 2121 0420)

Dear Ms Sit,

Depreciation allowances for profits tax in respect of machinery or plant under the Inland Revenue Ordinance (Cap. 112)

I refer to Item 7 on the list of outstanding items for discussion. Please find attached for the Panel's information the following –

(a) the submission of the Joint Liaison Committee on Taxation ("JLCT") to the Administration;
(b) the Administration's response to the JLCT; and
(c) the Administration's reply to an oral question raised at the LegCo on 24 November 2010, setting out the outcome of the Administration's review of the matter.

Yours sincerely,

(Miss Fiona Chau)
for Secretary for Financial Services and the Treasury

Encl.

JOINT LIAISON COMMITTEE ON TAXATION

CONSTITUENT MEMBERS: THE AMERICAN CHAMBER OF COMMERCE
THE HONG KONG GENERAL CHAMBER OF COMMERCE
HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
THE INTERNATIONAL FISCAL ASSOCIATION - HONG KONG BRANCH
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THE TAXATION INSTITUTE OF HONG KONG
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11 June 2010

Prof. K.C. Chan, SBS JP
Secretary for Financial Services & The Treasury
Financial Services & The Treasury
8/F West Wing
Central Government Offices
Lower Albert Road
Hong Kong

Dear Prof. Chan,

Tax relief for expenditure on plant and machinery used in manufacturing operations outside Hong Kong

This letter is submitted in response to a request made by Mr Kenneth Cheng on your behalf, in the March 4, 2010 meeting of our committee. Kenneth asked us to provide advice on how the Inland Revenue Ordinance ("IRO") could be amended so as to permit Hong Kong taxpayers to claim tax relief in respect of expenditure on equipment (technically, "plant and machinery") that is used outside Hong Kong in the manufacturing of goods that produce taxable profits, bearing in mind the Government's concerns about the possibility of tax avoidance.

Policy aspects

Our proposed amendments to the IRO are set out below. Before discussing the technical aspects of the proposal, we would like to explain our view of the matter from a policy perspective.

A fundamental principle of Hong Kong profits tax is that it is charged only on assessable profits arising in or derived from Hong Kong. A corollary principle is that, in determining the assessable profits arising in or derived from Hong Kong, expenditure by the taxpayer is deductible as provided in the IRO to the extent that such expenditure is incurred in the production of chargeable profits. Under these principles, the availability of depreciation allowances with respect to expenditure on the provision of equipment does not ordinarily depend on where the equipment is located but rather on whether its use produces taxable profits for the taxpayer who incurred the expenditure.

The JLCT believes that this principle is a correct one. If the tax system in Hong Kong imposes tax on a person who conducts taxable activities outside of Hong Kong, elementary fairness

dictates that the taxpayer should be entitled to deduct expenses and depreciate assets that it uses to produce those profits, in the same way that tax relief is conferred for activities and assets in Hong Kong.

The problem that has arisen

Section 39E was previously amended for the purpose of preventing tax avoidance through leasing arrangements involving aircraft and other assets which were used outside Hong Kong by lessees having no connection to the Hong Kong taxpayer. To explain this further, at one stage, for example, many foreign airlines were financing their new aircraft through Hong Kong based leasing partnerships in order to take advantage of Hong Kong's generous tax depreciation regime. The Legislative Council reacted appropriately to counter such perceived abuse by amending the IRO to deal with the aircraft situation. At the same time, LegCo amended section 39E further to deny depreciation allowances in cases involving sale and leaseback transactions, and also to prevent Hong Kong based lessors from claiming depreciation allowances for leased assets that were located outside Hong Kong.

The last amendment is the one that has given rise to the difficulties that have arisen. This amendment was justified in LegCo because it was accepted in LegCo that lease income from assets located outside Hong Kong was not taxable in the first place, and hence the denial of depreciation allowances would not have any adverse impact.

The problem that has arisen is that the definition of "lease" in section 2 of the IRO can be, and has been, interpreted as covering not only the type of leasing arrangements which the legislation was meant to cover, but also arrangements in which manufacturing equipment owned by a Hong Kong taxpayer is used rent-free in Mainland China, under the taxpayer's control, in operations that are integrally related to the taxpayer's trading or manufacturing business.

The result has been the denial of tax relief for the taxpayer's expenditure on such equipment even though its use produces chargeable profits for the taxpayer. This is far removed from the abuse that the amendments were designed to cover. It is clear from the LegCo transcripts that, when LegCo debated the amendments, members accepted that the denial of depreciation allowances would apply where a Hong Kong lessor leased equipment to companies manufacturing on the Mainland, in the context of typical financing arrangements. However, at no stage did LegCo address the situation in which a Hong Kong trader or manufacturer would consign equipment rent-free to factories on the Mainland in the pursuance of the trader's or manufacturer's own trading or manufacturing business. The amendments were not aimed at such consignment arrangements which, in 1992, were not as prevalent as they are today.

This unintended result conflicts with the fundamental principle of profits tax noted above that a taxpayer should be entitled to deduct expenses that it incurs, and depreciate assets that it uses, to generate taxable profits, regardless of where those activities occur and where the assets are located.

The proposed solution

To rectify this situation, it is necessary to amend the definition of "lease" in section 2 so as to exclude such manufacturing-related arrangements. Legislative amendment is called for. In doing so, it is important to ensure that no tax avoidance opportunities are created. We have drafted our proposed amendments with that in mind.

To overcome the denial of depreciation, we believe that the simplest approach would be to amend the definition of the word "lease" in section 2 simply to exclude from its scope equipment which is made available by taxpayers to manufacturers and contract processors outside Hong Kong. The effect of this amendment would thereby avoid the application of the depreciation denial provisions in section 39E which hinges on whether there is a "lease" in place as defined in section 2.

We also propose that this exclusion would apply only where equipment is consigned to the factory on a rent-free basis. This reflects LegCo's original intention to include financing arrangements within the scope of the 1992 amendment, whilst recognizing that it was not LegCo's stated intention to adversely affect pure consignment arrangements.

We therefore propose that the IRO be amended as set out in the annex to this letter. The Legislative Draftsman will no doubt have his own views about our precise drafting and may seek to refine it, but the basic thrust of our amendments should, in our view, be sufficient to overcome the problems that have arisen.

Avoidance Issues

We have also considered the administrative issue that has been raised by the Commissioner of Inland Revenue in regard to the proposal, namely that such an amendment could promote tax avoidance or evasion.

We understand that the Commissioner's primary concern is that it might be difficult for field auditors to obtain access to premises in Mainland China for the purpose of verifying that the taxpayer's equipment is actually being used in operations that produce taxable profits for the taxpayer. There is also a concern that the equipment might not belong to the taxpayer at all but might belong to the overseas factory instead.

In our view, this administrative issue has limited significance in view of

(1) the rarity of field audits in which the assessors actually attend taxpayers' premises in order to verify the use and ownership of equipment even in Hong Kong where no such restriction on making visits exists,

(2) the Commissioner's ability to rely on audited financial statements supporting every Hong Kong company's profits tax computation,

(3) the fact that the Inland Revenue Department already permits tax depreciation for equipment located offshore in those cases where the taxpayer qualifies for the so-called 50/50 contract processing concession (the same evasion concerns presumably arise in such cases, but there has been no suggestion that the Inland Revenue Department has been unable to police the tax laws effectively in those cases),

(4) the fact that, if the issue is in doubt, the taxpayer has the positive burden of proving that it owns the equipment and that the equipment is being used for the required purpose (eg, by being required to produce appropriate documents),

(5) the fact that, under the double tax arrangement between Hong Kong and the Mainland, the Commissioner can request the Mainland tax authorities to gather evidence from the Mainland (and in this context we note that this arrangement was amended a couple of weeks ago to widen such information exchange powers), and

(6) the fact that, where arrangements are entered into for tax avoidance purposes, the Commissioner has wide powers under general anti-avoidance provisions (sections 61 and 61A) to ignore such arrangements.

The concern that a dishonest taxpayer will disregard his obligations under the IRO exists with respect to all of the provisions of the tax laws. In our view, this concern, in relation to the proposed amendment, does not provide a basis for concluding that honest taxpayers must be taxed unfairly. Worse, it appears to be based on a presumption that taxpayers are dishonest, and this is hardly a basis on which the tax authority of any jurisdiction should seek to administer its tax laws.

Implications for "prescribed fixed assets"

We have also considered the implications for section 16G which was enacted in 1998 (after the relevant amendments were made to section 39E). Section 16G permits a deduction of 100% of the cost of capital expenditure incurred on a "prescribed fixed asset", which is defined to include certain manufacturing equipment that is used specifically and directly for any manufacturing process (including computer hardware, computer software and computer systems). The same issue of denial of tax relief applies to "prescribed fixed assets" which are owned by Hong Kong taxpayers but which are used in factories outside Hong Kong.

In our view, the proposed amendment to the word "lease" in section 2 will similarly overcome this problem.

Additional points

There are three additional points we wish to make.

First, you might wish to consider whether amendments to correct this problem should be given retrospective effect. We have no view on this and merely wish to raise the issue for your consideration. We appreciate that retrospective legislation is generally undesirable, but in this case could arguably be supported by the fact that the purpose of the amendment would be to correct a situation that was never intended to occur in the first place. Also, if you were to accept our proposal, we appreciate that transitional provisions would need to be put in place. We would be happy to comment on transitioning issues in due course.

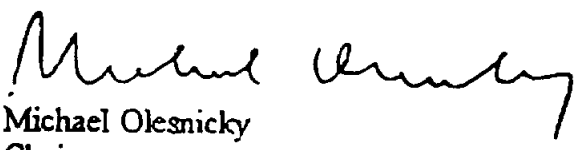
Secondly, the same issue of denial of depreciation allowances applies to taxpayers who conduct business in Hong Kong but who make equipment available to service entities outside Hong Kong. An example is an airline or product distributor who establishes (or contracts with) a call centre entity or data processing centre entity outside Hong Kong to perform services for the Hong Kong business. The Hong Kong taxpayer might provide the equipment to the offshore entity in order to enable it to perform those services, yet retain ownership of the equipment that it provides. This could be because the offshore entity does not have the financial ability to invest in such equipment itself, and/or because the Hong Kong business wishes to be able to remove such equipment if it were to terminate its relationship with the offshore entity. Our amendments

therefore deal with this situation as well. That being said, we acknowledge that, as a practical matter, this issue does not appear to have arisen in practice, but we cannot rule out the possibility that it will emerge as a real issue in future. In any event, it raises exactly the same issue of fairness as does the manufacturing scenario.

Thirdly, and finally, we would observe that section 39E has another undesirable effect which is to deter companies from establishing regional and global leasing operations based in Hong Kong. This is due to the fact that such lessors could be taxed in Hong Kong on their leasing income without being entitled to claim off-setting depreciation allowances for their leased equipment. This is different from the immediate issue facing Hong Kong traders and manufacturers who produce goods in (or buy goods from) factories abroad, and it raises wide-ranging policy issues that could usefully be addressed as part of a separate exercise. The amendments in the annex to this letter by contrast are designed to address and deal more quickly with the more immediate and pressing difficulty faced by Hong Kong manufacturing and trading companies. Nevertheless, and without pre-judging the issue, we would observe that this wider issue of encouraging the use of Hong Kong as a leasing hub deserves separate attention.

We hope you find these comments useful. If you have any questions, please call me at 28461716.

Yours sincerely,



Michael Olesnicky
Chairman
Joint Liaison Committee of Taxation

ANNEX

PROPOSED AMENDMENTS TO SECTION 2 OF THE INLAND REVENUE ORDINANCE

Generally

The idea is that the change to the section 2 definition of "lease" takes the relevant assets out of s 39E altogether, so no change is necessary in s 39E itself. The same rationale applies with respect to section 16G. Both sections 16G and 39B will only provide relief to the extent that the assets are used in the production of chargeable profits, so there should not be any opportunity for abuse.

The proposed amendments are shown in italics and underlined.

IRO, section 2

"lease" in relation to any machinery or plant, includes-

(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,

but does not include:-

(c) a hire-purchase agreement or a conditional sale agreement unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised; *or*

(d) any arrangement under which machinery or plant is used in (i) manufacturing or processing products ordered or commissioned by the owner of the machinery or plant or (ii) performing services under a contract with the owner of the machinery or plant, provided in both cases that no rent or other fee is charged for the use of the machinery or plant. [For the purposes of this provision, an adjustment of any price or fee paid by the owner to any such manufacturer, processor or service provider based on the lack of a charge of rent or other fee shall not be regarded as a charge of rent or other fee for the use of the machinery or plant.]

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24 November 2010

Mr Michael Olesnicky
Chairman
Joint Liaison Committee on Taxation
14/F, Hutchison House
Central
Hong Kong

Dear Chairman,

Tax relief for expenditure on plant and machinery used in manufacturing operations outside Hong Kong

Thank you for your letter of 11 June 2010 to the Secretary for Financial Services and the Treasury, setting out the proposal of the Joint Liaison Committee on Taxation ("JLCT") to amend the definition of "lease" in relation to machinery or plant in section 2 of the Inland Revenue Ordinance ("IRO") so as to permit Hong Kong taxpayers to claim depreciation allowances for expenditure on their machinery or plant that is used outside Hong Kong for manufacturing of goods or performing services as ordered or commissioned by them with no rent or other fee being charged for use of such machinery or plant. I am authorised to reply on his behalf.

The Administration's Position

After thorough deliberations, we consider that JLCT's proposal is not in line with the established taxation principles and has yet to address the enforcement

issues identified by the Administration. Hence, we have fundamental difficulty taking on board JLCT's proposal. Our rationale is elaborated in the ensuing paragraphs.

The Administration's Considerations

As a rule of law, we agree that an expenditure incurred in the production of Hong Kong chargeable profits should be allowed for deduction. However, we have fundamental difficulty accepting that the machinery or plant, which is provided at no rent for use by the Mainland enterprises under "import processing", is used to produce chargeable profits of the Hong Kong enterprises.

In this regard, we wish to point out that "contract processing" and "import processing" are entirely two different modes of operation. Under "contract processing" arrangements, while conducting part of the business and production activities in Hong Kong, Hong Kong enterprises have to participate in the manufacturing activities in the Mainland in various ways, including providing raw materials, machinery or plant, and technical support as well as assigning technical and managerial staff to the Mainland. The Mainland production units only charge the Hong Kong enterprises processing fees. As a result, part of the profits of the Hong Kong enterprises are regarded as sourced in Hong Kong and taxed under the Hong Kong Law accordingly. Based on the same facts, the Mainland authorities may treat the Hong Kong enterprises carrying out the said production activities in the Mainland as permanent establishments, and consider imposing taxes on them for the profits they derive from their subsequent sales of products.

To avoid disputes on the apportionment of profits, the Inland Revenue Department has all along allowed Hong Kong enterprises engaging in "contract processing" to apportion their profits on a 50:50 basis according to the territorial source principle for assessment of Hong Kong profits tax payable. As the production unit in the Mainland is considered an integral part of the business of the Hong Kong enterprise, the machinery or plant is made available for use in the Mainland not under a lease. Since no leasing arrangement is involved, section 39E of the IRO is not triggered. Based on the "tax symmetry" principle, the Hong Kong enterprises are eligible for the depreciation allowances for the machinery or plant used for the production of their chargeable profits. However, since only 50%

of the Hong Kong enterprises' profits are taxable in Hong Kong, adjustments to the amount of depreciation allowances have to be made and only 50% are granted subsequently.

Under "import processing", such machinery or plant is indeed used by the Mainland enterprises (being separate legal entities) to generate their own chargeable profits in the Mainland deriving from their manufacturing operations; whereas the Hong Kong enterprises' chargeable profits are derived from their trading transactions. As the machinery or plant used by the Mainland enterprises is unrelated to the chargeable profits of the Hong Kong enterprises, according to the "tax symmetry" principle, there is no justifiable grounds to grant depreciation allowances for such machinery or plant to the Hong Kong enterprises.

In fact, based on our understanding, during the process of upgrading and restructuring of processing trade, considerable Hong Kong enterprises have transferred the title of their machinery or plant to the newly established Mainland enterprises as capital injection. For those who charge rent in providing machinery or plant for use by the Mainland enterprises, the rental income is taxable in the Mainland.

For rent-free provision of machinery or plant for the Mainland enterprises, we need to consider the matter with extra caution for fear that transfer pricing arrangements may be involved. As a responsible tax jurisdiction, Hong Kong should observe the arm's length principle set out in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Transfer Pricing Guidelines"). We are mindful that Hong Kong should not be, or seen to be, acting in violation of the internationally-recognised arm's length principle, otherwise Hong Kong may be regarded a harmful tax competitor whose action constitutes an erosion of tax base of other tax jurisdictions.

Given that in most of the cases of "import processing", the Hong Kong enterprises and their Mainland counterparts are associated enterprises, we need to be very cautious when considering whether the restriction in section 39E of the IRO should be relaxed, so as to forestall any perception that we are acting in violation of the internationally-recognised arm's length principle or encouraging such practice.

Indeed, according to the comprehensive avoidance of double taxation agreement between Hong Kong and the Mainland, the Mainland tax authorities could make tax adjustments to the chargeable profits of the Mainland enterprises to offset the effect of transfer pricing arrangements between associated enterprises. In such cases, IRD has an obligation to make corresponding tax adjustments to the chargeable profits of the Hong Kong enterprises. As evidenced by the proposed amendment to the term "lease" in section 2 of the IRO, it is apparent that JLCT also envisages that there can be an adjustment of price or fee paid because of the lack of a charge of rent for the use of machinery or plant by enterprises outside Hong Kong.

In case the Administration were to accede to the request of some of the Hong Kong enterprises to relax the restriction of section 39E to the effect that they could enjoy depreciation allowances in Hong Kong for the machinery or plant provided at no rent to the Mainland enterprises, once the Mainland tax authorities, upon detection of transfer pricing arrangements, determine that the Hong Kong enterprises should charge rent for the machinery or plant and make tax adjustments to the chargeable profits of the Mainland enterprises accordingly, the HKSAR Government would suffer revenue loss in two ways: on the one hand, as suggested by the JLCT, IRD should not claw back the depreciation allowances because of any rent deemed by the Mainland tax authorities; whereas under the CDTA between Hong Kong and the Mainland, IRD has an obligation to make tax adjustments to the chargeable profits of the Hong Kong enterprises correspondingly.

Avoidance issues

We could not agree to JLCT's view that the administrative issues have limited significance. In this regard, we note that no practical solutions are yet suggested by JLCT to address the enforcement difficulties.

Conclusion

All in all, given the above-mentioned considerations, we are of the view that there are no justifiable grounds to relax the anti-avoidance provisions in section 39E of the IRO.

Thank you very much for JLCT's advice on this matter.

Yours sincerely,

(Miss Cathy Chu)
for Secretary for Financial Services and the Treasury

c.c. Administrative Assistant to Secretary for Financial Services and the Treasury

Please check against actual delivery

(Translation)

LEGCO QUESTION NO. 1

(Oral Reply)

Asked by: Dr Hon LAM Tai-fai

Date of Meeting: 24 November 2010

Replied by: Secretary for Financial Services and the Treasury

Question

The Secretary for Financial Services and the Treasury ("SFST") indicated in February this year that a review of the implementation of section 39E of the Inland Revenue Ordinance ("section 39E") would be conducted through the Joint Liaison Committee on Taxation ("JLCT"). It has been learnt that JLCT had completed the review months ago and submitted its review report and recommendations to the Bureau, but time and again in his replies to the questions raised by Members of this Council, SFST only indicated that the authorities would complete the study as soon as practicable. In this connection, will the Government inform this Council:

(a) of the exact date of receipt of the aforesaid JLCT report by the authorities, the reasons for not disclosing the receipt of the report and not publicizing its contents all along, and when they will publicize the contents of the report to the public;

(b) of the meaning of the word "practicable" used by SFST as referred above; and

(c) whether it has assessed the negative impact on the commerce and industry sector if there is delay in or mishandling of the review of section 39E, and how SFST, as a principal official under the accountability system, should be held responsible; if it has, of the details; if it has not, the reasons for that?

Reply

President,

(a), (b) and (c)

Over the past year, Dr Hon Lam Tai-fai proposed on a number of occasions at the Legislative Council to relax section 39E of the Inland Revenue Ordinance ("IRO") in order to allow Hong Kong enterprises engaging in "import processing" arrangements to claim depreciation allowances for machinery and plant made available for use by the Mainland enterprises rent-free. We have repeatedly reiterated that since section 39E is an anti-avoidance provision, relaxing the relevant restriction would affect the completeness of the anti-avoidance provisions in the IRO. There are also practical difficulties in implementation and the provision could easily be abused.

Nevertheless, we are pleased to explore further whether there is room to relax section 39E of the IRO. Hence, in March this year, we invited the Joint Liaison Committee on Taxation ("JLCT") to study the relevant issue so as to see if at the technical level, there are practical and feasible options that could comply with the taxation principles while relaxing section 39E. Subsequently, in June this year, the JLCT submitted its advice on the matter to the Administration. We are grateful for the JLCT's views.

After due consideration, we find that the JLCT's proposal in respect of some of the traders' request for relaxing section 39E is not in line with Hong Kong's established taxation principles of "territorial source" and "tax symmetry". Besides, the JLCT has not proposed effective measures to plug possible tax avoidance loopholes. The JLCT also recommends that when there is an adjustment to the rental charge of the machinery and plant involved in a rent-free leasing arrangement of a Hong Kong enterprise, the Inland Revenue Department ("IRD") of Hong Kong should not claw back the proposed depreciation allowances as a result of such adjustment. We have grave concerns about this. I shall now explain in detail why we could not accept the proposal.

All along, Hong Kong enterprises point out that there is no fundamental change in operation after they have upgraded and restructured their processing trade in the Mainland from "contract processing" to "import processing". From the taxation perspective, we do not agree to such a view. Under "contract processing", Hong Kong enterprises have to participate in the production activities in the Mainland in various ways, and are responsible for supplying all necessary raw materials and production equipment. The "contract processing

factories" of the Mainland are basically responsible for processing the raw materials according to the instructions and requirements of the Hong Kong enterprises. The finished products so produced belong to the Hong Kong enterprises. The Mainland authorities strictly require that the finished products under "contract processing" should all be exported. The expenses incurred by the Hong Kong enterprises in conducting the production activities under "contract processing" in the Mainland, and the profits derived from such production activities are all reflected in the accounts of the Hong Kong enterprises. Based on the "territorial source" and "tax symmetry" principles, we allow the Hong Kong enterprises engaging in "contract processing" to apportion their profits on a 50:50 basis for assessment of Hong Kong profits tax. Accordingly, we allow 50% deduction of expenses incurred by these Hong Kong enterprises, including depreciation for machinery and plant used in the Mainland, for generating the above taxable profits.

However, under "import processing", the Mainland enterprises, which are responsible for the Mainland production activities, are independent legal entities. These Mainland enterprises have to pay for importing raw materials and to install production equipment as needed. The finished products belong to the Mainland enterprises and it is their responsibility to arrange for domestic sale or export of their finished products. The Hong Kong enterprises maintain the buyer/seller relationship with their Mainland counterparts. The taxable profits of the Hong Kong enterprises in Hong Kong are derived from their trading transactions. Since the profits derived from the production activities in the Mainland do not belong to the Hong Kong enterprises, such profits would not be reflected in the accounts of the Hong Kong enterprises. As a result, the IRD would not charge profits tax on the Hong Kong enterprises in relation to the Mainland production activities. Based on the "tax symmetry" principle, depreciation allowances for the machinery and plant solely used in the production activities would not be granted. According to the "territorial source" principle, we could not apportion part of the profits of the Mainland enterprises derived from the production activities and transfer such to the Hong Kong enterprises for assessment of Hong Kong profits tax.

According to our understanding, in the course of upgrading and restructuring the processing trade in the Mainland, considerable Hong Kong enterprises have opted to transfer the title of their machinery and plant to the newly established Mainland enterprises as capital injection. For some Hong Kong enterprises which have provided machinery and plant to the newly established Mainland enterprises at a rent, they have to pay business tax and income tax in the Mainland as their rental income is taxable profits in the Mainland.

As for machinery and plant provided for use by the Mainland enterprises rent-free, we are worried that if we accede to the request of some enterprises and provide depreciation allowances in Hong Kong for such machinery and plant, we may be perceived as encouraging transfer pricing which would affect the taxing rights of Hong Kong and other tax jurisdictions (including the Mainland). This would violate the international principles and guidelines for handling transfer pricing and Hong Kong would be regarded as a harmful tax competitor. The so-called transfer pricing refers to the arrangement where Party A provides Party B with raw materials or equipment at a price lower than the market level and in return Party A procures finished products from Party B at a price below market level. Such arrangement would transfer Party B's profits to Party A, thereby reducing the taxable profits of Party B. In other words, the tax authorities of Party B would suffer tax loss as a result of such arrangement.

On this score, I have to point out that with the globalization of world economy in recent years, cross-border economic activities have increased significantly. The Organisation for Economic Co-operation and Development and the tax authorities around the world are all increasingly concerned about the transfer pricing issue arising from cross-border trading activities between associated enterprises. These transactions, which do not reflect market price, would affect the taxing rights of the tax authorities. There is consensus among the tax authorities to prevent transfer pricing arrangements as far as possible in order to protect their respective tax revenue.

Given that the Hong Kong enterprises and the Mainland enterprises are associated parties in many cases, we have to be extremely careful in considering the request for relaxing section 39E so as to avoid any perception that we are acting in violation of the "arm's length principle", and that we are in a way encouraging transfer pricing arrangements disapproved by the tax authorities around the world.

In fact, for transfer pricing arrangements between associated enterprises of the Mainland and Hong Kong, according to the comprehensive avoidance of double taxation agreement ("CDTA") between Hong Kong and the Mainland, the Mainland tax authorities can make adjustments to the amount of tax payable according to the "arm's length principle" and the IRD has an obligation to make corresponding adjustments to the amount of tax charged in Hong Kong.

If the Administration were to relax section 39E to allow the Hong Kong enterprises to claim depreciation allowances for machinery and plant provided to the Mainland enterprises rent-free, once the Mainland tax authorities detect transfer pricing arrangements and make adjustments to the tax payable by the Mainland enterprises according to the "arm's length principle" as it is

considered that the Mainland enterprises should pay rent for such machinery and plant to the relevant Hong Kong enterprises, Hong Kong would end up suffer tax loss in two ways: on the one hand, as suggested by the JLCT, the IRD should not claw back the proposed depreciation allowances because of any rent deemed by the Mainland tax authorities; whereas under the CDTA between Hong Kong and the Mainland, IRD has an obligation to make adjustments to the tax amount of the Hong Kong enterprises correspondingly.

President, as officials responsible for Hong Kong tax policy, we have to take into account the overall interests of all the taxpayers in making each and every policy decision. Based on the above considerations (particularly our long-held taxation principles), our review has come to a conclusion that there are no justifiable grounds to relax the existing restriction in section 39E.

- End -