香港稅務學會
THE TAXATION INSTITUTE OF HONG KONG
(Incorporated in Hong Kong as a company limited by guarantee)

Your ref.: CB1/PL/FA

4 December 2009

CB(1)601/09-10(02)

Ms Noel Sung
Clerk to the LegCo's Panel on Financial Affairs
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Ms Sung,

Re: Panel on Financial Affairs - Special meeting on 14 December 2009
Tax depreciation allowances for profits tax in respect of machinery or plant used outside Hong Kong under a processing arrangement

Thank you for your letter dated 16 November 2009 inviting the Taxation Institute of Hong Kong to make a submission on taxpayers' concerns as regards the denial of tax depreciation allowances under section 39E of the Inland Revenue Ordinance for plant and machinery used wholly or principally outside Hong Kong.

In a recent decision of the Board of Review (BOR), D61/08, the BOR endorsed the Revenue's current strict interpretation of section 39E, in its denial of tax depreciation allowances to taxpayers who provide plant and machinery to manufacturing entities in mainland China under import processing arrangements[1].

[1] An "import processing arrangement" is an arrangement where a mainland entity purchases raw materials for processing or manufacturing and then sells finished goods for its own account, typically back to the same Hong Kong entity that sold it the raw materials.

21/F Kam Sang Building, 255-257 Des Voeux Road Central, Hong Kong Mailing address: G.P.O. Box 6281, Hong Kong
Tel: (852) 2810 0438 Fax: (852) 2523 1263 Web Site: www.tihk.org.hk E-Mail: tihkadm@tihk.org.hk

The decision in D61/08 represents an independent tax tribunal's view that, based on a literal interpretation of the wording of section 39E, the section *"might catch innocent situations"*[2] in its denial of tax depreciation allowances. Under a common law system, a court is empowered to construe a legislation following a set of rules. The need to refer to the legislative intent is the exception rather than the rule only if the legislation is unclear and produces absurd result. The drafting of section 39E is clear but its loose language and wide coverage have produced undesirable effects and are unfair to the taxpayers.

Legislative intent – the application of section 39E to deny tax depreciation allowances for plant and machinery under import processing arrangements appears to be an after-thought

To put the issue in perspective, the Secretary for Financial Services and the Treasury, Professor K C Chan in response to questions raised on the issue regarding the legislative intent of section 39E made the following comments on 25 November 2009:

> *"When section 39E of the Inland Revenue Ordinance (IRO) was enacted in 1986, sub-paragraph (1)(a) targeted "sale and leaseback" arrangements of all machinery or plants (including ships and aircrafts). Sub-paragraphs (1)(b) and (1)(c) of section 39E targeted "leverage leasing" arrangements, the former being applicable to machinery or plants not being ships or aircrafts while the latter being applicable to ships or aircrafts....*
>
> *Section 39E was indeed enacted in 1986 to target "sale and leaseback" and "leverage leasing" arrangements only. At that time, only "leverage leasing" arrangements involving machinery or plants used outside Hong Kong by other persons were restricted by section 39E. However, the Administration noticed that many companies could technically circumvent the definition of "leverage leasing" and made arrangements which were in substance similar to "leverage leasing" arrangements, whereby machinery or plants (mainly involving ships and aircrafts) were made available for use by other persons outside Hong Kong. Such arrangements were not caught by section 39E and tax avoidance was achieved. To plug the loophole, the Administration amended section 39E in 1992... After the amendment, so long as the machinery or plants (including ships and aircrafts) under a leasing arrangement is principally used by another person outside Hong Kong, section 39E will apply. Thus the scope of application of section 39E has been extended beyond "sale and leaseback" and "leverage leasing" arrangements to cover all kinds of leasing arrangements.*
>
> *As pointed out above, section 39E was amended in 1992 to target those companies which technically circumvented the definition of "leverage leasing". "Leasing arrangement" in my*

[2] Paragraph 54 of the decision in D61/08 refers.

replies refers to any arrangement within the definition of "lease" under the IRO, and is not limited to "leverage leasing".

Section 39E of the IRO is a specific anti-avoidance provision. It is applicable to any commercial arrangement falling within the specific scope of the provision..."

From the above quoted passages, it appears that on the Administration's own admission, the 1992 amendment to section 39E was technical in nature, i.e., *"to target those companies which technically circumvented the definition of "leverage leasing" and made arrangements which were in substance similar to "leverage leasing" arrangements."* As such, one can hardly argue that the 1992 amendment intentionally targeted the provision of plant and machinery by a Hong Kong company to its mainland subcontractor under a processing arrangement for the production of goods ordered by the Hong Kong company, as part of a normal commercial arrangement.

If it were indeed the intent of the Administration that the 1992 amendment was to deny tax depreciation allowances of plant and machinery used outside Hong Kong under any types of processing arrangements, the Administration did not appear to have made this intent known in any technical briefings when the LegCo considered the amendment.

The 1992 amendment made no exception for contract processing arrangements and the Revenue has to subsequently rely on an extra-statutory concession in granting tax depreciation allowances in respect of relevant plant and machinery used in mainland China under contract processing arrangements[3].

Furthermore, after the 1992 amendment was enacted, it appears that, as a matter of practice, the Revenue had for a number of years not invoked section 39E to deny tax depreciation allowances for plant and machinery used outside Hong Kong under import processing arrangements. The controversy as regards the Revenue's current strict interpretation of section 39E appears to have started at the earliest only in the late 1990s, when it denied the concessionary depreciation allowances given to plant and machinery used outside Hong Kong under import processing arrangements.

All of the above suggest that the application of section 39E to deny tax depreciation allowances for plant and machinery used outside Hong Kong under import processing arrangements is more of an after-thought. This is not only unfair to the taxpayers, but has also created undue financial hardships to the manufacturers in Hong Kong who are affected.

---

[3] Paragraph 19 of Departmental Interpretation and Practice Notes No. 15 states that *"Under a contract processing arrangement...Even though the machinery or plant is not used wholly or principally in Hong Kong, the Department as a concession is prepared to allow 50 per cent of the depreciation allowances on the leased machinery or plant on the condition that the profits from manufacturing activities of the Hong Kong company are assessed on a 50:50 basis...".*

香港稅務學會
THE TAXATION INSTITUTE OF HONG KONG
(Incorporated in Hong Kong as a company limited by guarantee)

Our submission

The Taxation Institute of Hong Kong would submit that it is a matter of policy for the Government to consider either granting the extra-statutory concessionary treatment applicable to contract processing arrangements to import processing arrangements, or amending the terms of section 39E such that tax depreciation allowances on plant and machinery used outside Hong Kong under both import and contract processing arrangements would not be denied.

Yours faithfully,

Patrick Kwong and Kenneth Leung
Co-chairmen
Taxation Policy Committee

21/F Kam Sang Building, 255-257 Des Voeux Road Central, Hong Kong Mailing address: G.P.O. Box 6281, Hong Kong
Tel: (852) 2810 0438 Fax: (852) 2523 1263 Web Site: www.tihk.org.hk E-Mail: tihkadm@tihk.org.hk