PRICEWATERHOUSECOOPERS

羅兵咸永道有限公司

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

PricewaterhouseCoopers Ltd.
21/F, Edinburgh Tower
15 Queen's Road Central
Hong Kong
Telephone (852) 2289 8888
Facsimile (852) 2810 9888
www.pwchk.com

By email (yhcheung@legco.gov.hk) and by post

Hon CHAN Kam-lam
Chairman,
Panel on Financial Affairs
Legislative Council
Hong Kong SAR Government

1 December 2009

Dear Hon Mr Chan,

Tax Relief for Plant and Machinery owned by Hong Kong Taxpayers and used in the Mainland

We refer to your invitation for submission on the above-mentioned subject. In general PricewaterhouseCoopers support a simple, efficient and fair tax system in Hong Kong. On this basis we have the following submission.

In our submission, we would like to set forth the typical arrangements under which the plant and machinery / moulds owned by a Hong Kong manufacturing / trading company are used by a Mainland entity outside Hong Kong for the production of the Hong Kong company's profits subject to Hong Kong Profits Tax while the current practice of the Inland Revenue Department ("IRD") is to deny the tax deductions for such plant and machinery / moulds in the form of depreciation allowances. We further provide our views on the arguments put forward by the IRD on this issue and finally conclude with our suggestions.

Hong Kong manufacturers with a typical import processing arrangement

Historically, when China adopted the "open door" policy to attract foreign investment in the early 1980s, many Hong Kong manufacturers were allowed to perform their manufacturing operations in the Mainland through a contract processing arrangement. However, starting from the early 2000s, there was a trend where contract processing arrangement was no longer being encouraged by the governments in the Mainland. As a result, many Hong Kong manufacturers had to change their existing contract processing arrangement to an import processing arrangement in order to continue their manufacturing operations in the Mainland. Despite changing the legal form of operation from contract processing to import processing, what the Hong Kong manufacturers do remains the same in substance (i.e. they continue to be substantially involved in the manufacturing operations in the Mainland and own and provide the necessary plant and machinery to the Mainland sub-contractors, etc.).

In the appendix to this submission, we include a description of the business model of a typical import processing arrangement which is commonly used by Hong Kong manufacturers. Under the import processing arrangement, the Hong Kong manufacturers may make their plant and machinery (including moulds) available for use by their Mainland sub-contractors for the processing of the goods all of which will be sold to the Hong Kong manufacturers. The business reasons for this common arrangement are for the control of

the quality of the goods produced and the protection of the product design and technology know-how. Although no rent is charged on the use of the plant and machinery by the Hong Kong manufacturers, the Hong Kong manufacturers will be able to purchase the finished goods from the sub-contractors at a price reflecting the fact that the sub-contractors are not required to make investment in the plant and machinery and hence bear the risk of owning the plant and machinery.

Hong Kong trading companies providing moulds to Mainland manufacturers

Another common type of business model involving an import processing arrangement is where a Hong Kong company is purely a trading company and does not involved in any manufacturing operations. The manufacturing operations are being carried out by a separate entity in the Mainland, which could be an unrelated party. However, the Hong Kong company will provide the necessary moulds to the Mainland entity for the same business reasons mentioned above. Again, the price paid by the Hong Kong company on the finished goods will reflect the provision of moulds by the Hong Kong company.

Arguments put forward by the IRD

As mentioned in the replies to the questions raised in the Legislative Council recently, the administration consider no depreciation allowances could be allowed to the Hong Kong companies in both of the above situations on the following grounds:

1. The plant and machinery / moulds are used by someone other than the Hong Kong companies outside Hong Kong. This arrangement is a "lease" under section 2 of the Inland Revenue Ordinance ("IRO"). Because the assets are used outside Hong Kong, section 39E is applicable and hence no depreciation can be allowed.

2. The administration is also concerned about the practical difficulties in determining "whether the machinery or plant used in Mainland China is producing profits chargeable to tax in Hong Kong; whether it is used for the manufacturing of goods sold solely to the Hong Kong enterprise; whether the machinery or plant has been sold; whether depreciation allowances of the same machinery or plant have been claimed by other enterprises, etc."

Our Submissions

- Technical grounds

  As mentioned by Hon Lam Tai Fai in his questions in the Legislative Council, "the legislative intent of the above provision is to strike down acts of tax avoidance". It is clear from the business models described above that there is no avoidance of tax in Hong Kong. On the contrary, the entire profits derived by those Hong Kong companies are subject to Hong Kong Profits Tax.

  Furthermore, technically, there is no clear legal authority to support the IRD's contention that the physical use of assets by a person other than the taxpayer free of charge is a "lease" under section 2 of the IRO. It is possible, for a business reason, that the owner of an asset lets another person to use the asset to produce economic benefits for the owner. Control of the product quality and protection of trade secrets in the manufacturing process are business reasons for doing so. If this is for the economic benefits of the owner, as it is in the case of import processing, there is no business

reasons for the owner to charge rent from the Mainland entity for the use of the assets. Arguably the use of the assets by others in such case is not a "lease" as the one who economically derives the benefits from the use of the asset is the owner, not the person who physically uses it.

There could be unclear and different interpretations of section 39E in practice. These different interpretations have led to increasing amount of disputes between taxpayers and the IRD in recent years. In view of this, we have suggested two possible options to resolve these disputes in the last part of our submission.

- Principle of taxation

  It is commonly understood that the principle of income tax is to allow tax deductions of expenditures that are incurred for the production of taxable profits. Capital expenditures on plant and machinery are usually allowed in the form of depreciation allowances. Applying section 39E literally without taking into consideration the legislative intent is not in line with this general principle of taxation.

- Practical difficulties

  The second argument mentioned by the administration in its replies in the Legislative Council is there are practical difficulties in ensuring the assets used outside Hong Kong are employed to produce goods that are sold to the Hong Kong companies or depreciation allowances on the assets are not claimed both in Hong Kong and in the Mainland.

  The practical difficulties of ensuring tax deduction claims made by taxpayers are genuine do not only exist in the import processing arrangement; rather, they exist in all form of business operations. The investigation power conferred under the IRO to the IRD and the relevant penalty provisions should be adequate for the IRD to combat any abuse of tax deductions. This has been proved to be an efficient deterrence for any abuse in the past. Further, the Exchange of Information Article in the Double Taxation Arrangement between Hong Kong and the Mainland should provide the IRD with proper channel to gather the information about the manufacturing operations in the Mainland.

  Hence we are of the view that the practical difficulties mentioned by the administration did not and should not be a reason for the current practice of the IRD.

- Flexibility exercised by the IRD

  While we understand the IRD hold a technical interpretation of section 39E different from ours as mentioned above, in considering the claim of depreciation allowances under import processing we believe the IRD can be flexible and practical. Many import processing arrangements were originally contract processing arrangements and were changed in their form due to the change in policy in the Mainland. In substance they operate just like contract processing arrangements. Since the IRD is allowing depreciation allowances on plant and machinery in the contract processing arrangements in practice, as we suggested below, it is fair if the IRD could be flexible in following the same treatments in import processing arrangements.

PRICEWATERHOUSECOOPERS

Our suggestions

As we mentioned above, given the arguable interpretation of section 39E currently adopted by the IRD and such interpretation is neither in line with the business reality nor the principle of taxation, we would like to suggest the following:

1. Given it is obvious that the taxpayers in the typical import processing arrangements described above do not involve in any tax avoidance scheme, we submit that the IRD could reconsider its interpretation and application of section 39E set out in Departmental Interpretation and Practice Notes No. 15 (Revised) ("revised DIPN 15"), taking into account the unclear legal interpretation and the business reality. The IRD can stipulate (say, in revised DIPN 15) the conditions under which depreciation allowances on the assets used for manufacturing goods under an import processing arrangement would be, as a concession, allowed to the Hong Kong taxpayers. Like any other false claims, taxpayers will be subject to penalty if the information provided to the IRD is incorrect or not substantiated. This could avoid the trouble of running into bitter and long-running disputes between taxpayers and the IRD, some of which might end up in courts.
2. An alternative to the change of practice / interpretation is to make legislative changes to section 39E to make it clear that section 39E is not applicable to plant and machinery used in import processing arrangement.

If you have any questions on our submission, please feel free to contact the undersigned at tim.leung@hk.pwc.com and medinah.ip@hk.pwc.com or Mr Fergus Wong, our technical director, at fergus.wt.wong@hk.pwc.com

Yours faithfully,

Tim Leung

Tax Partner
Leader of Retail and Consumer Products

Medinah Ip

Tax Partner
Leader of Industrial Products

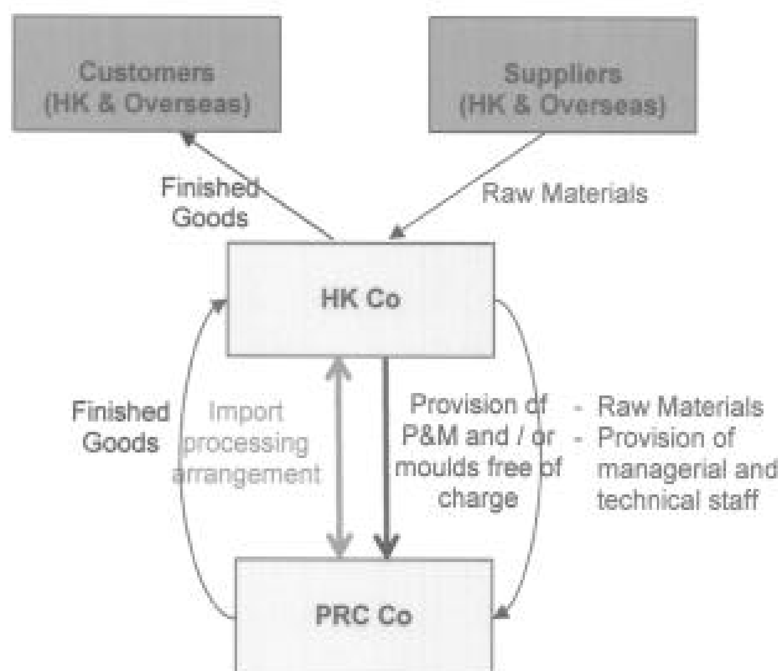
Appendix: A typical import processing arrangement

By taking the advantages of the substantially lower manufacturing cost and labour cost in the PRC, in the past ten years, many Hong Kong manufacturers have moved its manufacturing operations to the Mainland China. Typically, a Hong Kong company ("HK Co") would enter into a processing / sub-contracting arrangement with a PRC related or unrelated company ("PRC Co") for manufacture of tailor-made products. Such arrangement is so called import processing arrangement. In most situations, the PRC Co solely manufactures products for the HK Co.

Under a typical import processing arrangement, the HK Co purchases the raw materials from the suppliers and then sells to the PRC Co for manufacturing. Upon completion of processing, the PRC Co sells the finished goods back to the HK Co for subsequent re-sale to the ultimate customers.

To ensure the quality and specification of the finished goods are up to the requirement of the HK Co and to minimize the investment and risk of the PRC Co, plant and machinery ("P&M") and / or moulds used for the manufacture of goods are provided by the HK Co to the PRC Co free of charge. The purchase price of the finished goods charged by the PRC Co to the HK Co reflects the involvement of the HK Co in the production process through provision of P&M and moulds and is lower than what could be charged if the PRC Co is required to make its own investment in P&M. Moreover, the HK Co would normally send its managerial and technical staff to the PRC to monitor and support the manufacturing operations.

We have depicted below the typical import processing arrangement:



There are two major reasons why the HK Co would provide the P&M and moulds to the PRC Co free of charge. Firstly, by doing so, the HK Co can ensure that the required finished goods manufactured by the PRC Co meet the quality requirements of the ultimate customers. Secondly, this can enable the HK Co to hold the ownership of such P&M and moulds in order to protect its interest in these assets and proprietary technology know-how.

In summary, the HK Co should be entitled to depreciation allowance on the P&M and moulds provided to the PRC Co on the following basis:

1. The HK Co has incurred capital expenditure in acquiring the P&M and moulds, and the legal titles and ownership of these assets have never been transferred to the PRC Co or any other company.

2. The PRC Co does not book these assets in its accounts nor claim any allowance in the PRC. In addition, the P&M are not imported to the PRC Co through the HK Co's capital injection into the PRC Co.

3. The P&M and moulds provided by the HK Co are solely used to manufacture goods for resale by the HK Co in the production of its assessable profits.

4. By providing the P&M and moulds to the PRC Co free of charge, the HK Co can enjoy a lower purchase cost for the finished goods acquired from the PRC Co in return. In other words, the P&M and moulds are acquired for producing a higher profit of the HK Co, which would be subject to Hong Kong profits tax.

5. The arrangement between the HK Co and the PRC Co in respect of the use of the P&M and moulds is not a "lease" arrangement as the PRC Co has no exclusive right to use such assets. In this regard, section 39E should not apply to deny the HK Co's entitlement to deprecation allowance on the P&M and moulds.