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11 December 2009

Professor K C Chan
Secretary for Financial Services and the Treasury
Central Government Offices
Lower Albert Road
Hong Kong

Dear Professor Chan,

Depreciation Allowances for Plant & Machinery used outside Hong Kong

We refer to our letter dated 21st August 2009 ("our Letter") regarding the unfair treatment to a group of Hong Kong manufacturers by the Inland Revenue Department ("IRD") by invoking S.39E of the Inland Revenue Ordinance ("IRO"), an anti avoidance provision, to deny depreciation allowances on P&M used in an ordinary production arrangement commonly known as import processing arrangement whereby the P&M were used by the Chinese factories free of charge in the production of the Hong Kong manufacturers' taxable Hong Kong profits.

In our Letter, we have pointed out that S.39E was not intended to restrict the use of P&M by Hong Kong manufacturers in the ordinary course of their business. We therefore recommended that concession of allowing 50% of depreciation allowances on P&M in contract processing arrangement should be extended to import processing arrangement.

Subsequent to our Letter, a decision of the Board of Review involving S.39E and other sections of the IRO was published in which the IRD's application of S.39E on the relevant P&M was confirmed by the Board. However, this was a case of a sale and lease back arrangement where the P&M were repurchased back by the taxpayer from the Chinese entity which was then allowed to use the P&M free. Such arrangement was caught by a special sub-section of S.39E and depreciation allowances on the P&M would be denied whether or not the assets were used outside Hong Kong. Another reason for dismissing the appeal was that in the hearing the taxpayer failed to reconcile the two lists of P&M purported to have been repurchased from the Chinese entity. Neither did it provide cogent documentary evidence regarding the purported repurchases and thus failed to discharge the onus of proof as required in an appeal. As the arrangement is different from the general cases where the relevant assets are owned by the Hong Kong taxpayers from the outset, this case cannot be taken as precedent.

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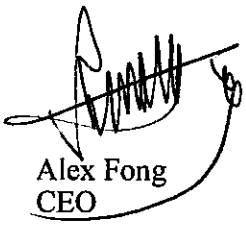
In the decision, the Board has endorsed the IRD's strict interpretation of S.39E. In light of the speeches of the two Financial Secretaries in introducing the original S.39E and in proposing the amendment as mentioned in our Letter, many professionals are of the view that a more liberal interpretation of the law should be given in applying this anti avoidance provision to an ordinary business arrangement with no tax avoidance intention. Since the taxpayer was not represented by counsel in the hearing, the Board has formed its view without the benefit of a thorough legal argument on the correct interpretation of the relevant sections. We believe that should the case be heard by the Courts, a more liberal interpretation in the taxpayers' favor would likely be adopted. Thus the Board's view cannot be taken as authority until this issue is decided by the Courts.

In the absence of any forth coming appeal on S.39E in an import processing arrangement with the relevant asset owned by the taxpayer from the outset, there will be uncertainty as to the correct interpretation of this section in the foreseeable future. Meanwhile, there is an urgent need to alleviate the financial burden of the taxpayers as the economy has not yet been fully recovered. In a recent reply to similar questions regarding the application of Section 39E raised in LegCo, the government refused to extend the concession on the grounds that it was a complicated matter involving various issues including whether the P&M 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 P&M has been sold; whether depreciation allowances of the same PM claimed by other enterprises. While the Revenue's concerns as to the actual usage, the verification of the ownership and possible double deduction claim of the PM are understandable, it seems that these concerns can be resolved as they relate to factual matters. As other claims for tax deductions, the onus of proof is on the taxpayers who should provide documentary evidence in support of their claims. In case of doubt, the IRD may seek information from the Chinese authorities to verify the taxpayers' claims as provided under the Double Taxation Arrangement with Mainland China.

As pointed out in our Letter, denying a taxpayer the depreciation allowances under the import processing arrangement is in violation of the basic principle of allowing taxpayers to deduct the cost incurred in the production of profits. It is also prejudice against manufacturers who has to pay higher tax as a result of the production arrangement with no intention at all to avoid Hong Kong tax. In granting 50% of depreciation allowances only to contract processing arrangement by way of concession, the IRD has applied the law discriminately against other group of taxpayers. We strongly urge the government to rectify such unfair situation either by way of amending the IRO or extending the concession immediately to import processing arrangement. The workload of the officers of the IRD may increase as a result of the relaxation but this should not be the reason for withholding any measures to correct the unfairness.

In light of our above submission, we respectfully request the government to seriously review its recent decision.

Yours sincerely,



Alex Fong
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