Hong Kong Institute of
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香港會計師公會

By email (yhcheung@legco.gov.hk) and by fax (2121 0420)

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Hon. Chan Kam-lam, SBS, JP
Chairman, Panel of Financial Affairs
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Mr. Chan,

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

The Hong Kong Institute of CPAs ("Institute") would like to thank the panel for the invitation to comment on the above issue.

Inland Revenue Ordinance ("IRO") section 39E was introduced as an anti-avoidance provision for defeating opportunities for tax deferral through various forms of plant and machinery leasing. Section 39E(1)(b) operates to deny depreciation allowances for leased plant and machinery ("P&M") used outside Hong Kong. However, given its increasingly wide application, the provision now impacts unfavourably upon genuine businesses which are required to use P&M outside of Hong Kong to generate profits that are chargeable to tax in Hong Kong.

The examples below are three of many that could be cited to illustrate the potential negative impact of section 39E on genuine businesses and, ultimately also, Hong Kong's competitiveness. They relate to processing trade, trading companies, and container leasing:

Processing trade arrangements

Processing trade arrangements between a Hong Kong company and a Mainland processing factory may be in the form of contract or import processing arrangements. Although different in legal form[1], the two kinds of arrangement are generally considered to be similar in substance.

Whereas previously contract processing arrangements were commonplace, import processing is now the norm for Hong Kong taxpayers manufacturing in the Mainland, due to the requirements of the Mainland authorities, and not, for example, as a result of tax planning by Hong Kong taxpayers. In both contract and import processing arrangements, it is not uncommon for a Hong Kong company to loan the P&M to the Mainland processing factory, while ownership remains with the Hong Kong company.

[1] Contract processing involves a single legal entity with operations in Hong Kong and the Mainland, whereas for import processing, in form a separate legal entity is established in the Mainland, which enters into a contract with the Hong Kong entity.

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This is the case particularly with moulds. According to the terms of the processing arrangement, the manufactured items are produced solely for export only, i.e., the P&M is used solely for the production of products that belong to the Hong Kong company and so for the generation of profits that are chargeable to tax in Hong Kong.

Given that Hong Kong levies tax on the basis of the source of profits, in relation to contract processing, the Inland Revenue Department ("IRD"), as a matter of administrative convenience, accepts a fixed apportionment of profits on a 50:50 (Hong Kong/offshore) basis. In these situations, the IRD also allows taxpayers to claim half of the depreciation allowances on their P&M used in the Mainland. However, in the case of import processing arrangements, the IRD treats the Hong Kong taxpayer as a trader, not involved in any manufacturing, and the Mainland manufacturing entity as an independent business. Consequently, the IRD does not accord the Hong Kong taxpayer the same 50:50 apportionment, nor does it allow half of the deprecation allowances to be claimed. A Hong Kong import processor, therefore, is liable to be taxed on all of its profits and cannot obtain any depreciation allowances for its P&M located in the Mainland factory, thus bearing a double burden.

--- The Institute first raised this issue in an annual meeting with the IRD in 2004 and we reiterated and elaborated on our concerns in the 2006 -2009 annual meetings (see the references in the Appendix). In our view, where a taxpayer owns P&M and uses this to generate income that is chargeable to tax in Hong Kong, depreciation allowances should be granted, in accordance with the basic principle of allowing taxpayers to get relief for costs incurred in generating revenue. On this basis, it would be equitable for taxpayers involved in import processing to be granted the full depreciation allowances.

As regards granting depreciation allowances on administrative basis, the IRD has expressed concern about possible practical and technical difficulties, such as that:

(i) the P&M may be subsequently sold or transferred to other parties;

(ii) depreciation allowances on the same P&M may be claimed by other entities;

(iii) the P&M may be used to manufacture goods sold other than to the Hong Kong entity. (An ability for the Mainland entity to sell goods in the domestic market would mean that the P&M may not be used exclusively to generate profits chargeable to tax in Hong Kong.)

The Institute has suggested that audited accounts and management representation letters could be used to verify continuing ownership of the P&M. Other documents could be referred to show that there is no right to sell goods domestically under the import processing contract.

Despite the availability of supporting documents, particularly the audited accounts, which are, for example, commonly accepted in fulfilment of a company’s regulatory and filing requirements, and also the fact that any abuses or misrepresentations by taxpayers would be subject to penalty provisions under the IRO, it seems the IRD remains concerned that there may be other administrative problems yet to be identified.

The prevalence of import, rather than contract, processing arrangements in respect of Mainland manufacturing, means that fewer and fewer Hong Kong-based companies can now obtain the benefit of 50:50 profits tax apportionment, and hence also half of the depreciation allowances for P&M. For Hong Kong import processors, which are taxed on all of their profits and receive no depreciation allowances for P&M, manufacturing in the Mainland is likely to become increasingly non-viable in its present form. Ultimately, they may have little choice but to relocate their business to other jurisdictions that are actively encouraging investment and prepared to adjust to the commercial realities of cross-border and international business.

Trading companies

The above issue of moulds located in Mainland factories extends beyond processing trade arrangements. Some Hong Kong companies trade custom-made goods that are manufactured solely for them by an overseas supplier on an "arm's length basis". In such cases, customised moulds may be provided by the Hong Kong company to the supplier in order to manufacture the custom-made goods. Section 39E would also operate to deny depreciation allowances for these moulds should they be placed at the suppliers' factories outside of Hong Kong. This gives rise to similar questions regarding the long-term viability of operating these businesses in Hong Kong.

Container leasing

Businesses with mobile assets are also affected by section 39E, such as container leasing. Such businesses derive income from rental of the containers. The taxability of such income is usually determined with reference to the location of the assets. However, it is also argued that the rental income could be taxed based on where the leasing contract is entered into. If the business is carried on and managed in Hong Kong, the leasing contract would normally be considered as entered into in Hong Kong and, accordingly, the rental income would be subject to Hong Kong tax. However, should the income be treated as being chargeable to tax in Hong Kong, section 39E would work to deny the depreciation allowances in respect of the containers located outside Hong Kong.

This is a relevant factor in leasing businesses being advised to set up in other jurisdictions rather than Hong Kong, which is clearly to Hong Kong’s economic detriment. When decisions are made to locate businesses elsewhere, Hong Kong loses not only the immediate economic benefits deriving from those specific businesses, but also the spin off activities to which they give rise.

The Institute notes that in the 1998 version of the Departmental Interpretation and Practice Notes ("DIPN") 21 - *Locality of Profits*, it is stated, in paragraph 20, that, where section 39E of IRO operates to disallow depreciation allowances in respect of leased P&M, the income from leasing such P&M will generally be regarded as non-taxable. However, this is purely an administrative concession and, in fact, reference to this particular concession has been removed from the revised DIPN21, just issued on 4 December 2009. It is, therefore, uncertain whether the concession will continue to be granted in the future.

Way forward

In relation to processing arrangements and to the type of trading company described above, if the IRD's continuing reservations prevent its agreeing to grant any administrative concession in respect of depreciation allowances, then the Institute would advocate amending the law. We would propose that section 16G of the IRO, relating to prescribed fixed assets, be amended to remove from the definition of "excluded fixed assets", P&M provided to Mainland factories by related Hong Kong companies. This could be made subject to conditions to prevent abuse. Were this amendment to be made to section 16G, section 39E would no longer be applicable. This would allow full tax deductions for P&M expenditure incurred by taxpayers involved in the Mainland processing trade. This amendment would appear to us to be justified, and so worthy of consideration, on the basis of commercial considerations and improving Hong Kong's competitiveness.

As regards the broader issue of the impact of section 39E on other legitimate businesses, global trade has changed markedly since this section was enacted in 1986, and subsequently amended in 1992 and, as a result, it now creates an impediment for a range of business actvities to be conducted in Hong Kong, in ways that were not foreseen when it was first introduced. Under the circumstances, we would suggest that there is a need to conduct a comprehensive review of the aims and objectives, and the practical implications, of this section of the IRO. It seems clear to us that, at the very least, it needs to be substantially rewritten to confine its effect to addressing the mischief that it originally sought to prevent.

If you have any questions on the Institute's submission, please do not hesitate to contact me on 22877084 or at peter@hkicpa.org.hk.

Yours sincerely,

Peter Tisman
Director, Specialist Practices

PMT/EC/ay
Encl.

APPENDIX

Related discussions on section 39E of the IRO from the annual meeting minutes between the Institute and IRD

- 2004, Agenda item A2(e), Section 39E application to a Hong Kong taxpayer's plant and machinery used by its wholly-owned subsidiary company in the Mainland
  Link: http://www.hkicpa.org.hk/file/media/section5_membership/Professional%20Representation/tb14.pdf

- 2006, Agenda item A4(a), Applicability of Section 39E on contract processing and import processing arrangements
  Link: http://www.hkicpa.org.hk/file/media/section5_membership/Professional%20Representation/tb16.pdf

- 2007, Agenda item A3(b), Plant and machinery used in import processing
  Link: http://www.hkicpa.org.hk/file/media/section5_membership/Professional%20Representation/tb17.pdf

- 2008, Agenda item A3(b), Plant and machinery used in import processing
  Link: http://app1.hkicpa.org.hk/publications/bulletins/tax/tb18.pdf

- 2009, Agenda item A3(a), Depreciation on plant and machinery used in import processing trade
  Link: http://www.hkicpa.org.hk/file/media/section5_membership/Professional%20Representation/tb19.pdf