Press release

LCQ16: Inland Revenue Ordinance

Wednesday, December 8, 2010

Following is a question by Dr Hon Lam Tai-fai and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (December 8):

Question:

Regarding the reply given by the Secretary for Financial Services and the Treasury (SFST) to my oral question on November 24 this year, will the Government inform this Council:

(a) whether it will fully publicise the report submitted by the Joint Liaison Committee on Taxation (JLCT) on the review of the implementation of section 39E of the Inland Revenue Ordinance (Cap. 112) (section 39E), as well as the relevant correspondences and documents exchanged between the authorities and JLCT; if it will, when they will be published; if not, of the reasons for that;

(b) given that SFST stated that "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", whether the Government has data showing the number of the aforesaid "considerable Hong Kong enterprises"; if so, of the details; if not, on what objective facts SFST has based in arriving at such understanding;

(c) given that SFST stated that "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", yet there is in fact no question of the Hong Kong enterprises receiving rent when they provide machinery and plant to processing enterprises to produce goods to be sold by themselves, why the authorities could interpret that such machinery and plant are provided "at a rent";

(d) given that SFST stated that "for machinery and plant provided for use by the Mainland enterprises rent-free (under 'import processing'), 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", yet the Organisation for Economic Co-operation and Development and the Inland Revenue Department in Hong Kong have both issued specific guidelines on the handling of the issue of transfer pricing, of SFST's justifications for the aforesaid worry;

(e) given that according to the Inland Revenue Board of Review Case Nos. D37/01 and D60/06, the Board has ruled that the tax liability of a taxpayer should be determined by local legislation, and no consideration should be given to whether the foreign tax authorities have suffered tax loss, why SFST raised the issue of taxing rights of other tax jurisdictions (including the Mainland);

(f) given that according to section 16 of the Inland Revenue Ordinance, all outgoings and expenses shall be deducted to the extent to which they are incurred in the production of chargeable profits, whether it has assessed if it is a violation of the basic principles of "tax symmetry" and deduction of expenses under section 16 of the Inland Revenue Ordinance when depreciation allowances for machinery and plant used in the production of chargeable profits may not be granted merely because such machinery and plant are used outside Hong Kong; if not, of the reasons for that;

(g) whether it has assessed the impact of the authorities' refusal to improve section 39E on the commerce and industry sector, employment in our society and economic development; and whether it has assessed if the loss in tax revenue suffered by the Government as a result of reduced profits consequent upon decreased productivity and competiveness in the wake of Hong Kong enterprises reducing their investment in machinery and plant will outweigh the reduction in tax revenue brought about by "relaxing section 39E" as referred by SFST; if it has, of the details; if not, the reasons for that;

(h) given that members of the trade have requested the authorities to resume compliance with the legislative intent of section 39E, which is only intended to strike down the acts of tax avoidance through sale and leaseback and leveraged leasing arrangements, why the authorities have interpreted such a request as "relaxing" section 39E;

(i) whether the authorities will further consult the commerce and industry sector, accountancy sector and tax experts, etc. on the contents of the reply to the question on November 24 this year; if they will, of the details; if not, the reasons for that; and

(j) whether it will consider convening a joint conference of sectors and inviting representatives from the four major chambers of commerce of Hong Kong, the chambers of commerce of small and medium enterprises, accounting and audit firms as well as tax experts, etc. to discuss the ways in handling the enforcement of section 39E; if it will, of the details; if not, the reasons for that?

Reply:

President,

(a) We are grateful to the Joint Liaison Committee on Taxation (JLCT) for its study in relation to section 39E of the Inland Revenue Ordinance (IRO) and its recommendations. With the consent of the JLCT, we have provided the report of the JLCT and the corresponding reply of the Administration to the Legislative Council Panel on Financial Affairs for information.

(b) We have learnt from the relevant authorities of the Guangdong Province that considerable Hong Kong enterprises have, in the course of upgrading and restructuring the processing trade in the Mainland, opted to transfer the title of their machinery and plant to the newly established Mainland enterprises as capital injection. However, the relevant authorities in the Guangdong Province do not have the relevant data.

(c) to (f) According to section 16 and other related provisions of the IRO, a prerequisite for a taxpayer to deduct the specified expenses is that such expenses must be incurred for generating chargeable profits. This is in line with the "tax symmetry" principle. As we have pointed out to the Legislative Council on a number of occasions, the Hong Kong enterprises maintain the buyer/seller relationship with their Mainland counterparts under "import processing". The taxable profits of these Hong Kong enterprises in Hong Kong are derived from their trading transactions. Since the profits derived from the production activities in the Mainland are not attributed to the Hong Kong enterprises, according to the "territorial source principle", the Inland Revenue Department of Hong Kong would not charge profits tax on the Hong Kong enterprises for the Mainland production activities. Also, according to the "tax symmetry" principle, the Hong Kong enterprises would not be granted depreciation allowance for the machinery and plant solely used in the production activities in the Mainland.

In our reply to the oral question raised by Dr Hon Lam Tai-fai on November 24 this year, we have clearly pointed out the concern of the international community about the transfer pricing issue involved in cross-border trading activities between associated enterprises, and the stance taken by the tax authorities around the world on this issue. 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.

Cases D37/01 and D60/06 handled by the Board of Review are both related to source of taxable income under salaries tax. They are not related to section 39E.

(g) to (j) In our reply to the written question raised by Dr Hon Lam Tai-fai on November 25 last year, we explained in detail the evolution of section 39E from its enactment in 1986 to its amendment in 1992. The scope of application of the current section 39E has gone beyond "sale and leaseback" and "leveraged leasing" arrangements and covered all kinds of leasing arrangements. Hence, excluding machinery and plant which are provided for use by the Mainland enterprises rent-free from the scope of application of section 39E would involve relaxation of the restriction in that provision. This would affect the completeness of the anti-avoidance provisions.

We have examined whether there is room for relaxing section 39E, but we have to make assessment carefully in view of the complicated issues involved. During the course of deliberations, we have already taken into consideration the views of the industrial and commercial sector, the accounting sector and tax experts. As indicated in our reply to the oral question raised by Dr Hon Lam Tai-fai on November 24 this year, we have to take into account the overall interests of Hong Kong and all the taxpayers in making each and every policy decision. Our review has come to a conclusion that there are no justifiable grounds to relax the existing restriction in section 39E.

Ends