Press release

LCQ16: Depreciation allowances

Wednesday, October 21, 2009

Following is a question by Dr the 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 (October 21):

Question :

The Inland Revenue (Amendment) Ordinance 1986 added section 39E to the Inland Revenue Ordinance (Cap. 112). The provision aims to limit the opportunities for tax deferral or avoidance through sale and leaseback and leveraged leasing arrangements. In making such relevant arrangements, an owner of machinery or plants will be denied initial allowances and annual allowances (depreciation allowances) in respect of the capital expenditure incurred on the provision of such machinery or plants. When the provision was scrutinised and passed by the former Legislative Council in 1986, the Government had stated that the provision was intended to strike down such acts of tax avoidance, and specifically stated that the provision only targeted at the two leasing arrangements of sale and leaseback and leveraged leasing. At the same time, it assured that general leasing transactions and normal commercial transactions would not be affected. Upon passage of the Bill, the Commissioner of Inland Revenue issued the Departmental Interpretation and Practice Notes No. 15, which stated clearly that the Notes only apply to the two leasing arrangements of sale and leaseback and leveraged leasing. In this connection, will the Government inform this Council:

(a) given that members of the trade are of the view that the original Notes No. 15 already reflected clearly the legislative intent of section 39E, and no problem has arisen from the enforcement of the relevant legislation, yet the Government amended in January 2006 the Notes relating to the enforcement of the Ordinance, of the reasons for that;

(b) given that the Government had assured the former Legislative Council in 1986 that the departmental guidelines issued by the Commissioner of Inland Revenue in respect of section 39E would reflect the literal meaning and the legislative spirit of the legislation, whether the assurance was fulfilled when the Government amended the Notes concerned in 2006; if it was, how the new Notes reflect the legislative spirit of the legislation; if not, of the reasons for that;

(c) given that the legislative intent of the above provision is to strike down acts of tax avoidance, and it has been especially stated that the provision only targets at the two leasing arrangements of sale and leaseback and leveraged leasing, why Hong Kong enterprises are denied depreciation allowances, even if they have not committed or intended to commit the above acts of tax avoidance, and have absolutely not involved in the above two leasing arrangements, but have merely made the machinery and plants available for use by factories or their outsourced manufacturers on the Mainland in accordance with general commercial arrangements (e.g. import processing arrangement), so as to manufacture commodities for sale by Hong Kong enterprises, and the profits of these Hong Kong enterprises are all subject to taxes in Hong Kong;

(d) given that the Government had assured the former Legislative Council in 1986 that general leasing transactions and normal commercial transactions would not be affected by the provision, whether the relevant assurance is still valid today; if so, how it ensures that the assurance is complied with; if not, of the reasons for that;

(e) whether it has assessed the actual impact of implementing the new Notes on normal economic activities; if it has, of the details; if not, the reasons for that;

(f) whether, in implementing the new Notes, it has taken into consideration the situation of the northern migration of industries and regional economic integration in the Pearl River Delta at present; if it has, of the details; if not, the reasons for that;

(g) whether it has taken into consideration that the new Notes have rendered Hong Kong enterprises unable to tie with the Mainland policy of requiring enterprises to upgrade and restructure, and have dealt a severe blow to the productivity and competitiveness of the manufacturing industry; if it has, of the details; if not, the reasons for that; and

(h) whether it has plans to review the above Notes and related legislation; if it has, of the details; if not, the reasons for that?

Reply :

President,

(a) to (e) Section 39E of the Inland Revenue Ordinance was enacted in 1986 and amended in 1992 to become the current version. The legislation aims at limiting tax avoidance opportunities in various forms of machinery or plant leasing arrangements. As many of such tax avoidance arrangements involve machinery or plant owned by a Hong Kong enterprise being used by an enterprise outside Hong Kong for a long period of time, section 39E stipulates that the Hong Kong enterprise will not be granted depreciation allowances for the relevant machinery or plant under such circumstances.

Section 39E is not intended to have any impact on normal commercial leasing transactions. As we explained to the Legislative Council when we proposed the amendment to section 39E in 1992, if a Hong Kong enterprise leases its machinery or plant to another enterprise outside Hong Kong through a normal leasing arrangement, although the Hong Kong enterprise will no longer be granted depreciation allowance for the relevant machinery or plant, its rental income derived from outside of Hong Kong will not be subject to Hong Kong tax. Therefore, section 39E should not have impact on such transactions.

The Inland Revenue Department issues and updates departmental interpretation and practice notes from time to time for the implementation of various provisions of the Inland Revenue Ordinance (including section 39E). The notes provide detailed explanations and realistic examples so as to facilitate taxpayers' understanding of and compliance with the relevant provisions. However, the notes have no legal binding force and cannot change the legislative intent of any provision.

(f) to (h) We have noticed the restructuring of Hong Kong enterprises in the Pearl River Delta in recent years. We understand that under the import processing arrangement they may make their machinery or plant (mainly moulds) available for use by Mainland enterprises free of charge. In such circumstances, they would neither receive any rental income nor enjoy the relevant depreciation allowances because of section 39E.

We appreciate that the industry would like to continue to enjoy the deduction of depreciation allowances in Hong Kong under the above-mentioned circumstances. However, we consider that it is a rather complicated matter involving various issues, including 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. There are practical difficulties in relaxing the relevant restriction.

Ends