A good tax system provides relief for costs incurred in generating taxable revenue; one way to achieve this is by granting depreciation allowances for capital expenditure on plant and machinery used in producing taxable income.

But the Inland Revenue Department’s practice of denying depreciation allowance claims by companies having import processing arrangements in accordance with section 39E of the Inland Revenue Ordinance seems to deviate from this principle.

Given that section 39E of the ordinance is seen as a specific provision to target tax avoidance under leasing arrangements, the department’s strict application of the section to genuine commercial arrangements has raised much concern in the business community.

The law and its intent
Section 39E denies relief on capital expenditure on plant and machinery, which a taxpayer would otherwise be entitled to under sections 37, 37A and 39B if they meet certain specified conditions.

Enacted in 1986, section 39E was originally intended to target “sales and leaseback” and “leverage leasing” arrangements only, the latter of which refers to leasing plant and machinery used outside of Hong Kong.

The IRD, however, later noticed that many companies could technically circumvent the definition of leverage leasing by making arrangements for their
plant or machinery (mainly ships and aircraft) used by persons outside the territory. To plug the loophole, the administration amended the section in 1992 by replacing the word “and” with “or” in the provisions related to leverage leasing. This wrapped all leasing arrangements, under which machinery or plant is used wholly or principally outside Hong Kong, into section 39E.

It has now become clear that the wide coverage of section 39E and the loose definition of the term “lease” affect many innocent cross-border businesses – raising questions whether this broad approach is proportionate to what the legislation originally set out to achieve.

In its recent decision on case D61/08, the Board of Review endorsed this strict interpretation. In that case, the taxpayer sought tax relief through a section 16G claim or section 39B depreciation allowance claim on plant and machinery it supplied to its mainland subsidiary for producing goods resold to the taxpayer.

The revenue derived by the taxpayer on reselling the goods was fully chargeable to Hong Kong profit tax. However, the taxpayer was unsuccessful in its claim because it failed to demonstrate there was any capital expenditure incurred, or that the capital expenditure had any connection with generating chargeable profit.

The board went on to say that even if the taxpayer was able to show this connection, the arrangement of providing plant and machinery for use by another party would have fallen within the meaning of a lease arrangement as defined under the ordinance. And if the plant and machinery were used wholly or principally outside Hong Kong, section 39E would deny any depreciation allowance claim that would have been granted otherwise.

**Impact on import processing**

Trade processing arrangements between a Hong Kong company and a mainland enterprise are very common, and these take the form of contract processing or import processing. Both arrangements are quite similar in that the Hong Kong entity provides plant, machinery and technical skills, while the mainland enterprise provides labour to produce products for export to the Hong Kong company.

Under this contract processing arrangement, the profit derived by the Hong Kong company is currently assessed, as a concession, on a 50 percent basis whereas in the case of import processing, 100 percent of the profit would normally be assessed.

It is common in both cases that the Hong Kong company owns the plant and machinery, the assets are recorded in its books and depreciation is charged according to its accounting policy. But because of a processing arrangement, the plant and machinery are moved to the premises of the mainland enterprise, where they are used to produce goods. The local company retains title to the plant and machinery, and thus has control to ensure quality and to protect product design and technology.

Section 39E(1)(b)(i) stipulates that no depreciation allowance on capital expenditure shall be granted to the taxpayer if it leases the plant and machinery to another person outside Hong Kong wholly or principally during the period of the lease.

And this section would be applied strictly and literally in cases where the plant and machinery is owned by the Hong Kong company but operated on the mainland by the subcontractor, which is a separate legal entity, to deny any depreciation allowances for the Hong Kong company.

In practice, the IRD has adopted a concessionary treatment for contract processing arrangements by allowing the taxpayer 50 percent of the depreciation allowance claim on plant and machinery despite section 39E. However, taxpayers under an import processing arrangement are denied such concessions and they consider this unfair. Given the significant costs of the plant and machinery, the denial of such relief imposes a significant burden on the Hong Kong company and will inevitably hinder business development.

Due to policy changes in the mainland, fewer contract processing licences will be granted or renewed and the predominant form of trade processing is bound to shift to import processing. With the strict application of section 39E, pressure will build on businesses with manufacturing operations in China.
Hong Kong tax

The IRD... could grant a temporary concession to import processing businesses because in substance, they operate just like contract processing arrangements.

Reason for the IRD’s stance
The issue was recently raised in the Legislative Council, but the department reiterated its stance and was reluctant to relax the interpretation of section 39E. The IRD’s concerns are:

• The plant and machinery may be subsequently sold or transferred to other parties.
• Other entities may claim depreciation allowances on the same plant and machinery.
• The plant and machinery may be used to manufacture goods sold other than to the Hong Kong entity.
• Other administrative problems may arise in future.

The wording of section 39E may be clear and unambiguous. As pointed out by the Board of Review in D61/08, it does not require an intention to avoid tax for its application. Nevertheless, the consequence of the strict application of section 39E could be unrealistic, given the trend of import processing.

Whether section 39E should ultimately be amended is a matter of policy for the legislature. It is a trade-off between the need to combat tax avoidance and the sustained development of Hong Kong’s economy. In the meantime however, the IRD could have taken some interim measures to minimize the adverse impact on genuine businesses by applying a restrictive interpretation to certain key points in section 39E, for example, “lease” and “use.”

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 without charge is a “lease” under section 2 of the Inland Revenue Ordinance. It is possible that an asset’s owner lets another person use it for reasons of quality control and protection of trade secrets. Similar to the import processing cases, there are no business reasons for the owner to charge rent for the use of such assets because the owner, rather than the person physically using the asset, is the one who derives economic benefits. Arguably, the use of the assets by others in such a case is not a “lease.”

The IRD should reconsider its interpretation of section 39E, taking into account the unclear legal interpretation and business reality. It could grant a temporary concession to import processing businesses because in substance, they operate just like contract processing arrangements.

The practical difficulties of ensuring the authenticity of tax deduction claims exist in all forms of business operations. The investigative power conferred to the IRD and relevant penalty provisions should be adequate to combat any tax deduction abuse. Furthermore, the exchange of information article in the double taxation agreement between Hong Kong and the mainland should give the department a proper channel to gather information about a taxpayer’s manufacturing operations in China.

Eva Yeung is a tax director at PricewaterhouseCoopers and Jova Lui is the firm’s senior tax manager.