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# Tax Analysis

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Hong Kong Tax

## Hong Kong court disallows deduction for manufacturing assets used in China

Hong Kong's Court of Appeal handed down its decision in the Braitrim (Far East) Limited (BFE) case on 6 December 2012, upholding the disallowance of a deduction for the cost of certain fixed assets used by a Hong Kong taxpayer in its manufacturing operations in China. The decision is a significant blow to Hong Kong's manufacturing industry after numerous unsuccessful appeals to the government on the unfairness of the relevant legislation.

**Background**

The manufacturing industry has played a vital role in Hong Kong's success since the 1960s. In the 1960s, most factories of Hong Kong manufacturers were located in Hong Kong, providing ample employment opportunities for the Hong Kong workforce. With the increase in Hong Kong property prices, rents and labor costs, Hong Kong manufacturers gradually began to move their factories to Mainland China. With the Hong Kong side supplying machinery, equipment and supervision, and the China side supplying the land and workforce, manufacturers entered into contract processing (toll manufacturing) arrangements under which the materials and finished products belonged to the Hong Kong entity. Under this type of arrangement, the Mainland factory typically is operated by a local Chinese individual/entity in order to comply with Mainland regulations and the factory charges the Hong Kong entity a processing fee. The Hong Kong Inland Revenue Department (IRD) generally taxes the profits of the Hong Kong entity on a 50:50 basis (i.e. half of the profits are regarded as sourced offshore and therefore non-taxable, and half are subject to Hong Kong profits tax) on the grounds that the selling operations take place in Hong Kong and the manufacturing operations in China. On this basis, the manufacturing equipment provided by the Hong Kong entity for use by the Mainland China entity qualifies for half of the depreciation allowances that would otherwise not be available.

Over time, the Mainland government began to encourage Hong Kong manufacturers to set up wholly foreign owned enterprises (WFOEs) on a formal basis to take over the Mainland factories. At the same time, contract processing (toll manufacturing) arrangements were being replaced by import processing (contract manufacturing) arrangements. The latter type of arrangement is similar to a contract processing arrangement, except that the ownership of the raw materials and finished products no longer lies with the Hong Kong entity, but with the Chinese entity (usually a WFOE of the Hong Kong entity). The Hong Kong entity usually sells the raw materials to the Chinese entity for processing and the finished products are sold to the Hong Kong entity after processing. The Chinese entity does not charge the Hong Kong entity a processing fee, the Chinese entity's reward for its involvement in the arrangement instead being represented by the manufacturing margin. The IRD has taken the position that the profits made by the Hong Kong entity in these circumstances are no longer in the nature of "manufacturing profits," but instead in the nature of "trading profits" wholly subject to Hong Kong tax, since the Chinese entity — a separate entity — has taken over the "manufacturing operations". In the two cases regarding the nature and source of such profits taxpayers appealed to the court *(CIR v Datatronic Limited and CIR v C G Lighting Limited)*, the court has ruled in favor of the IRD.

Since the profits in these circumstances are treated as wholly subject to Hong Kong tax, an issue that has continually arisen is whether the machinery or equipment provided by the Hong Kong entity to the Chinese entity is eligible for depreciation allowances or a cost deduction, as discussed below.

In order to promote manufacturing industries (as well as information technology industries), in 1998, the Hong Kong government enacted section 16G of the Inland Revenue Ordinance (IRO) to allow an upfront tax deduction for capital expenditure incurred on "prescribed assets," including certain manufacturing and computer equipment. On the other hand, back in 1992, section 39E of the IRO was enacted primarily to counter tax avoidance schemes involving leveraged leases of assets (including aircrafts and ships) used principally outside Hong Kong. Although section 39E was not intended to target manufacturing industries, the IRD, in mid-2000s, began to deny depreciation allowances on manufacturing assets provided by Hong Kong entities to Mainland entities in the context of contract manufacturing operations. To pronounce this change, the IRD, in January 2006, also revised its Departmental Interpretation and Practice Note No. 15 by adding a number of paragraphs explaining that depreciation allowances for assets wholly or principally used outside Hong Kong must be denied under section 39E of the IRO.

Sections 16G and 39E of the IRO operate to disallow the deduction of the cost of prescribed fixed assets (section 16G) and depreciation allowances (section 39E) where there is a "lease" (for section 39E to apply the asset has to be used wholly or principally outside Hong Kong). As the first case on this issue to have reached the court, BFE is certain to attract the attention of a large number of taxpayers.

## Facts

The taxpayer, BFE, was incorporated in Hong Kong in 1998. BFE carried on the business of supplying plastic garment hangers and related packaging materials until it ceased business in 2002. The hangers were manufactured by two Mainland companies unrelated to BFE using moulds provided by BFE under the guidance of BFE's staff seconded to Mainland China. The ownership of the moulds remained with BFE. The moulds were used to manufacture hangers to be sold to BFE. BFE's profits for the years of assessment 2000/01 to 2002/03 were treated as fully taxable in Hong Kong. In calculating its assessable profits, BFE claimed a full tax deduction for the cost of "prescribed fixed assets" under section 16G with respect to the cost of the moulds in the amounts of HKD 11 million, HKD 3 million and HKD 4 million for the years of assessment 2000/01, 2001/02 and 2002/03, respectively. The IRD challenged the deductions on the grounds that the assets did not qualify as "prescribed fixed assets" within the meaning of section 16G of the IRO. Under the section 16G definition, certain assets known as "excluded fixed assets" are outside the scope of prescribed fixed assets. Excluded fixed asset mean *"a fixed assets in which any person holds rights as a lessee under a lease."*

The issue in question involves the interpretation of the meaning of the term "lease" and whether it should follow the "statutory definition" under section 2 of the IRO. The "statutory definition" is widely drawn:

> *"in relation to any machinery or plant, includes-*
>
> *(a) any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person; and*
>
> *(b) any arrangement under which a right to use the machinery or plant, being a right derived directly or indirectly from a right referred to in paragraph (a), is granted by a person to another person, but does not include a hire-purchase agreement or a conditional sale agreement unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised".*

Because of the wide scope of the "statutory definition," BFE's manufacturing assets would fall within the definition of "excluded fixed assets," were the statutory definition to apply.

In August 2011, the Hong Kong Board of Review (a tax tribunal) held that the statutory definition should apply. Bypassing the Court of First Instance, the taxpayer appealed to the Court of Appeal, which upheld the opinion of the Board of Review and ruled against the taxpayer on the basis that the historical circumstances indicated that the statutory definition under section 2 was intended by the legislature to apply in the context of section 16G, as well as that of section 39E.

## Comments

Unless the taxpayer decides to appeal the Court of Appeal’s decision and manages to prevail before the Final Court of Appeal, it would seem that taxpayer failure at both the administrative level and before the courts has confirmed that no tax deduction or depreciation allowance is to be granted with respect to manufacturing assets provided by Hong Kong entities for use by factories outside Hong Kong.

If one looks at the various measures undertaken by jurisdictions around the globe to promote their local manufacturing industries, it seems unfortunate that the Hong Kong government should be insufficiently flexible to allow deductions/depreciation allowances to taxpayers whose profits are treated as wholly taxable in Hong Kong. In light of the significant tax cost that this practice creates, Hong Kong manufacturers will have to find other ways to evolve, beyond restructuring their businesses, in order to remain competitive.

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