

Case No. D31/13

Profits tax – whether capital expenditure on the assets can be deducted from assessment – sections 16G and 39E of the Inland Revenue Ordinance ('IRO') – whether the assets will be regarded as under a lease – subsidiary nature of the user.

Panel: Chan Chi Hung SC (chairman), Cheng Chung Hon Neville and Leung Lit On.

Date of hearing: 18 November 2013.

Date of decision: 24 January 2014.

The Appellant incurred capital expenditure on the provision of machines, moulds and tooling ('the Assets'). The user of the machines was a wholly owned subsidiary of the Appellant located in Mainland China. The subsidiary company used the machines at no consideration. The users of moulds and tooling were factories located in Mainland China, and the users were not owned by the Appellant save for the said subsidiary. They also used the moulds and tooling without consideration. The Appellant's case is that the Assets were used for manufacturing the Appellant's goods. The Appellant claimed for deduction of capital expenditure incurred on the provision of the Assets.

The dispute is whether the Appellant is entitled to deduction (from the assessment of tax chargeable profits) for the capital expenditures in question.

Held:

1. Both sections 16G and 39E of the IRO expressly exclude any such deduction if, in relation to the asset in question, a person holds rights as a lessee under a lease.
2. If the Appellant caused the subsidiary and the Mainland manufacturers to use the machines, moulds and toolings free of charge and without any form of consideration, and the Appellant retained the control as to the use of the Assets, that is the use of the Assets were only for the production of goods to the Appellant's specification and specified quantities to be supplied to the Appellant only, was it rather equivalent to the Appellant's own use of the Assets, and therefore was not a use by, and thus not a lease to, the subsidiary and the Mainland manufacturers? The answer is a clear 'No'.
3. The Assets will be regarded as under a lease to the various manufacturing parties in Mainland China (the subsidiary and the Mainland manufacturers),

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despite the Appellant's contention that the use of the Assets was limited to the Appellant's specified purposes only, and the Assets were under the Appellant's control. The Assets were clearly used by these other persons, and clearly the right to so use the Assets has been granted by the Appellant. Thus the subsidiary and the Mainland manufacturers were all lessees under a lease within the meaning of section 16G and 39E of the IRO (Braitrim (Far East) Limited v Commissioner of Inland Revenue, FAMV No 18 of 2013 followed).

4. As the subsidiary of the Appellant is a separate legal entity incorporated and operating in Mainland China, the fact that it was a subsidiary of Appellant, does not make any difference in the above analysis.
5. On the facts and evidence in this case, the subsidiary and Mainland manufacturers were operating in the nature of, to draw an analogy, independent contractors, rather than as the servants or employees of the Appellant.

Appeal dismissed.

Case referred to:

Braitrim (Far East) Limited v Commissioner of Inland Revenue, FAMV No 18 of 2013

Anthony Lui from Messrs Milne Ross Certified Public Accountants and Mr Pablo Lombardo from the Appellant Company for the Appellant.
Chan Siu Ying Shirley and Yau Yuen Chun for the Commissioner of Inland Revenue.

Decision:

The issue

1. The issue is whether the Appellant was entitled to deduct the following which were capital expenditure incurred by the Appellant on the provision of machines, moulds and tooling ('the Assets') for the years of assessment 2002/03 to 2004/05:

<u>Year of assessment</u>	<u>2002/03</u>	<u>2003/04</u>	<u>2004/05</u>
	\$	\$	\$
Capital expenditure on prescribed fixed assets	619,169	-	8,503,173
Depreciation allowance	-	3,663,514	427,410

The relevant legislation

Deduction for prescribed fixed assets

2.1 Section 16 of the Inland Revenue Ordinance ('the IRO') provides:

'(1) *In ascertaining the profits in respect of which a person is chargeable to tax under [Part 4] for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under [Part 4] for any period, including-*

...

(ga) *the payments and expenditure specified in sections ... 16G ... as provided in those sections;...*'

2.2 Section 16G provides:

'(1) *Notwithstanding anything in section 17, in ascertaining the profits of a person from any trade, profession or business in respect of which the person is chargeable to tax under [Part 4] for any year of assessment, there shall ... be deducted any specified capital expenditure incurred by the person during the basis period for that year of assessment.*

(2) *Where a prescribed fixed asset in respect of which any specified capital expenditure is incurred is used partly in the production of profits chargeable to tax under [Part 4] and partly for any other purposes, the deduction allowable under this section shall be such part of the specified capital expenditure as is proportionate to the extent of the use of the asset in the production of the profits so chargeable to tax under [Part 4].*

...

(6) *In this section-*

*"excluded fixed asset" (例外固定資產) means a fixed asset in which **any person holds rights as a lessee under a lease** (emphasis added);*

"prescribed fixed asset" (訂明固定資產) means-

(a) *such of the machinery or plant specified in items 16, 20, 24, 26, 28, 29, 31, 33 and 35 of the First Part of the Table annexed to rule 2 of*

the Inland Revenue Rules (Cap 112 sub. leg. A) as is used specifically and directly for any manufacturing process;

...

but does not include an excluded fixed asset;

“specified capital expenditure”(指明資本開支), in relation to a person, means any capital expenditure incurred by the person on the provision of a prescribed fixed asset ...’

2.3 Section 17(1) provides:

‘(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of-

...

(c) any expenditure of a capital nature or any loss or withdrawal of capital;...’

2.4 Section 2 of the IRO defines ‘lease’ in relation to any machinery or plant to include:

‘(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, ...’

2.5 Item 26 of the First Part of the Table annexed to rule 2 of the Inland Revenue Rules refers to ‘*plastic manufacturing machinery and plant including moulds*’.

Deduction for depreciation allowances for plant and machinery

3.1 Section 18F provides:

‘(1) The amount of assessable profits for any year of assessment of a person chargeable to tax under [Part 4] shall be ... decreased by the allowances made to that person under Part 6 for that year of assessment to the extent to which the relevant assets are used in the production of the assessable profits.’

3.2 Section 39B provides for initial and annual allowances on plant and machinery:

‘ (1) *Where a person carrying on a trade, profession or business incurs capital expenditure on the provision of machinery or plant for the purposes of producing profits chargeable to tax under Part 4 then ... there shall be made to him, for the year of assessment in the basis period for which the expenditure is incurred, an allowance, to be known as an “initial allowance”.*

...

(2) *Where during the basis period for any year of assessment or during the basis period for any earlier year of assessment a person owns or has owned and has in use or has had in use any machinery or plant for the purposes of producing profits chargeable to tax under Part 4, there shall be made to him in respect of each class of machinery or plant for that year of assessment an allowance, to be known as an “annual allowance”, for depreciation by wear and tear of such machinery or plant.’*

3.3. Section 39E provides:

‘ (1) *Notwithstanding anything to the contrary in [Part 6], a person (in this section referred to as “the taxpayer”) who incurs capital expenditure on the provision of machinery or plant, ... for the purpose of producing profits chargeable to tax under Part 4 shall not have made to him the initial or annual allowance prescribed in section ... 39B if, at a time when the machinery or plant is owned by the taxpayer, **a person holds rights as lessee under a lease of the machinery or plant** (emphasis added), and-*

...

(b) *the machinery or plant ... is while the lease is in force-*

(i) *used wholly or principally outside Hong Kong by a person other than the taxpayer; ...’*

The relevant facts

4. The Appellant has agreed to the facts as stated in the Determination by the Deputy Commissioner. The facts in essence are as follows:

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- (a) The Appellant incurred the following capital expenditure:

<u>Year of assessment</u>	<u>2002/03</u>	<u>2003/04</u>	<u>2004/05</u>
	\$	\$	\$
Moulds and toolings	<u>619,169</u>	<u>5,088,214</u>	8,239,092
MK08 line machines			<u>264,081</u>
			<u>8,503,173</u>

- (b) The Appellant claimed deduction of capital expenditure as prescribed fixed assets and depreciation allowance as follows:

<u>Year of assessment</u>	<u>2002/03</u>	<u>2003/04</u>	<u>2004/05</u>
	\$	\$	\$
Capital expenditure on prescribed fixed assets	619,169	-	8,503,173
Depreciation allowance	-	⁴ 3,663,514	⁴ 427,410

Note 4: Depreciation allowance

	\$	\$	
Mould and toolings	5,088,214		
<u>Less: Initial allowance (@60%)</u>	<u>3,052,928</u>	3,052,928	
	2,035,286		
<u>Less: Annual allowance (@30%)</u>	<u>610,586</u>	<u>610,586</u>	
Written down value	1,424,700	<u>3,663,514</u>	(2003/04)
<u>Less: Annual allowance (@30%)</u>	<u>427,410</u>	<u>427,410</u>	(2004/05)
Written down value	<u>997,290</u>		

- (c) The user of the machines was a wholly owned subsidiary of the Appellant located in Mainland China. The subsidiary company used the machines at no consideration.
- (d) The users of the moulds and tooling were factories located in Mainland China. The users were not owned by the Appellant save for the said subsidiary. They used the moulds and tooling without consideration.
- (e) The Appellant's case is that the Assets were used for manufacturing the Appellant's goods.

Analysis and Decision

5. The dispute in this appeal is whether the Appellant is entitled to deduction (from the assessment of tax chargeable profits) for the capital expenditures in question. If they were incurred on prescribed fixed assets, then the relevant provision is section 16G of

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the IRO. Another provision allowing deduction for capital expenses, irrespective of whether the relevant fixed assets were prescribed fixed assets, was section 39E of the IRO.

6. Both sections expressly exclude any such deduction if, in relation to the asset in question, a person holds rights as a lessee under a lease (the slight difference in words in the 2 sections in relation to the exclusion of leased assets, is immaterial).

7. Thus, the only issue is this. If the Appellant caused the subsidiary and the Mainland manufacturers to use the machines, moulds and toolings free of charge and without any form of consideration, and the Appellant retained the control as to the use of the Assets, that is the use of the Assets were only for the production of goods to the Appellant's specification and specified quantities to be supplied to the Appellant only, was it rather equivalent to the Appellant's own use of the Assets, and therefore was not a use by, and thus not a lease to, the subsidiary and the Mainland manufacturers? The answer is a clear 'No'.

8. The wide interpretation of the definition of 'lease' (statutorily defined as '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'), as including the arrangement similar to that in the present case, by the Appeal Committee of the Court of Final Appeal in Braitrim (Far East) Limited v Commissioner of Inland Revenue, FAMV No 18 of 2013, judgment dated 22 August 2013, puts the issue beyond any argument. The Assets will be regarded as under a lease to the various manufacturing parties in Mainland China (the subsidiary and the Mainland manufacturers), despite the Appellant's contention that the use of the Assets was limited to the Appellant's specified purposes only, and the Assets were under the Appellant's control. The Assets were clearly used by these other persons, and clearly the right to so use the Assets has been granted by the Appellant. Thus the subsidiary and the Mainland manufacturers were all lessees under a lease within the meaning of sections 16G and 39E of the IRO.

9. As the subsidiary of the Appellant is a separate legal entity incorporated and operating in Mainland China, the fact that it was a subsidiary of Appellant, does not make any difference in the above analysis. Certainly, whether there is a lease within the meaning of these 2 sections of the IRO depends on substance and not form, and often is fact sensitive as a matter of degree, and the mere fact that the Taxpayer and the actual user are separate legal persons, may not be conclusive. In an appropriate case, one cannot rule out circumstances that on true analysis the Taxpayer may be found to be the true user using the machine or plant through its own servants and agents. However, on the facts and evidence in this case, that certainly was not the case. The subsidiary and Mainland manufacturers were operating in the nature of, to draw an analogy, independent contractors, rather than as the servants or employees of the Appellant.

10. Thus, the Appellant clearly was not entitled to the deductions claimed, and the Deputy Commissioner was entirely correct in his Determination.

11. For the forgoing reasons, the appeal is dismissed unanimously.