

Case No. D12/12

Profits tax – deduction for prescribed manufacturing machinery or plant – section 16G of the Inland Revenue Ordinance (‘the IRO’) – whether the plant and machinery were under a lease as defined in the Inland Revenue Ordinance – onus of proving capital expenditure on the audited equipment and machinery.

Panel: Cissy K S Lam (chairman), Jose-Antonio Maurellet and Kelly Wong Yuen Hang.

Dates of hearing: 24 October 2011 and 25 November 2011.

Date of decision: 27 June 2012.

The Appellant was a private company incorporated in Hong Kong and was engaged in the trading of electronic components. The audited accounts reported an acquisition of equipment and plant and machinery. All these audited equipment and machinery were delivered to a factory in China to manufacture products of the Appellant. The factory had the status of a legal person and it had a PRC tax registration and had to pay county tax and land tax. The Appellant however did not have a PRC business or tax registration.

The Appellant claimed deduction for prescribed manufacturing machinery or plant under section 16G of the Inland Revenue Ordinance. The Assessor took the view that the plant and machinery in question were used by a factory in China and as such were ‘excluded fixed assets’ within the meaning of section 16G and rejected the Appellant’s claim. The view was upheld in the determination and the Appellant appealed against it.

The Appellant argued that the factory in fact was one and the same entity as the Appellant because all the plant and machinery was supplied by the Appellant and all the operation expenses were paid by the Appellant. The Appellant was the one who managed and run the factory and was also the one who employed workers for the factory. All the goods manufactured by the factory were sold to the Appellant. The factory did not do any trade independent of the Appellant and did not earn any profit by selling to the Appellant.

The crucial issue is whether the plant and machinery in question were under a lease as defined in the Inland Revenue Ordinance. The second issue was how much was incurred for the audited equipment and machinery.

Held:

1. The Board does not doubt that as a matter of fact, the factory was under the full control and management of the Appellant and the reasons arguing that

they were one and the same company were genuine. However these facts could not displace the true legal position which was that the factory was an independent legal entity established under PRC law with the status of a legal person separate and distinct from the Appellant. It entered into the Agreement as an independent party. It has its own business and tax registration in the PRC. It had its own legal representative in the PRC.

2. The definition of a 'lease' in the IRO is very wide. Once it is accepted, as does the Appellant, that the factory has the status of a legal person, then in the eyes of the law, the factory's rights to use the audited equipment and machinery could only be as a lessee under a lease within the meaning of the IRO. As such the audited equipment and machinery were 'excluded fixed assets' and no deduction could be claimed under section 16G of the IRO.
3. The Appellant has the onus of proving that capital expenditure on the audited equipment and machinery was in fact incurred and its exact sum. On the basis of the audited accounts, the Board is prepared to accept the sum for the audited equipment and machinery as accurate.

Lee Kwok Wai of Tact Management Limited for the Taxpayer.

Chan Tsui Fung and Leung Wing Chi for the Commissioner of Inland Revenue.

Decision:

1. In the Appellant's Profit Tax Return for the year of assessment 2002/03 ('the Tax Return'), the Appellant claimed deduction for Prescribed Manufacturing Machinery or Plant in the sum of \$1,177,259 under section 16G of the Inland Revenue Ordinance, Chapter 112 ('the IRO'). Following correspondence with the Appellant, the Assessor took the view that the plant and machinery in question were used by a factory in China and as such were 'excluded fixed assets' within the meaning of section 16G and rejected the Appellant's claim. This view was upheld by the Deputy Commissioner of Inland Revenue in his determination dated 29 April 2011 ('the Determination'). The Appellant now appeals to us.

Part IV of the IRO

2. Part IV of the IRO deals with profits tax. Section 16(1)(ga) thereof provides that in ascertaining the profits in respect of which a person is chargeable to profits tax for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred in the production of profits including the payments and expenditure specified in section 16G as provided therein.

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3. Section 16G provides that in ascertaining the profits of a person from any trade or business in respect of which the person is chargeable to profits tax 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.

4. Section 16G defines ‘specified capital expenditure’ to mean ‘any capital expenditure incurred by the person on the provision of a prescribed fixed asset ...’ and ‘prescribed fixed asset does not include an excluded fixed asset’.

5. Section 16G further defines ‘excluded fixed asset’ to mean ‘a fixed asset in which any person holds rights as a lessee under a lease’.

6. A definition of ‘lease’ can be found in the interpretation section, that is section 2 of the IRO. Lease, in relation to any machinery or plant, includes ‘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’.

The issues

7. The crucial issue is whether the plant and machinery in question were under a lease as defined in the IRO.

8. In addition Miss Chan for the Commissioner of the Inland Revenue challenges the veracity of the sum claimed. She questions whether any sum, and if so how much, was incurred for the plant and machinery in question.

The evidence

9. The Appellant was a private company incorporated in Hong Kong in 2000. It commenced business in 2001 and closed its first set of accounts on 31 December 2002. As per the report of directors and audited accounts for that period (‘the audited accounts’) the Appellant was engaged in the trading of electronic components.

10. The audited accounts reported an acquisition of equipment and plant and machinery totalling HK\$1,177,259 (‘the Audited Equipment and Machinery’). An itemized list of the equipment and a separate itemized list of the plant and machinery acquired together with their individual costs were attached to the audited accounts (‘the Audit Lists’). The Audited Equipment and Machinery is the item of expenditure now in dispute.

11. Mr C, a director of the Appellant, gave evidence before this Board. According to his evidence the Appellant operated a factory (‘Factory D’) in City E, the People’s Republic of China (‘PRC’). All the Appellant’s products were manufactured by Factory D and the Audited Equipment and Machinery were delivered to Factory D to enable the manufacturing to be done.

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12. Factory D was established under the preferential contract processing policy (三來一補) in the PRC. A contract processing agreement in Chinese dated 21 May 2001 ('the Agreement') was produced to this Board. The Agreement was signed by four parties:

- (a) 'Party A (甲方)' was City E External Services Company ('Company A')
 - (b) 'Party A Factory (甲方工廠)' was Factory D
 - (c) 'Party B (乙方)' was the Appellant
 - (d) 'Business Agent (商務代理)' was City E External Processing and Assembling Service Company ('Company F').
- (1) Mr C signed on behalf of the Appellant.
 - (2) One Madam G signed on behalf of Factory D. She was the owner of the piece of land on which Factory D was built and the legal representative of Factory D. She was not an employee of the Appellant and was not involved in the daily operation of Factory D.
 - (3) By the Agreement, the Appellant undertook to supply without consideration equipment and plant and machinery ('the Agreement Listed Machinery') necessary for the contract processing work as per the list attached to the Agreement ('the Agreement List'). The Agreement Listed Machinery would be delivered to Factory D starting from May 2001. The total value of the Agreement Listed Machinery was HK\$960,000 and their ownership right remained with the Appellant.
 - (4) Clause 1 of the Agreement further provided that
 - (a) the Appellant would supply without consideration all the raw materials, supplementary materials and packing materials. Company A would provide the necessary factory premises, electricity supply and workforce for the Appellant's contract processing work and would receive a processing fee and management fee. All the finished products would be exported to the Appellant.
 - (b) After delivering the Agreement Listed Machinery to Factory D, the Appellant would as soon as possible send technicians to Factory D to assist in their installation and to provide technical training. The Appellant was responsible for all the expenses relating to the provision of the technicians.
 - (5) Clause 2 of the Agreement set out the amount of the processing fee and Clause 3(1) stated the basis on which it was calculated.

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- (6) Clause 3(2) stipulated that Company A would provide factory premises of 1000 square meter. Out of the processing fee, the Appellant would pay a monthly workman management fee.
- (7) The duration of the Agreement was 5 years.

13. According to Mr C, the processing fee was remitted monthly to the Foreign Economic and Trade Office (外經辦) which charged 10% thereof as their revenue and remitted the remaining sum back to Factory D for its operation.

14. A copy of the Regulations of the General Administration of Customs of the PRC on the Control of Processing and Assembly Undertaken for Foreign Parties ('Regulations') was produced to this Board. Both parties accepted that the Regulations governed the Agreement and the contract processing work undertaken by Factory D.

15. The last paragraph of Article 3 of the Regulations stipulated that: 'Enterprises undertaking processing and assembling for foreign parties shall be economic entities with the status of legal persons.'

16. Mr C accepted that according to PRC law, Factory D had the status of a legal person. It had a PRC tax registration and had to pay county tax and land tax. The Appellant, on the other hand, did not have a PRC business or tax registration.

17. Despite having the status of a legal person under PRC law, Mr C urged this Board to find that Factory D was in fact one and the same entity as the Appellant for the following reasons:

- (1) All the plant and machinery necessary for the operation of Factory D was supplied by the Appellant. All the operation expenses of Factory D were paid by the Appellant.
- (2) Mr C was the one who managed and run Factory D. He was the one who employed the workers for Factory D.
- (3) Factory D had no 'sale ability' – it could only sell to the Appellant and to no one else. All the goods were manufactured for the Appellant and exported to the Appellant.
- (4) Factory D did not do any trade independent of the Appellant and did not earn any profit by selling to the Appellant. The processing fee was not paid to Factory D but to the Foreign Economic and Trade Office. Factory D did not keep any accounts. All the necessary expenditure was included as 'direct overhead' in the Appellant's audited accounts.

Issue 1: Claim under section 16G of the IRO

18. The argument of Miss Chan is very simple: the Audited Equipment and Machinery were not used by the Appellant. Rather a right to use them was granted by the Appellant to Factory D. Such an arrangement fell within the definition of a 'lease' in the IRO. Factory D held rights as a lessee in the Audited Equipment and Machinery. It follows that they were 'excluded fixed assets' and no deduction could be claimed under section 16G.

19. The Appellant's answer to this is that the Appellant and Factory D were one and the same company or business. There was no question of the Appellant granting the right to use the Audited Equipment and Machinery to a lessee because they were the same 'person'. The Audited Equipment and Machinery were used by the Appellant to manufacture its own products. They were solely owned and used by the Appellant.

20. We can understand why the Appellant should take the view that they do. We do not doubt that as a matter of fact, Factory D was under the full control and management of the Appellant and the reasons given by Mr C for arguing that they were one and the same company were genuine. However, these facts could not displace the true legal position which was that Factory D was an independent legal entity established under PRC law with the status of a legal person separate and distinct from the Appellant. It entered into the Agreement as an independent party. It had its own business and tax registration in the PRC. It had its own legal representative (法人代表) in the PRC, namely Madam G. Factory D was established to take the full benefit of the preferential contract processing policy and must bear the full force of its legal consequences.

21. The definition of a 'lease' in the IRO is very wide. Once it is accepted, as does the Appellant, that Factory D has the status of a legal person, then in the eyes of the law, Factory D's rights to use the Audited Equipment and Machinery could only be as a lessee under a lease within the meaning of the IRO. As such the Audited Equipment and Machinery were 'excluded fixed assets' and no deduction could be claimed under section 16G of the IRO.

22. In the correspondence between the Appellant and the Assessor, sections 39B and 39E of the IRO were referred to at some stage. At the hearing Mr Lee representing the Appellant confirmed to us that no claim was made under either section and that we did not need to consider them.

23. Further in the correspondence between the Appellant and the Assessor, the Assessor had at some stage proposed 50:50 apportionment of the claim in line with the Inland Revenue Department's policy regarding the assessment of profits tax involving contract processing factories in the PRC. But that was proposed as a concession and it was not accepted by the Appellant. It is not relevant to our present considerations.

Issue 2: How much was incurred for the Audited Equipment and Machinery

24. The Appellant has the onus of proving that capital expenditure on the Audited Equipment and Machinery was in fact incurred and its exact sum.

25. A comparison of the Audit Lists and the Agreement List show that the Audited Equipment and Machinery and the Agreement Listed Machinery do not correspond whether in terms of unit quantity or unit price. Out of a total of eighteen items of the Audited Equipment and Machinery, only six items could find a correct match in the Agreement List.

26. Apart from the Agreement, Mr C also produced to this Board twenty-two invoices showing the purchase of various equipment and plant and machinery. The Appellant's Tax Representative Mr Lee produced a table to this Board purportedly to reconcile the Audit Lists and the Agreement List by showing that a combination of the Agreement List and the invoices proved that the Audited Equipment and Machinery were indeed purchased.

27. These invoices were attacked by Miss Chan on several fronts:

- (1) One of the invoices was issued to a different company unrelated to the Appellant or Factory D. Mr C was not clear in his explanation as to how the invoice came to be included. He seemed to accept that it was the wrong invoice but maintained that the machines stated on the invoice were in fact purchased.
- (2) One of the invoice was dated 8 May 2001, that is it pre-dated the Agreement. Mr C explained that the Appellant had started to purchase the necessary equipment and machinery before the Agreement was signed. In this regard we note that the Agreement provided for the delivery of the Agreement Listed Machinery to Factory D starting from May 2001, not starting from the date of the Agreement.
- (3) The invoices did not show the Appellant as the purchaser or evidence payment. It is true that they were invoices and not receipts, but in normal circumstances when there is a purchase, payment follows. It is also true that many of the invoices did not include the full name of the purchaser and where they did, the name was that of Factory D rather than the Appellant. But if we accept Mr C's evidence that Factory D had no independent financial resources and all expenses were paid by the Appellant, then it follows that the invoices must have been paid by the Appellant.

28. Miss Chan complained of a general lack of documentary evidence such as bank remittance advice and receipts to support the claim. Mr C's evidence was that many of the documents had been lost and all the documents that he could find he had produced to this

Board. We note that Factory D was closed in 2006 whereas query on the claim for deduction of the Audited Equipment and Machinery was not raised by the tax assessor until January 2007. And even then no challenge was made as to the quantum of the claim. Indeed the issue between the assessor and the Appellant's Tax Representative was always the validity of the claim and not its quantum.

29. Under the Agreement the Appellant was obliged to deliver to Factory D the Agreement Listed Machinery at the total cost of HK\$960,000. There is no evidence that the Appellant did not fulfil its obligation. We accept that there are discrepancies between the Audit Lists and the Agreement List and they cannot all be reconciled even with the invoices produced. However, Mr C's evidence was that at the time the auditors prepared the audited accounts, all relevant documents were produced to the auditors. When the auditors prepared the Audit Lists, they must have looked at the relevant documents and satisfied themselves that the quantity and price paid for the Audited Equipment and Machinery were correct. We note that while the auditors inserted a caveat regarding the quantities and condition of the inventories, no such caveat was inserted in relation to the Audited Equipment and Machinery.

30. On the basis of the audited accounts we are prepared to accept the sum of HK\$1,177,259 for the Audited Equipment and Machinery as accurate. But having regard to our decision on the first issue, this appeal must fail.

Conclusion

31. In conclusion, we find that Factory D held rights in the Audited Equipment and Machinery as a lessee under a lease within the meaning of the IRO. The Audited Equipment and Machinery were 'excluded fixed asset' and no deduction could be claimed in respect of them under section 16G of the IRO.

32. The Profits Tax Assessment for the year of assessment 2002/03 is confirmed and the appeal is hereby dismissed.