Case No. D54/12

Profits tax – depreciation allowance of assets of the factory set up in Mainland China – whether deductible as subcontracting fee – sections 16G, 34, 33A, 37, 37A of the Inland Revenue Ordinance ('the IRO').

Panel: Cissy K S Lam (chairman), Julia Pui-g Lau and Leung Lit On.

Date of hearing: 20 November 2012.
Date of decision: 22 March 2013.

The Appellant's directors set up a factory in Mainland China ('the Mainland Factory'). The Appellant injected funds for the acquisition of the capital assets and the daily operation costs of the Mainland Factory.

The Appellant accepts that it is not entitled to any deduction of allowance in respect of the Mainland Factory's assets.

Yet the Appellant argued that depreciation on the assets acquired by the Mainland Factory should be regarded as part of the processing costs incurred by the Appellant and be allowed as deductions in arriving at its assessable profits/loss for the years of assessment 2002/03 to 2006/07.

Held:

1. There is no legal basis for treating the depreciation of the assets of the Mainland Factory, a separate legal entity, as revenue expenses of the Appellant.

2. The Appellant never paid any 'subcontracting fee' to the Mainland Factory. It is illogical to argue that depreciation of the assets of the Mainland Factory should be treated as a payment of subcontracting fee.

3. About 20% to 30% of the Mainland Factory's products were sold domestically. There is no reason to accept the argument that the Appellant should be allowed to deduct the whole of the depreciation loss as 'compensation' or 'subcontracting fee' to the Mainland Factory.

Appeal dismissed.

Messrs Cheng & Cheng Taxation Services Company for the Taxpayer.
Yip Chi Chuen and Chan Siu Ying Shirley for the Commissioner of Inland Revenue.

Decision:

1. The Appellant objected to the Assessor's revised Statements of Loss for the years of assessment 2002/03 to 2005/06 and Profits Tax Assessment for the year of assessment 2006/07. The Appellant argued that in computing its assessable profits/loss, it should be allowed to deduct depreciation as 'subcontracting charges'.

2. Save otherwise stated, all statutory provisions referred to herein are references to provisions of the Inland Revenue Ordinance, Chapter 112 ('the IRO').

The facts

3. The Appellant is a private company incorporated in Hong Kong in 1992. It closes its account on 31 March annually. In the audited accounts of the Appellant for the relevant years of assessment, the principal activities of the Appellant were described as manufacture and trading of elastic weaving products.

4. In 1995, the Appellant's directors set up a factory in Mainland China named A Factory Limited ('the Mainland Factory') to manufacture the Appellant's products. The Mainland Factory was set up as an 'Import Processing Factory'. Materials were acquired by the Appellant and imported to the Mainland Factory at an import price determined by the Customs Department of Mainland China (which is not at commercial rate). After the manufacturing process, the finished products were exported back to the Appellant at an export price also determined by the Customs Department (also not at commercial rate). In the beginning, the products of the Mainland Factory were 100% exported and sold to the Appellant. In the relevant years of assessment, in addition to exporting to the Appellant, part of its products (between 20% to 30%) were sold domestically in Mainland China.

5. According to Mr Cheng representing the Appellant, the funds for the acquisition of the capital assets and the setting up of the Mainland Factory were injected by the Appellant as share capital of the Mainland Factory and by further advances. The daily operation costs were funded by the Appellant via two channels: (1) By actual remittance of the export price of the finished products as aforesaid; and (2) insofar such remittance was insufficient to cover its running expenses, funds were remitted to the Mainland Factory through indirect channel.

6. The directors of the Appellant regarded, quite wrongly as they now admit, the Appellant and the Mainland Factory as one and the same company. As a result of that all the income and expenses of the Mainland Factory were included in the Appellant's audited accounts as part of the Appellant's own income and expenses. So, for example, wages paid

to workers at the Mainland Factory were listed in the Appellant's audited accounts as the Appellant's wage outlay. Likewise machinery and plant installed in the Mainland Factory were treated as the Appellant's machinery and plant for which deduction of Prescribed Fixed Asset ('PFA') under section 16G and Depreciation Allowance ('DA') under section 37 and section 37A of the IRO were claimed. Similarly, Industrial Building Allowance ('IBA') under section 34 and Commercial Building Allowance ('CBA') under section 33A were claimed in respect of the Mainland Factory's building and structure.

7. Separately, the Mainland Factory has its own set of accounts prepared according to Chinese law for submission to the Chinese authority and it pays tax in accordance with the Chinese tax regulations.

8. The Appellant now accepts that the Mainland Factory was a separate legal entity and that the Appellant's audited accounts should have been segregated into two accounts, one for the Appellant and another for the Mainland Factory. The Appellant further accepts that it was not entitled to any deduction of PFA or to any claim for DA, IBA and CBA in respect of the Mainland Factory's assets (including machinery and plant, furniture and fixture and building and structure). The Appellant argues, however, that because it provided the money for the purchase of the Mainland Factory's assets, it should be allowed to deduct depreciation of these assets as 'subcontracting fees' to the Mainland Factory.

9. In reply to the Assessor's letter of 13 August 2008, the Appellant by its tax representative by letter of 13 February 2009 stated its argument as follows:

> ' The subsidiary in Mainland China was established solely to assist the Company to carry out all manufacturing processes for the Company so that the costs of the Company could be reduced leading to higher profit margins to the Company. The Company should have given the subsidiary profit margin on the manufacturing processes provided for the Company. The present arrangement is that the Company compensated the subsidiary all expenses incurred by it, including both revenue and capital expenses, for the manufacturing processes carried out for the Company. The compensation should at least be regarded as minimum subcontracting fees to or earning of the subsidiary.
>
> … …
>
> …. As instructed by our client, we would like to propose the China factory expenses, both capital and revenue in nature, be regarded as compensation or subcontracting fee made by the Company to its subsidiary and be allowed as deduction in arriving at the assessable profits of the Company. Depreciation of plant and machinery, following the present depreciation policy, is included as part of the compensation or subcontracting fee.'

10. The Assessor replied by letter of 30 September 2009 rejecting the Appellant's claim for deduction of such hypothetical compensation or subcontracting fee.

11. The Appellant by its tax representative by letter of 28 January 2010 maintained its claim. It argued that had the Appellant not made the mistake in its accounts and had treated the Mainland Factory as a separate entity, all of the Mainland Factory's costs including depreciation would have been integrated as subcontracting charges to the Appellant. Hence 'the equitable way is to determine the value of subcontracting fees ought to be paid to the Subsidiary and regard it as allowable deduction in arriving at the assessable profits of the Company.' To further this argument the Appellant stated that all the plant and machinery mistakenly included in the books of the Appellant were actually fixed assets of the Mainland Factory. The title of the plant and machinery should go to the Mainland Factory. As such 'depreciation of the plant and machinery would form part of the subcontracting charges so as to reflect the opportunity costs for using the plant and machinery for carrying out the manufacturing processes for the Company. It is impractical to imagine any acceptable subcontracting charges without considering any wear and tear result from service of the plant and machinery. Consequently, depreciation of the plant and machinery should form part of the production cost incurred by the Subsidiary and as a result, the subcontracting charges charged to the Company incurred in the production of assessable profits of the Company.'

12. The Assessor replied by letter of 30 September 2010 again rejecting the Appellant's argument of a hypothetical subcontracting charge.

The audited accounts and the assessments

13. In the Appellant's audited accounts and tax computation, the 'profits/loss before taxation' was arrived at by deducting from the Appellant's annual turnover various expenses and outgoings which included depreciation of the Mainland Factory's assets. When it came to calculating the 'assessable profits/loss', this depreciation loss or charge (see the item **bolded** in Table 1 below) was added back to the profits/loss before taxation and in lieu thereof, DA, CBA, IBA and PFA were deducted.

Table 1

	2002/03	2003/04	2004/05	2005/06	2006/07
	$	$	$	$	$
Profit/loss before taxation:	161,424	840,718	2,000,711	1,355,116	1,857,590
Adjustments:					
Add:					
Depreciation	**1,020,163**	**1,327,059**	**1,196,668**	**1,316,404**	**1,529,692**
[& Other items]	… …	… …	… …	… …	… …
Less:					
CBA (re building					

	2002/03	2003/04	2004/05	2005/06	2006/07
	$	$	$	$	$
located in Mainland China)	15,089	15,089	15,089	19,187	39,951
IBA	338,819	321,789	337,271	337,271	337,271
DA	102,869	66,783	105,169	398,236	1,590,137
PFA	21,608	13,843	33,750	211,624	-
[& Other items]	… …	… …	… …	… …	… …
Equal					
Assessable profits /Adjusted loss:	736,775	1,943,164	-1,298,397	1,806,630	1,489,382

14. The reason depreciation was added back was that depreciation is capital in nature. Section 17(1)(c) makes it clear that for the purpose of ascertaining a taxpayer's chargeable profits no deduction shall be allowed in respect of any expenditure of a capital nature or any loss or withdrawal of capital. So depreciation cannot be deducted simpliciter as outgoings or expenses under section 16(1). To claim depreciation of machinery and plant, such machinery and plant must either be a PFA or qualify for DA under section 37, and to claim depreciation of building and structure, they must qualify for IBA or CBA.

15. On rejecting the Appellant's claim for depreciation and its argument of a hypothetical subcontracting fee, the Assessor added back the various allowances to the profits/loss of the Appellant. On 30 June 2011 the Assessor issued Statements of Loss for the years of assessment 2002/03 to 2005/06 and Profits Tax Assessment for the year of assessment 2006/07 as per Table 2 attached hereto.

Table 2

	2002/03	2003/04	2004/05	2005/06	2006/07
	$	$	$	$	$
Profits/loss per return:	736,775	1,943,165	-1,298,397	1,806,630	1,489,382
Add back:					
CBA (re building located in Mainland China)	15,089	15,089	15,089	19,187	39,951
IBA	338,819	321,789	337,271	337,271	337,271
DA	102,869	66,783	105,169	398,236	1,590,137
PFA	21,608	13,843	33,750	211,624	-
Assessable profits /Adjusted loss:	1,215,160	2,360,669	-807,118	2,772,948	3,456,741
Less:					
Loss set-off:	1,215,160	2,360,669		2,772,948	727,607
Equal					
Net assessable profits:	0	0	0	0	2,729,134

Statement of Loss for the years of assessment 2002/03 to 2005/06

	2002/03	2003/04	2004/05	2005/06
	$	$	$	$
Loss brought forward:	-6,269,266	-5,054,106	-2,693,437	-3,500,555
Loss set-off:	1,215,160	2,360,669	-807,118	2,772,948
Loss carried forward:	-5,054,106	-2,693,437	-3,500,555	-727,607

Profits Tax Assessment for the year of assessment 2006/07

	2005/06
	$
Net assessable profits:	2,729,134
Tax payable thereon:	477,598

16. The Appellant through its tax representative by letter of 20 July 2011 objected to that assessment on the same argument and supplied further documents including a summary of additions to fixed assets for the relevant years of assessment.

17. The Assessor likewise rejected the Appellant's argument, but upon the further documents supplied by the Appellant, the Assessor accepted that certain additions were additions to assets in Hong Kong in respect of which PFA and DA could be claimed. The Assessor revised the Statements of Loss for the years of assessment 2002/03 to 2005/06 and Profits Tax Assessment for the year of assessment 2006/07 as per Table 3 attached hereto.

Table 3

	2002/03	2003/04	2004/05	2005/06	2006/07
	$	$	$	$	$
Assessable profits / Adjusted loss as per Table 2:	1,215,160	2,360,669	-807,118	2,772,948	3,456,741
Add back:					
CBA over-claimed	-	-	-	4,097	4,097
	1,215,160	2,360,669	-807,118	2,777,045	3,460,838
Less:					
PFA	12,349	13,843	25,417	6,719	-
DA for HK assets:	1,346	2,986	60,996	52,069	56,032
Assessable profits /Adjusted loss:	1,201,465	2,343,840	-893,531	2,718,257	3,404,806
Less:					
Loss set-off:	1,201,465	2,343,840		2,718,257	899,235
Equal					
Net assessable profits:	0	0	0	0	2,505,571

Statement of Loss for the years of assessment 2002/03 to 2005/06

	2002/03	2003/04	2004/05	2005/06
	$	$	$	$
Loss brought forward:	-6,269,266	-5,054,106	-2,693,437	-3,500,555
Loss set-off:	1,201,465	2,343,840	-893,531	2,718,257
Loss carried forward:	-5,067,802	-2,723,961	-3,617,492	-899,235

Profits Tax Assessment for the year of assessment 2006/07

	2005/06
	$
Net assessable profits:	2,505,571
Tax payable thereon:	438,474

18. By determination dated 5 April 2012 ('the Determination'), the Deputy Commissioner of Inland Revenue confirmed the revised Profits Tax Assessment.

19. By its Notice of Appeal, the Appellant appeals against the Determination on the ground that 'depreciation on the assets acquired by [the Mainland Factory] should be regarded as part of the processing costs incurred by [the Appellant] and should be allowed as deductions in arriving at the assessable profits of [the Appellant].' There followed a statement of the grounds of appeal which stated the same arguments as per its letters.

20. At the hearing before this Board, Mr Cheng formulated his arguments as follows:

(1) It is common practice that a company without a factory will appoint another entity to carry out manufacturing processes for the company. By doing so, the company pays a fee to that other entity to cover the expenses incurred by that other entity plus a margin as a reward for its services. The fee is usually called subcontracting fee.

(2) Thus the question is what should be the reasonable compensation (labeled as subcontracting fee) that the Mainland Factory should impose on the Appellant for the services it provided for the Appellant.

(3) The Mainland Factory should charge the Appellant at least enough to cover all the expenses it incurred plus a reward to compensate the loss of interest on capital injected by the shareholders of the Mainland Factory for the setting up of the factory and the efforts by the management of the Mainland Factory. The Appellant should be willing to compensate the Mainland Factory at a price that was sufficient for the Mainland Factory to continue the production services for the Appellant. If the compensation was only sufficient to cover the daily operating expenses, the Mainland Factory could hardly survive to continue its services for the

Appellant especially when the plant and machinery required replacement.

(4) The compensation should be the actual daily running costs plus the amortization costs incurred by the Mainland Factory. The mere acceptance of the daily running costs would be unrealistic and commercially impractical. Should it be the case, it would be the Mainland Factory to subsidize the Appellant by providing their assets free of charge when they provided production services for the Appellant. Thus depreciation on plant and machinery installed and used by the Mainland Factory should be accepted as costs for the production of services for the Appellant and there the compensation on that part of expenses or costs should be allowed as deductions in arriving at the assessable profits of the Appellant.

21. In effect Mr Cheng asked that the audited accounts and tax computation be re-written so that 'depreciation' should be written as 'subcontracting fee' and the process of adding back 'depreciation' be reversed so that the sum could be deducted as 'subcontracting fee' paid out by the Appellant.

This Board's decision

22. We are unable to accept the Appellant's argument. First of all, now that the Appellant accepts and states that the assets in question were owned by the Mainland Factory, depreciation in value of such assets was clearly a loss suffered by the Mainland Factory and not by the Appellant. Mr Cheng submitted that 'outgoings' mean expenses required by a company to support its operation and so can include amortization or depreciation. Be that as it may, amortization or depreciation of assets that belonged to the Mainland Factory was suffered by the Mainland Factory. They were the Mainland Factory's outgoings, not the Appellant's.

23. Secondly, both Mr Cheng representing the Appellant and Mr Yip representing the Revenue agree that depreciation represents a loss in value of a capital asset over the life of that asset and is capital in nature. It is not a deductible loss. That was precisely why the auditors added back 'depreciation' to the Appellant's profits/loss before taxation in calculating the assessable profits/loss (see paragraph 14 and Table 1 above).

24. We can find no legal basis for the argument that notwithstanding that the depreciation was a loss suffered by a third party, namely the Mainland factory, and capital in nature, it should nonetheless be treated as revenue expenses of the Appellant because the Appellant would have or should have compensated the Mainland Factory for such a loss in the form of a subcontracting fee. There is simply no legal basis to support such an argument.

25. Moreover, depreciation is not a payment of expenses but a loss. To argue that depreciation should be treated as a payment of subcontracting fee is illogical. It might be

that had it done the account differently, the Appellant would have arranged for a suitably adequate 'subcontracting fee' or 'compensation' to be paid to the Mainland Factory that would cover such depreciation loss. But the fact remains that the Appellant never paid the Mainland Factory 'subcontracting fee' of $1,020,163 in 2002/03 or $1,327,059 in 2003/04 and so on.

26. Furthermore, we were told by Mr Cheng that between 20% to 30% of the Mainland Factory's products were sold domestically. It follows that the assets in question were not used solely to manufacture the Appellant's products for sale to the Appellant. There is no reason why we should accept the argument that the Appellant should be allowed to deduct the whole of the depreciation loss as 'compensation' or 'subcontracting fee' to the Mainland Factory.

27. We understand the Appellant's frustration because it was the Appellant who paid for the assets in question and it will be the Appellant who will have to pay for their replacement. So it is the Appellant who has suffered the depreciation loss, and yet it cannot deduct such a loss. But if the Appellant chose to conduct its business by setting up a factory outside Hong Kong, it must also accept all the legal and fiscal ramifications that such a set up brings and should have arranged its affairs properly beforehand and not seek to turn the clock back afterwards.

28. In summary, we reject the Appellant's grounds of appeal. We accept the Assessor's revised Statements of Loss for the years of assessment 2002/03 to 2005/06 as correct and we confirm his revised Profits Tax Assessment for the year of assessment 2006/07.