Case No. D61/08

Profits tax – special deduction and depreciation allowance – prescribed fixed assets – industrial building allowance – sections 2, 16(1), 16G, 18F, 37, 39B, 39E, 40(1), 66(3) and 68(4) of the Inland Revenue Ordinance ('IRO') – DPIN No 15.

Panel: Chow Wai Shun (chairman), Alan Ng Man Sang and Wendy W Y Yung.

Date of hearing: 18 December 2008.
Date of decision: 30 March 2009.

The Appellant, a company incorporated in Hong Kong, set up a subsidiary known as Company D in the PRC. The Appellant prepared a list of the equipment to be acquired by Company D to meet the requirement for ' the funds for equipment' in accordance with the terms of Company D' s Memorandum. The Appellant filed its profits tax returns and claimed, inter alia, that the Appellant should be allowed to claim industrial building allowance for the expenditure the Appellant incurred in the Building located in the PRC. The Appellant contended that although it is not an owner or lessee of the Building, it did have an interest in the Building through Company D being the owner of the Building. The Appellant also provided the Revenue a revised list of fixed assets claimed to have been repurchased by the Appellant from Company D. The Assessor did not accept that the Appellant was entitled to claim deduction on prescribed fixed assets, depreciation allowance and industrial building allowance in respect of the assets used by Company D outside Hong Kong. During the hearing the Appellant amended the claim for industrial building allowance to commercial building allowance.

Held:

1. The Building is a factory in the PRC. This is clearly an industrial building. The claim for commercial building allowance must fail either because the facts in no way point to that direction or because the Appellant fails to satisfy, to any extent, the burden of proof.

2. On the evidence made available before the Board, it is not satisfied that the Appellant incurred such capital expenditure by way of repurchase in the year of assessment 2001/02. Even if the Board held that expenditure had been incurred by the Appellant by way of repurchase of certain assets from Company D, special deduction or depreciation allowance (whether initial or annual), as the case may be,

would only be allowed to the extent that such expenditure had been incurred in the production of the Appellant's profits chargeable to tax under Part IV. The Board is not persuaded of the requisite connection between the expenditure incurred, if any, in respect of the assets in question and the production of the Appellant's assessable profits.

3. 'Lease' as defined under the IRO is broad enough to cover the present facts. The arrangement that Company D was allowed to use those fixed assets owned by the Appellant excludes such assets from being 'prescribed fixed assets'. If the alleged repurchase had been established, depreciation allowance would have been denied since Company D, as lessee, owned and used the assets prior to being acquired back by the Appellant. Alternatively, there is no dispute that the assets were used by Company D in its factory premises in the PRC, outside Hong Kong. Depreciation allowance must, therefore, be denied.

4. In the Board's view, the paragraph cited from DIPN No 15 only indicates that section 39E of the IRO is intended to be a preventive, rather than a remedial, provision. It is there to guard against certain mischiefs. From the provision itself, it does not require an intention to avoid tax for its application. The reference to the concession under paragraph 19 of DIPN No 15 further shows that but for the concession the provision might catch innocent situations.

Appeal dismissed.

Cases referred to:

D43/06, (2006-07) IRBRD, vol 21, 801
D125/99, IRBRD, vol 15, 4
D39/99, IRBRD, vol 14, 431
D35/96, IRBRD, vol 11, 504
D39/07, (2008-09) IRBRD, vol 23, 1
CIR v Secan and another (2000) 3 HKCFAR 411
CIR v Lo & Lo [1984] HKC 220
Strong v Woodifield [1906] AC 448
CIR v Chu Fung Chee [2006] 2 HKLRD 718
Pepper v Hart [1993] AC 593

Tse Yue Keung of Aoba Business Consulting Limited for the taxpayer.
Yvonne Cheng Counsel instructed by the Department of Justice for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the determination of the Acting Deputy Commissioner of Inland Revenue dated 14 August 2008 ('the Determination') whereby:

(1) Profits tax assessment for the year of assessment 2001/02 under charge number X-XXXXXXX-XX-X dated 20 January 2004, showing assessable profits of $33,123,039 with tax payable thereon of $5,299,686 was confirmed.

(2) Profits tax assessment for the year of assessment 2002/03 under charge number X-XXXXXXX-XX-X dated 26 January 2004, showing assessable profits of $13,564,404 with tax payable thereon of $2,170,304 was confirmed.

2. The following facts were agreed upon by the parties and we find them relevant facts to this appeal:

(1) The Appellant was incorporated as a private company in Hong Kong on 30 April 1974 (then known as Company A). At all relevant times, the Appellant's immediate and ultimate holding companies were Company B and Company C respectively. Both Company B and Company C were incorporated in Country J. In its profits tax returns, the Appellant described its principal activity as 'investment holding, trading and provision of services'.

(2) In 1995, the Company set up a subsidiary known as Company D in City K, Province L, People's Republic of China ('PRC'). The Memorandum (**章程**) of Company D provided, among other things, the following:

(a) Company D was established under the Law of the PRC Concerning Enterprises with Sole Foreign Investment (**中華人民共和國外資企業法**).

(b) Company D was an entity with limited economic liability (**有限經濟責任單位**) and had the status of a legal person (**法人**) under the PRC law.

(c) The total investment in Company D was to be HK$ 197,000,000 (including registered capital of HK$80,000,000) as shown below. The capital was to be contributed by the Appellant and the remaining investment amount was to be financed by bank loan.

	HK$
Funds for equipment	138,000,000
Liquid funds	30,000,000
Fee for land usage	4,000,000
Construction fee for factory and living area	25,000,000
	197,000,000

(d) The scope of operations of Company D was the manufacture and sale of metal and rubber products, such as rubber rollers used in printers, copiers and facsimile machines.

(e) Company D's equipment for production, raw materials, office supplies were to be imported from foreign countries unless permitted to be purchased in the PRC.

(f) 100% of Company D's products were to be exported.

(g) Company D's staff were to be recommended by the local authorities of Labour or recruited by itself.

(h) Company D should pay tax in respect of its economic activities in accordance with the relevant Chinese tax regulations and might enjoy preferential treatment upon application.

(i) Company D should adopt the internationally accepted accrual basis and debit and credit accounting system (that is, **權責發生制和借貸記帳法**) in preparing its annual accounts. Company D should carry out independent audit, it should be self-financing and should follow the accounting system set by the Ministry of Finance of the PRC (Clause 26: **外資企業實行獨立核算，自負盈虧，執行中華人民共和國財政部門規定的會計制度**).

Copies of Company D's Memorandum, Business Licence (**營業執照**) and Tax Registration (**稅務登記證**) were attached to the Determination as Annexes A, A1 and A2.

(3) The Appellant prepared a list of the equipment dated 11 December 1995 to be acquired by Company D to meet the requirement for ' the funds for equipment' amounting to HK$135,666,100 in accordance with the terms of Company

D's Memorandum. The list and the corresponding Customs approval were attached to the Determination as Annexes A3 and A4 respectively.

(4) In February 2001, the total investment in Company D was increased from HK$ 197,000,000 to HK$217,760,000, which was represented by an increase in equipment of HK$20,760,000.

Copies of Company D's second supplemental Memorandum dated 14 February 2001, a list of the further equipment to be acquired by Company D in accordance with the terms of the second supplementary Memorandum and the corresponding Customs approval were attached to the Determination as Annexes B, B1 and B2 respectively.

(5) Insofar as relevant, the Appellant filed its profits tax returns, together with financial statements and profits tax computations, for the years of assessment 2001/02 and 2002/03.

(a) In the returns, the Appellant reported the following assessable profits after deducting, among other things, expenditure on prescribed fixed assets, depreciation allowances and industrial building allowances in respect of assets reportedly purchased from Company D as shown below:

		2001/02	2002/03
		HK$	HK$
(i)	Assessable profits/(Loss)	(5,132,683)	13,472,646
After deducting:			
(ii)	Expenditure on prescribed fixed assets	37,297,363	-
(iii)	Depreciation allowance in relation to the assets purchased from a subsidiary	936,848	88,173
(iv)	Industrial building allowance	21,511	3,585

(b) The notes to the financial statements for the year ended 31 December 2001 stated that the Appellant had purchased fixed assets in the amount of HK$38,764,709 from Company D.

(c) The Appellant's financial statements for the years ended 31 December 2001 and 2002 were audited by Company E ('the Auditor'). In the opinion of the Auditor, the financial statements gave a true and fair view of the state of the Appellant's affairs as at the respective balance sheet

date and of the result and cash flow for the respective relevant year then ended and the accounts had been properly prepared in accordance with the Companies Ordinance.

(6) In reply to the Assessor's enquiries about the additions to fixed assets, by letter dated 30 October 2003, Aoba Business Consulting Limited (formerly known as Hojin Business Consulting Ltd) ('the Representative') asserted the following:

(a) '[T]he deduction claim for the fixed assets under review should be viewed as a delay deduction claim on prescribed fixed assets expenditure incurred by the [Appellant] in its production of assessable profits.'

(b) The Appellant was a trading company. It purchased goods from its subsidiary Company D. Company D heavily relied on the Appellant as its sole customer as well as its support to the manufacturing operation. The Appellant purchased manufacturing machineries which were then sold to Company D and treated as receivable from Company D in the Appellant's books.

(c) 'Ideally, all the machineries sold by the [Appellant] to [Company D] should have been reflected as fixed assets in [Company D's] accounts. However, as [Company D's] requirement for machineries exceeded the amount anticipated, [Company D's] registered capital was not large enough to record all of the machineries sold by the [Appellant]. Accordingly, [Company D] could only record a lower value in its statutory accounts for the machineries sold from the [Appellant]. Therefore, there was a difference between the actual amount of expenditure incurred by the [Appellant] for [Company D] and the amount [Company D] could record in its statutory accounts. This difference was recorded as a loan receivable from [Company D] in the [Appellant's] books. However, a corresponding loan payable to the [Appellant] could not be recorded in [Company D's] statutory accounts due to the statutory accounts restriction on registered capital.'

(d) The Appellant had negotiated with the PRC government authorities to allow Company D to record the full amount of machinery sold by the Appellant to Company D. However, it was not successful.

(e) 'To truly reflect the total value on machineries incurred by the [Appellant], the [Appellant] decided to transfer the ownership of the

machineries, the machineries which the [Appellant] had actually incurred the expenditure on, back to itself. This is simply a matter of reconciling the accounting difference between the [Appellant's] books and [Company D's] statutory accounts, in addition to properly reflect the [Appellant's] expenditure in machineries incurred for [Company D] to manufacture products for the [Appellant]. Had the Appellant not sold the machineries to [Company D] at the very beginning, the fixed assets under review would have been deducted at the very beginning.'

(f) The fixed assets were housed in Company D in the PRC. They were used by Company D in its manufacturing operations to produce rubber rollers to the Appellant.

(g) The machineries were used specifically and directly in the manufacturing processes of the Appellant's products. Such expenditure should qualify for deduction as specified capital expenditure in accordance with section 16G(1) of the Inland Revenue Ordinance [' IRO'].

(7) In reply to the Assessor's enquiries, the Representative provided copies of the following documents to the Assessor:

(a) A summary of the machinery claimed to have been repurchased by the Appellant from Company D, which was attached to the Determination as Annex C (' the Original List').

(b) Company D's financial statements for the years ended 31 December 2000 to 2002, which were audited by the Auditor and were attached to the Determination as Annex D, Dl and D2 respectively.

(8) The Assessor did not accept that the Appellant was entitled to claim deduction on prescribed fixed assets, depreciation allowance and industrial building allowance in respect of the assets used by Company D outside Hong Kong. On 20 January 2004 and 26 January 2004, the Assessor raised on the Appellant the following profits tax assessments for the years of assessment 2001/02 and 2002/03 respectively:

		2001/02	2002/03
		$	$
Profits/(Loss) per return [paragraph 2(5)(a)(i)]		(5,132,683)	13,472,646
Add:	Deduction under section 16G	37,297,363	
	Depreciation allowance overclaimed	936,848	88,173
	Industrial building allowance	21,511	3,585

		overclaimed
Assessable profits	33,123,039	13,564,404
Tax payable thereon	5,299,686	2,170,304

(9) On behalf of the Appellant, the Representative objected to the above profits tax assessments in the following terms:

(a) ' The assessable profits are excessive.'

(b) ' The [Appellant] should be entitled to claim full deduction under section 16G(1) of the IRO for the expenditure incurred in the fixed assets of $37,297,363. This is because the fixed assets satisfied the definition of "Prescribed Fixed Assets" under Section 16G(6)(a) of the IRO since they were used specifically and directly for manufacturing process. There is no requirement that the fixed assets have to be used by the taxpayer directly in order to satisfy the definition under Section 16G(6)(a) of the IRO. Based on the relationship between the [Appellant] and [Company D], full deduction should be allowed.'

(c) ' Depreciation allowance for the additions of fixed assets of $ 1,377,718 to the 20% pool should be allowed as the [Appellant] incurred such expenditure in its production of chargeable profits. Based on the relationship between the [Appellant] and [Company D] ..., the issue of [Company D] being a separate legal entity is not relevant and applicable.'

(d) ' The [Appellant] should be allowed to claim industrial building allowance for the expenditure the [Appellant] incurred in the building located in the [PRC] (' the Building'). Although the [Appellant] is not an owner or lessee of the Building, the [Appellant] did have an interest in the Building through [Company D] being the owner of the Building. Based on the relationship between the [Appellant] and [Company D] ..., industrial building allowance should be allowed.'

(e) ' The net assessable profits [for the year of assessment 2002/03] are excessive as the losses brought forward of $5,132,683 from the year of assessment 2001/02 are not accounted for.'

(10) In reply to the Assessor's enquiries, by letter dated 11 April 2006, the Representative asserted, among other things, the following:

(a) '... if there is no provision prohibiting taxpayers from making a delayed claim of the deductions or allowances, your Department has no such authority (to deny the claim).'

(b) The Appellant's financial statements were correctly drawn in accordance with SSAP and in conformity with the IRO. Therefore, there was no ground for disallowing the Appellant's claim for deductions or allowances.

(c) 'The disallowance of deduction claim based on whether the fixed assets had "moved" was totally ridiculous.'

(d) 'The fact that the [Appellant] placed the plant and machinery at [Company D's] factory in [PRC] does not mean that the [Appellant] granted [Company D] the rights to use the prescribed fixed assets as a lessee under a lease.'

(e) 'In determining if there was a lease between the [Appellant] and [Company D], the determining factor was if [Company D] had obtained a right of peaceful enjoyment of the plant and equipment from the arrangement. Peaceful enjoyment would mean that [Company D] would, as its sole discretion rather than at the instruction of the [Appellant], have a right to use (or not to use) the plant and equipment in a way of its choosing.'

(f) 'According to the arrangements between the [Appellant] and [Company D], [Company D] had absolutely no right whatsoever in respect of how and when to use the plant and equipment. [Company D] must only use the plant and equipment solely and exclusively for producing the [Appellant's] work orders. In fact, the [Appellant] has always been the sole customer of [Company D]. ... Thus, the plant and equipment were not Excluded Fixed Assets.'

(g) 'We are not aware of any provision in the IRO stating that if the taxpayer was neither an owner nor a lessee of the building, the taxpayer had no relevant interest in the expenditure on industrial building. Therefore, your denial of industrial building allowance based on the argument that the [Appellant] was neither an owner nor lessee is not substantiated.'

(h) 'The [Appellant] had relevant interest in the structure as it was the one who incurred the expenditure and had control over the expenditure through [Company D] being the owner and occupant of the factory.

The [Appellant] does have access to the factory and has beneficial interest in the structure. The location of the structure is irrelevant.'

(11) In support of the Appellant's claim that there was no lease arrangement between Company D and the Appellant, the Representative forwarded a copy of an internal memorandum in Country J language dated 3 January 2000 (with English translation) from the Appellant to Company B, together with an English translation, which were attached to the Determination as Annexes E and El thereto respectively. The English translation showed, among other things, that in 2001, the Appellant would book in its accounts the surplus plant and machinery, which it had purchased on behalf of and imported to Company D.

(12) By letter dated 18 July 2006, the Representative further asserted the following:

(a) Company D was not able to record the subject machinery in its books as Company D was not able to increase its capital contribution. Therefore, there would be no amounts recorded in the books of Company D for the original purchase price, date of purchase, sales price, gain/loss on disposal and market value on the date of disposal of the subject machinery.

(b) No correspondence had been exchanged with the PRC authorities for approving to record the full value of machinery in the books of Company D. If such documents were available, there was no need for the Appellant to 're–purchase' the machinery.

(c) The application for recording the full value of the machinery in the books of Company D was made verbally and was rejected verbally. There were no copies of the import duties and Value Added Tax invoices and tax receipts issued.

(d) Company D had no ownership of the machinery as Company D could not own it. There were no copies of any approvals issued by the PRC Customs regarding the transfer/resale of the machinery by Company D to the Appellant.

(e) No appraisal report was made by the PRC Customs of the depreciation value according to the time of use of the machinery.

(f) '[It] is important to understand that the [Appellant] had to own the subject machinery by default as [Company D] cannot own the assets. It is important to note that there should be no double claiming of the

machinery in both the [Appellant's] books and [Company D] books as both the companies' accounts had been audited.'

(13) At the Assessor's request, the Representative supplied, among other things, copies of the following documents:

(a) The Appellant's invoices to Company D and other documents in respect of the assets claimed to have been repurchased from Company D, which were attached to the Determination as Annex F.

(b) Import Customs Declarations in respect of the assets claimed to have been repurchased from Company D, which was attached to the Determination as Annex G.

(c) Capital verification reports of Company D, which were attached to the Determination as Annexes H, H1, H2 and H3.

(d) Company D's financial statements for the years ended 31 December 2000 to 2002, audited by Company F ('City K CPA'), which were attached to the Determination as Annexes I, I1 and I2 respectively.

(e) Supporting documents in respect of industrial building allowance, which were attached to the Determination under Annex J.

(14) On 5 March 2007, the Assessor sent a draft statement of facts setting out facts in paragraphs 2 (1) to 2 (13) above for the Representative's comment and raised a number of queries on the accounts and requests for further documents.

(15) By letter dated 26 February 2008, the Representative responded to the Assessor's request and forwarded a revised list of fixed assets claimed to have been repurchased by the Appellant from Company D, which was attached to the Determination as Annex K ('the Revised List').

(16) By letter dated 8 May 2008, the Representative also contended, amongst other things, the following:

(a) The previous representations on the issue of the deduction or otherwise of the depreciation allowance claimed by the Appellant should be removed from the draft statement of agreed facts because they had been taken out of context from past correspondence given in response to specific questions posed by the assessor, and therefore were not coherent enough for the Respondent's consideration.

(b) At all relevant times, the Appellant used the relevant assets in question to produce its chargeable profits. It had substantial involvement in the manufacturing activities of Company D, which included sending its staff to take part in Company D's manufacturing operations, providing technical know-how and support in Company D's manufacturing operations and providing Company D the plant and machinery necessary for its manufacturing.

(c) Without the Appellant's involvement in Company D's manufacturing operations, the required quality of production output would not meet the requirement of the Appellant's customers. There was a clear nexus between Company D's operations and the production of the Appellant' s assessable profits.

(d) The Appellant repurchased plant and machinery from Company D due to compliance with the PRC regulations. The business reality was that the Appellant must continue to allow Company D to use such assets so that the Appellant could meet its customer's orders; otherwise the Appellant would not be able to produce the amount of assessable profits.

(e) The Assessor had wrongly concluded, without evidence, that Company D held rights in the Appellant's relevant fixed assets as a lessee under a lease or that they were excluded fixed assets within section 16G(6) of the IRO.

(f) The Appellant had not lost any legal rights as a legal owner of the fixed assets nor its rights to the assets been downgraded to a lessor. The arrangement did not confer upon Company D any legal rights as a lessee under a lease. In law and in fact, the Appellant could take back the fixed assets at any time.

(g) Even assuming the Appellant was not entitled to deduction under section 16G it was still entitled to capital allowances under section 18F.

(h) The Appellant was entitled to capital allowance in respect of fixed assets under section 18F of the IRO, in which no condition was laid down as to (i) whether the relevant assets needed to be used by the taxpayer personally; (ii) whether the assets needed to be used in Hong Kong; or (iii) whether the asset must not be leased out. The section only

required that the assets were used in the production of assessable profits.

(i) Section 39E(1)(b) of the IRO had no application to the Appellant's case because Company D neither held any rights as a lessee under a lease in respect of the machinery or plant, nor while the lease was in force used the assets wholly or exclusively outside Hong Kong.

(j) More importantly, section 39E did not target and was not intended to apply to a non-tax avoidance arrangement. Nor was it intended to discourage normal cross-border commercial activities such as those the Appellant and Company D had been carrying on.

(k) Alternatively, the Appellant's profits should be assessed on a 50% basis on the grounds that the Appellant had taken substantial manufacturing activities in the PRC, relying on the Board of Review Decision D43/06, IRBRD, vol 21, 801.

Grounds of appeal

3. The grounds of appeal as set out in the notice and statement of grounds of appeal are by and large identical to the grounds of objection [Paragraph 2(9) above]. In summary, the Appellant claimed for:

(a) for the year of assessment 2001/02:

i. special deduction for certain fixed assets as prescribed fixed assets;
ii. depreciation allowance for other fixed assets;
iii. industrial building allowance for the expenditure incurred in the Building in which the manufacturing process was carried out;

(b) for the year of assessment 2002/03, (a) ii and iii above and a (consequential) loss being brought forward from the year of assessment 2001/02.

4. Mr Tse started off with a one-page written opening submission, in which we were asked to refer to the Appellant's grounds of appeal. Mr Tse further informed us that he would elaborate on the arguments after the witness had given evidence. We shall deal with the testimony of the witness below. After the close of the Appellant's case and at the first facet of the Respondent's submissions when Ms Cheng was highlighting the various applicable statutory provisions, Mr Tse interrupted and said that the Appellant abandoned the claim for industrial building allowance (paragraph 3(a)iii above) and a claim for commercial building allowance would be substituted instead.

5. Section 66(3) of the IRO provides:

> '*Save with the consent of the Board and on such terms as the Board may determine, an appellant may not at the hearing of his appeal rely on any grounds of appeal other than the grounds contained in his statement of grounds of appeal given…*'

6. We ordered an adjournment during which Mr Tse was required to formulate the amended ground in writing and confirm if the Respondent would raise any objection to the amendment. With no objection secured from the Respondent, we gave our consent to the proposed amendment to the ground of appeal even though from the Appellant's perspective we could see no difference from dropping the claim for industrial building allowance entirely. We shall deal with this issue in our decision below.

The witness and his oral evidence

7. Originally, the Appellant intended to call two witnesses but Mr G, an accountant from the City K CPA who audited Company D's PRC accounts, could not attend the hearing. A letter from him dated 2 December 2008, together with an English translation, was enclosed in the Appellant's hearing bundle. We agree with Ms Cheng and attach no weight to the letter because Mr G has not attended the hearing to swear to give evidence before us and has not been subject to any cross examination: D125/99, IRBRD, vol 15, 4, paragraph 10; D39/99, IRBRD, vol 14, 431, paragraph 29 and D35/96, IRBRD, vol 11, 504 at page 516.

8. Only one witness, Mr H, gave oral evidence at the hearing. Mr H is a director of the Auditor and is the auditor of the Hong Kong accounts for both the Appellant and Company D.

9. Mr H explained why two different sets of accounts were prepared, how they were different, how he spotted the differences between the two sets of accounts and how he made the management of the Appellant aware of the matter. He also confirmed that he was not involved in preparing any tax return for the Appellant.

10. During cross-examination, Mr H confirmed that those accounts were prepared in accordance with instructions from the Appellant and that he himself was not personally involved in the management of either the Appellant or Company D.

11. Mr H was also asked to peruse a few documents, most notably including:

(a) letters from the Representative to the Respondent dated 18 July 2006 (paragraph 2(12)) and 26 February 2008 (paragraph 2(15)) respectively;

(b) the internal memorandum dated 3 January 2000 from the Appellant to Company B and its English translation (paragraph 2(11)); and

(c) the Revised List of fixed assets (paragraph 2(15)).

12. With regard to the letters, Mr H told us that he was not the signatories thereof and he had not seen those letters before. In relation to the other two documents, he could not recall if he had ever seen either of them.

13. Mr H was asked by Ms Cheng to confirm whether the purported repurchase was actual transaction or just involved mere accounting entries. Mr H replied that the record was made with reference to the sales invoices issued by Company D and discussion with the Appellant over the relevant period. When further asked if he had personally seen those invoices, Mr H replied that he had not but trusted that his staff would have done so.

14. It is clear to us that Mr H does not have any direct and personal knowledge of the relevant factual matters leading to the present appeal. In this regard, we find no assistance from Mr H's testimony.

15. In fact, we were almost certain that any testimony from the either of the witness would unlikely advance the Appellant's case to any meaningful extent when we declined the request from the Department of Justice for a direction that written witness statements be filed by the Appellant about a week before the hearing. In relation to the request for such a direction, Ms I of the Department of Justice referred us to the comments of the Chairman of this Board in D39/07, IRBRD, vol 23, 1 at page 20:

> '*39. The evidence in chief of the witnesses called by the appellant was commendably brief. The evidence in chief did not go beyond the adoption of their respective witness statements as evidence.*
>
> *40. This is how witness statements should be prepared. The witness statements should contain the whole of the witnesses' evidence in the detail in which the witnesses would have given if his/her evidence had been elicited by oral questions at the trial, see Ng Kam Chun (t/a Chun Mou Estate Agency Co) v Chan Wai Hing and others [1994] 2 HKLR 89. Unfortunately, this tends to be the exception rather than the rule for appeals to the Board. This case was a pleasant exception.'*

16. We are most ready to commend such a practice – the practice of having witness statements appropriately prepared and timely exchanged, particularly in complicated cases where a significant number of witnesses may be called upon and more often than not a professional representative is instructed to appear for and on behalf of the taxpayer, with a view to facilitating the

preparation for and the conduct of the hearing. We do not find, however, the comments cited to us would mean to serve as an authority for us to impose on either side of the proceedings to do so. With hindsight, the present appeal might not be a case warranting the necessity of written witness statements served in advance of the hearing.

Our decision

17. With reference to the grounds of appeal as amended and the written submission of the Appellant, the Appellant claimed that it should be entitled to:

(a) for the year of assessment 2001/02:

i. capital deduction for 'prescribed fixed assets' of the value of $37,292,363 under section 16G of the IRO;
ii. depreciation allowance in respect of other fixed assets of the value of $1,377,718 under section 39B of the IRO;
iii. commercial building allowance for expenditure incurred in the Building, purportedly under section 33A of the IRO although it was not made clear by the Appellant; and

(b) for the year of assessment 2002/03:

i. depreciation allowance for the written down value of those other fixed assets under (a)ii above, under section 39B of the IRO;
ii. commercial building allowance in respect of the same building under (a)iii above, again purportedly under section 33A of the IRO; and
iii. loss being brought forward from the year of assessment 2001/02, which is consequential to the claims in (a) above.

18. Section 68(4) of the IRO provides that the onus of proof is on the Appellant.

19. The claim for commercial building allowance can be swiftly disposed of and the other two claims have certain common factual issues which can be, to a certain extent, conveniently dealt with together.

Commercial Building Allowance

20. Section 18F of the IRO provides:

'*(1) The amount of assessable profits for any year of assessment of a person chargeable to tax under this Part [IV] shall be increased by the amount of any balancing charge directed to be made on that person under Part*

VI and decreased by the allowances made to that person under Part VI for that year of assessment to the extent to which the relevant assets are used in the production of assessable profits….'

21. Part VI of the IRO provides, inter alia, two types of depreciation allowance for buildings and structures – industrial building allowance and commercial building allowance. Section 33A provides:

'*(1) Where any person is, at the end of the basis period for any year of assessment, entitled to an interest in a building or structure which is a commercial building or structure and where that interest is the relevant interest in relation to the capital expenditure incurred on the construction of that building or structure, an allowance for depreciation by wear and tear, to be known as an "an annual allowance", of an amount equal to… one-twenty-fifth of that expenditure, shall be made to him for that year of assessment….'*

22. Section 40(1) of the IRO provides:

' *"commercial building or structure" means any building or structure or part of any building or structure used by the person entitled to the relevant interest for the purposes of his trade, profession or business other than an industrial building or structure;*

…

"industrial building or structure" means any building or structure or part of any building or structure used

(a) for the purposes of a trade carried on in a mill, factory or other similar premises;

…

"relevant interest" means, in relation to any expenditure incurred on the construction of a building or structure the interest in that building or structure to which the person who incurred the expenditure was entitled when he incurred it.'

23. In short, a taxpayer may claim an annual commercial building allowance if:

(a) the building qualifies as a commercial building or structure;

(b) at the end of the basis period for the year of assessment in question, the taxpayer is entitled to a relevant interest in the building;

(c) that interest is the same as the interest of the person incurring the expenditure on the construction of the building; and

(d) the building is for the purposes of producing assessable profits of the taxpayer.

24. Mr Tse put forward no written submission on this issue, nor did he provide any further evidence advancing the Appellant's case. He asserted that the Appellant had an equitable interest in the Building when asked but he did not forward any evidence to substantiate this claim.

25. The Building is a factory in the PRC (paragraph 2(2)(c)). This is clearly an industrial building. It remains a mystery to us how a claim for commercial building allowance could have been made on the facts of this case. Leaving aside whether the Appellant would have been entitled to industrial building allowance, the amendment to the grounds of appeal was suicidal.

26. We do not see the need to go any further with regard to this claim. This claim must fail either because the facts in no way point to that direction or because the Appellant fails to satisfy, to any extent, the burden of proof.

Special deduction and depreciation allowance

Statutory provisions for special deduction

27. Section 16(1) of the IRO provides:

'*In ascertaining the profits in respect of which a person is chargeable to tax under this Part [IV] 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 this Part for any period, including –*

…

(ga) the payments and expenditure specified in sections… 16G, as provided therein…'

28. 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 this Part 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 this Part 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 this Part.

…

(6) In this section –

"excluded fixed asset" means a fixed asset in which any person holds rights as a lessee under a lease;

"prescribed fixed asset" … does not include an excluded fixed asset; "specified capital expenditure", in relation to a person, means any capital expenditure incurred by the person on the provision of a prescribed fixed asset …'

29. Section 2 of the IRO provides

'*"basis period" for any year of assessment is the period on the income or the profits of which tax for that year ultimately falls to be computed'*

…

"lease", 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…'

30. In sum, section 16G allows an exception to the general rule against deduction of capital expenditure (section 17(1)(c) of the IRO). Deduction of such capital expenditure is specifically allowed:

(a) if such expenditure

i. is incurred during the basis period for the year of assessment in question; and

ii. falls within the definition of ' specified capital expenditure' which requires that the assets for which the expenditure is incurred are ' prescribed fixed assets' , not ' excluded fixed assets' ; and

(b) to the extent that is incurred in the production of profits chargeable to tax under Part IV.

Statutory provisions for depreciation allowances

31. Section 18F of the IRO (paragraph 20 above) serves as the starting point. In addition to depreciation allowance for buildings and structures, Part VI of the IRO also provides such allowance for machinery and plant. Relevant to the present appeal, section 39B (instead of section 37 referred to by the Appellant in some of its earlier correspondence) of the IRO provides

'*(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 IV then, except where such expenditure is … of a kind described in … s 16G, there shall be made to him, for the year of assessment in the basis period of which the expenditure is incurred, an allowance, to be known as an "initial allowance".*

(1A) For the purposes of subsection (1), the initial allowance shall be equal to the following percentages of the expenditure… -

(c) for any year of assessment commencing on or after 1 April 1989, 60%.

(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 purpose of producing profits chargeable to tax under Part IV, 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. …'

The applicable annual depreciation rate for any particular machinery or plant is prescribed by rule 2 of the Inland Revenue Rules pursuant to section 39B(3) of the IRO and can be 10%, 20% or 30%.

32. Section 39E of the IRO provides:

> '*(1) Notwithstanding anything to the contrary in this Part [VI], a person (… "the taxpayer") who incurs capital expenditure on the provision of machinery or plant… for the purpose of producing profits chargeable to tax under Part IV shall not have made to him the initial or annual allowances 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, and –*
>
> *(a) the machinery or plant was, prior to its acquisition by the taxpayer, owned and used by that person (whether alone or with others), or any associate of that person (which person or any such association is hereunder referred to as "the end-user"); or*
>
> *(b) the machinery or plant, not being a ship or aircraft or any part thereof, is while the lease is in force –*
>
> *(i) used wholly or principally outside Hong Kong by a person other than the taxpayer;…*
>
> *(2) Subsection (1)(a) shall not apply where –*
>
> *(a) the machinery or plant was acquired by the taxpayer on payment from the end-user at not more than the price which the end-user paid to the supplier (not being a supplier who is himself an end-user); and*
>
> *(b) no initial or annual allowances have at any time prior to the acquisition of the machinery or plant by the taxpayer been made under section…39B to the end-user in respect of such machinery or plant.*
>
> …
>
> *(5)* …
>
> *"end-user" means any person (whether alone or with others) holding rights as lessee under a lease of machinery or plant or any associate of such person;…'*

The term 'lease' is defined in section 2 of the IRO (paragraph 29 above).

33. In sum, a taxpayer may claim depreciation allowance for machinery or plant if:

(a) he incurs capital expenditure on the provision of such machinery or plant;

(b) the machinery or plant is for the purposes of producing profits chargeable to tax under Part IV;

(c) for initial allowance, the expenditure is incurred during the basis period for the year of assessment in question; whereas for subsequent annual allowances, the taxpayer owns or has owned and has in use or has had in use any machinery or plant in the relevant year of assessment;

(d) the facts are not such that at a time when the machinery or plant is owned by the taxpayer, there is a lessee of the machinery or plant, and the machinery or plant was, prior to the taxpayer's acquisition, owned and used by that lessee; and

(e) the facts are not such that at a time when the machinery or plant is owned by the taxpayer, there is a lessee of the machinery or plant, and the machinery or plant is, while the lease is in force, used wholly or principally outside Hong Kong by a person other than the taxpayer.

Expenditure incurred by way of the repurchase

34. The Appellant's case is that as advised by the Auditor and with the approval of Company B, it decided to eliminate the differences in Company D's two sets of accounts by the Appellant repurchasing from Company D in the year of assessment 2001/02 of such fixed assets that could not have been so booked in Company D's PRC accounts while the Appellant would continue allowing Company D to use such assets for manufacturing products for the Appellant. Some assets were claimed as 'prescribed fixed assets' while some were just other fixed assets. The Appellant argued that such repurchase was recorded in all Hong Kong accounts which were duly approved by the Board of Directors and audited.

35. Ms Cheng invited us to compare and contrast the Original List and the Revised List (referred to in paragraph 2(7) and 2(15) above respectively). We agree with Ms Cheng's observation on the following matters:

(a) the value of the assets on the Original List was RMB41,478,239.38 whereas that of the assets on the Revised List was RMB40,159,917.

(b) the Revised List comprised of more than 600 items, only 81 of those appeared on the Original List.

(c) the categorization of the assets had been revised, in that the value of assets falling under each of the heads of claim was different. For instance, annual depreciation allowance on the amount of HK$1,377,718 comprising only assets in the 20% pool was claimed under the Original List but allowances on over RMB1,800,000 comprising assets in all the 10%, 20% and 30% pools were claimed under the Revised List.

(d) The basis of claim on which the Revised List was prepared was different in the sense that it consisted of two limbs:

i. Difference between the amount booked in Company D's PRC account and the actual expenditure incurred; and
ii. Value of fixed assets not booked in Company D's PRC account.

36. Ms Cheng also asked us to consider subsequent and further changes in the Appellant's case. Specifically she drew our attention to

(a) the notice of appeal in which the Appellant appeared to have reverted to the figures as per the Original List and that no answer was received by the Respondent when the Appellant was asked how the items of assets on the Revised List could add up to the figures claimed in the notice of appeal; and

(b) the revised tax computation and depreciation schedules for the years of assessment in question enclosed in the Appellant's hearing bundle which appeared to have based on the Revised List but there was a new claim for commercial building allowance in substitute for industrial building allowance.

37. In his written submission, Mr Tse first seemed to have referred to figures matched with the Original List. However, in his oral reply, he explained how the Revised List and the revised schedule had come about. In respect of the Revised List, he said that it came about because of enquiries raised by the Assessor. With regard to the revised schedule, Mr Tse said that it was prepared when parties attempted to settle the agreed facts for this hearing. We find ourselves unfortunately being left in the dark of what assets the alleged repurchase comprised even after Mr Tse's closing submissions.

38. Ms Cheng also highlighted to us other aspects of inconsistency, contradiction, absurdity and confusion caused by the assertions, evidence and submissions of the Appellant. We do not find it necessary to list them out and go through each and every of them save and except to comment that the Appellant's case has been poorly managed, dreadfully pulled together and feebly

put forward.

39. In respect of assets on the Revised List which were not booked in Company D's PRC accounts, they were not reflected in the list of injected equipment or capital verification reports either. We agree with Ms Cheng that these were assets never owned by Company D and could not have been repurchased by the Appellant in 2001. On the other hand, we find no evidence suggesting that the Appellant had the ownership over those assets either and we would see no basis for any claim whatsoever over those assets by the Appellant.

40. So far as the assets on the Original List (which also appeared on the Revised List as assets booked at undervalue) are concerned, the Appellant agreed as per paragraphs 2(11) and 2(12) above that those could not be and were never owned by Company D. Consequentially, there could not have been any re-purchase by the Appellant from Company D in the year of assessment 2001/02. The Appellant was at all times the owner of these assets. Both sections 16G(1) and 39B(1) requires the expenditure to have been incurred in the relevant year of assessment. Logically, it must follow that the claims made under these two provisions must fail as any expenditure so incurred by the Appellant must have been incurred prior to 2001/02, that is, prior to the year of assessment in question: also see CIR v Secan and another (2000) 3 HKCFAR 411. What might have remained an issue would be whether the Appellant could succeed in claiming annual allowance under section 39B(2) which requires not just ownership but also use of the assets during the relevant year of assessment for the purpose of producing profits chargeable to tax under Part IV, which will be dealt with below.

41. Assuming that Company D had the ownership of the assets back in 1997, we find no cogent evidence of any sale to the Appellant in the year of assessment 2001/02. No documentary evidence, in the form of an invoice, a written resolution of either the Appellant or Company D, or even an inter-company transfer voucher, has even been produced to support even an accrued liability on the Appellant: c.f. CIR v Lo & Lo [1984] HKC 220. Mr H, when being cross-examined, admitted that although he believed that there should be invoices issued by Company D for the repurchase he had not seen them personally. Nor is there any evidence of payment by the Appellant to Company D in 2001/02. Mr H also said during cross-examination that payment might be done via inter-company accounts and there would be entries in ledgers. However, no such accounts or ledgers have ever been produced.

42. In sum, on the evidence made available before us, we are not satisfied that the Appellant incurred such capital expenditure by way of repurchase in the year of assessment 2001/02.

Expenditure incurred in the production of the Appellant's assessable profits

43. Even if we held that expenditure had been incurred by the Appellant by way of repurchase of certain assets from Company D, special deduction or depreciation allowance

(whether initial or annual), as the case may be, would only be allowed to the extent that such expenditure had been incurred in the production of the Appellant's profits chargeable to tax under Part IV. Mr Tse failed to make any submission on this issue; he focused on whether special deduction or depreciation allowance could be granted if assets were used outside Hong Kong.

44. With reference to paragraph 2(6) above, there is no dispute that the Appellant was a trader, not a manufacturer. It made profits by buying products from Company D and selling them. There is also no dispute that the fixed assets were used by Company D, not by the Appellant, in the process of the former making rubber rollers for sale to the Appellant. We are not persuaded of the requisite connection between the expenditure incurred, if any, in respect of the assets in question and the production of the Appellant's assessable profits: Strong v Woodifield [1906] AC 448 at 452-453, applied in CIR v Chu Fung Chee [2006] 2 HKLRD 718, (2006) 6 HKTC 743.

45. Up to this point, we find it sufficient to dismiss the appeal in its entirety. We proceed to deal with other issues raised by the parties below in case we might have been wrong in any part of our analysis above and for the sake of completeness.

Lease of assets and their use outside Hong Kong

46. If any machinery or plant in question is such that in which any person holds rights as a lessee under a lease, that machinery or plant will be disqualified from being a prescribed fixed asset. Depreciation allowance will further be denied if the machinery or plant:

(a) was owned and used by the lessee or its associate prior to its acquisition by the taxpayer, save and except where the taxpayer acquired the machinery or plant on payment from a lessee or its associate at not more than the price which the lessee paid to the supplier (not being a supplier who is himself also an associate of the lessee); or

(b) is used wholly or principally outside Hong Kong by a person other than the taxpayer.

47. For the purposes of the IRO, the term 'lease' is defined widely (see paragraph 29 above). In our view, the IRO provides a broader meaning to the term than either its ordinary meaning or its legal definition in land law. An arrangement, which is not necessarily in writing, suffices.

48. For assets not shown to be owned by the Appellant, this would not be an issue at all and the Appellant would have no basis for any claim. Even assuming that the Appellant was the owner of all those fixed assets, whatever they are and whether by way of the repurchase or otherwise, the Appellant allowed Company D to use them.

49. Mr Tse, in his written submission, argued against the existence of a lease. He referred us to the dictionary meaning of the term 'lease' and its definition under the Hong Kong Accounting Standard 17. He further said that since the Appellant did not carry on an asset leasing business, there was no basis to interpret the arrangement between the Appellant and Company D as being amounted to a lease. In our view, he has clearly misconceived of, or has been misguided in, this issue. 'Lease' as defined under the IRO is broad enough to cover the present facts. The arrangement that Company D was allowed to use those fixed assets owned by the Appellant excludes such assets from being 'prescribed fixed assets'.

50. If the alleged repurchase had been established, depreciation allowance would have been denied since Company D, as lessee, owned and used the assets prior to being acquired back by the Appellant. Mr Tse made no submission in this regard. In any event, we do not see how the exception in section 39E(2) can operate on the facts given to assist the Appellant.

51. Alternatively, there is no dispute that the assets were used by Company D in its factory premises in the PRC, outside Hong Kong. Depreciation allowance must, therefore, be denied.

52. In his submission, Mr Tse argued that section 39E of the IRO was a specific anti-avoidance provision and therefore it was not intended to cover the present appeal as there was no tax avoidance intended in the part of the Appellant. He cited long extracts from Hansard relating to the amendments to the provision in 1991, not the original introduction of the section in 1986, in support. He also referred us to paragraph 8 of the Departmental Interpretation and Practice Notes (DIPN) No 15 which reads:

> '*Section 39E was enacted to limit the opportunities for tax deferral or avoidance through sale and leaseback, offshore equipment leasing and leverage leasing arrangements.*'

53. Mr Tse also referred to paragraph 19 of DIPN No 15, which reads:

> '*Under a contract processing arrangement with a Mainland Chinese enterprise, a Hong Kong company is often required to provide machinery or plant for the use of the Mainland Chinese enterprise. Such arrangement is a lease as defined in section 2… and therefore section 39E needs to be considered. Even though the machinery or plant is not used wholly or principally in Hong Kong, the Department as a concession is prepared to allow 50 per cent of the depreciation allowances on the leased machinery or plant on condition that the profits from manufacturing activities of the Hong Kong company are assessed on a 50:50 basis.*'

In addition, he referred to an IRD' s circular to tax representatives and the minutes of the 2007 annual meeting between IRD and the Hong Kong Institute of Certified Public Accountants on the same matter. He submitted, inter alia, that section 39E of the IRO could not be applicable to non-tax avoidance situations.

54. In our view, the paragraph cited from DIPN No 15 only indicates that section 39E of the IRO is intended to be a preventive, rather than a remedial, provision. It is there to guard against certain mischiefs. From the provision itself, it does not require an intention to avoid tax for its application. The reference to the concession under paragraph 19 of DIPN No 15 further shows that but for the concession the provision might catch innocent situations.

55. In addition, clear judicial guidance has been given as to when Hansard can be referred to in the construction of a statutory provision and how it should be done: Pepper v Hart [1993] AC 593. It suffices for us to say that we are not satisfied that the circumstances warrant any necessary reference to Hansard, even if the Hansard being referred to related to the original introduction of the provision.

56. Mr Tse, relying on paragraph 19 of DIPN No 15, submitted that as a matter of concession, the Appellant should be entitled to the concession. This is clearly ill-based. The concession is confined to cases where the taxpayer has a contract processing arrangement with a mainland entity whereby the taxpayer engages in manufacturing process in the PRC. This is not the case here as it is not disputed that the Appellant was a trader, not a manufacturer, at all relevant times.

Conclusion

57. From the above analysis, this appeal must be dismissed and all assessments stated in paragraph 1 are hereby confirmed.