

HONG KONG TAX ALERT

ISSUE 5 | February 2013

Hong Kong manufacturers providing plant and equipment in the Mainland dealt a further blow

The Court of Appeal in *Bairrim (Far East) Limited v CIR* upheld the Commissioner of Inland Revenue's disallowance of a claim by the Company for 'prescribed fixed assets' used in a manufacturing process in the Mainland.

Background

The Company carried on the business of supplying plastic garment hangers to end-customers in the United Kingdom. The hangers were manufactured in the Mainland by third parties manufacturers using moulds which were owned by the Company. The Company authorised the factories in the Mainland to use the moulds for the purposes of manufacturing the hangers. The moulds were used only to manufacture hangers supplied to the Company and no monies were paid by the factories for using the moulds.

The Company's profits were treated as fully taxable to Hong Kong Profits Tax.

The Company claimed the cost of the moulds as a deductible expense pursuant to section 16G of the Inland Revenue Ordinance (IRO). Section 16G allows a deduction on the cost of 'prescribed fixed assets', which are defined to include assets used in a manufacturing process. However, assets subject to a lease are specifically excluded from the definition.

The issue

At issue before the Board of Review and the Court was whether the interpretation of the term 'lease' in section 16G(6) should reflect the statutory definition under section 2(1) of the IRO.

The moulds were used directly for a manufacturing process and prima facie qualified as prescribed fixed assets provided they were not excluded fixed assets. However, if the moulds were the subject of a lease, they would be excluded fixed assets, and no deduction could be claimed for the cost of their provision.

Section 2 of the IRO defines a 'lease' as follows:

*"In this Ordinance, unless the context otherwise requires –
...
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; and

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

To the extent relevant, section 16G(6) also provides:

*"(6) In this section –
excluded fixed asset means a fixed asset in which any person holds rights as a lessee under a lease;"*

The Company had not entered into a separate lease of the moulds to the manufacturing factories. The moulds were the subject of an arrangement under which a right to use the moulds was granted by the Company to the manufacturers. The Court found that that right to use came within the definition of a lease in section 2(1) of the IRO.

The decision

The Court noted that section 2(1) provides that the definitions apply unless the context otherwise requires. Accordingly, it was necessary for the Company to show that the context in which the term 'lease' is used in section 16G(6) required that the statutorily defined meaning of 'lease' did not apply.

The Court agreed with the Commissioner's representative that it was clearly the intention of the legislature that the extended definition of lease in section 2(1) was intended to apply to section 16G. Had this not been the intention, there would have been no need to move the definition out of section 39E (where it was confined to that section), particularly as the word 'lease' does not appear elsewhere in the amendments introduced by the Bill. The Court also agreed that it was the intention of the legislature to afford a deduction to capital expenditure on only those fixed assets falling within the statutory definition of 'prescribed fixed assets'.

Comment

The failure of the company both before the Board of Review and the Court of Appeal confirms that no deduction or depreciation allowances are allowable where plant and equipment is made available by a Hong Kong taxpayer to a factory outside Hong Kong to manufacture its products.

The Company has sought leave to appeal the decision to the Court of Final Appeal, but it remains to be seen whether leave will be granted. If leave is not granted, or the Company is unsuccessful before the Court of Final Appeal, the only remaining avenue for a tax deduction to be obtained in the above situation lies with an amendment of the relevant legislation. However, the Hong Kong Government, to date, has not demonstrated any willingness to an amendment of the law.



Khoon Ming Ho
Partner in Charge, Tax
China and Hong Kong SAR

Tel: +86 10 8508 7082
khoonming.ho@kpmg.com



Ayesha M. Lau
Partner in Charge, Tax
Hong Kong SAR

Tel: +852 2826 7165
ayesha.lau@kpmg.com



Chris Abbiss
Partner

Tel: +852 2826 7226
chris.abbiss@kpmg.com



Darren Bowdern
Partner

Tel: +852 2826 7166
darren.bowdern@kpmg.com



Barbara Forrest
Principal

Tel: +852 2978 8941
barbara.forrest@kpmg.com



Daniel Hui
Principal

Tel: +852 2685 7815
daniel.hui@kpmg.com



Charles Kinsley
Principal

Tel: +852 2826 8070
charles.kinsley@kpmg.com



John Kondos
Partner

Tel: +852 2685 7457
john.kondos@kpmg.com



Alice Leung
Principal

Tel: +852 2143 8711
alice.leung@kpmg.com



Curtis Ng
Partner

Tel: +852 2143 8709
curtis.ng@kpmg.com



Kari Pahlman
Principal

Tel: +852 2143 8777
kari.pahlman@kpmg.com



John Timpany
Partner

Tel: +852 2143 8790
john.timpany@kpmg.com



Wade Wagatsuma
Partner

Tel: +852 2685 7806
wade.wagatsuma@kpmg.com



Jennifer Wong
Partner

Tel: +852 2978 8288
jennifer.wong@kpmg.com



Chris Xing
Partner

Tel: +852 2978 8965
christopher.xing@kpmg.com



Karmen Yeung
Partner

Tel: +852 2143 8753
karmen.yeung@kpmg.com



Kate Lai
Director

Tel: +852 2978 8942
kate.lai@kpmg.com



Alex Lau
Director

Tel: +852 2143 8597
alex.lau@kpmg.com



Benjamin Pong
Director

Tel: +852 2143 8525
benjamin.pong@kpmg.com



Garry Laird
Senior Tax Advisor

Tel: +852 2143 8795
garry.laird@kpmg.com

kpmg.com/cn

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2013 KPMG, a Hong Kong partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. © 2013 KPMG Advisory (China) Limited, a wholly foreign owned enterprise in China and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International.