



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 7 (REVISED)

MACHINERY AND PLANT – DEPRECIATION ALLOWANCES

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in August 2002.

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Commissioner of Inland Revenue

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CONTENT

	Paragraph
Part I	Introduction
	Persons entitled to the allowances 3
	Expenditure which qualifies 4
	Meaning of “machinery or plant” 8
	Capital expenditure incurred prior to commencement of business 11
	Basis period 13
Part II	The “Pooling System” – 1980/81 onwards
	Background 15
	The allowances –
	Initial allowance 16
	Annual allowance 19
	Annual allowance rates 21
	Calculation of the allowances 22
	Assets brought into the business after non-business use 25
	Proceeds of machinery or plant disposed of 28
	Assets removed from pool for non-business use 30
	Succession to a trade, etc. 31
	Balancing allowances and balancing charges 32
	Assets put out of use upon cessation of trade, etc. 35
Part III	Situations where the pooling system does not apply
	Assets acquired under hire purchase agreements 37
	Total depreciation allowances not to exceed total capital expenditure 39
	Balancing allowance concession 41
	Machinery or plant used partly for the purposes of the trade, etc. 43

Part IV	Miscellaneous provisions	
	Commissioner’s discretion – rate of annual allowance	47
	Assets sold together	49
	Transactions between related parties	50
	Commissioner’s power to direct that the old scheme should apply	51
APPENDIX A(i)	Rates of depreciation, as prescribed by the Board of Inland Revenue	
APPENDIX A(ii)	“Implements, utensils and articles”, as prescribed by the Board of Inland Revenue	
APPENDIX B	Items which qualify as machinery or plant	
APPENDIX C	Items which do not qualify as machinery or plant	

PART I – INTRODUCTION

Sections 12(1)(b) and 12(5) of the Inland Revenue Ordinance (the Ordinance) provide for depreciation allowances and charges calculated in accordance with Part VI of the Ordinance to be taken into account in ascertaining the net assessable income of a person subject to Salaries Tax. Similarly, section 18F of the Ordinance provides for depreciation allowances and charges made under Part VI to be taken into account in ascertaining the assessable profits of a person subject to Profits Tax.

2. For years of assessment prior to 1980/81, the relevant provisions of Part VI are contained within sections 37, 37A, 38 and 39 (referred to in this Practice Note as “the old scheme”). A revised scheme, known as “the pooling system”, was introduced with effect from the 1980/81 year of assessment by the Inland Revenue (Amendment) (No. 4) Ordinance 1980. The calculation of depreciation allowances under the pooling system is basically provided by sections 39B, 39C and 39D. In certain circumstances, provisions of the old scheme, rather than of the pooling system, may apply in respect of a year of assessment subsequent to 1979/80.

Persons entitled to the allowances

3. Depreciation allowances in respect of machinery and plant are not restricted to persons carrying on particular kinds of trades, professions or businesses. Rather, the allowances under sections 37 and 39B are available to every person carrying on a trade, profession or business in respect of which the person is chargeable to Profits Tax under Part IV of the Ordinance. Similarly, by virtue of section 12(1)(b), all employees are entitled to depreciation allowances where the use of plant or machinery is essential to the production of assessable income.

Expenditure which qualifies

4. Depreciation allowances are made in respect of “capital expenditure” incurred on the provision of machinery or plant. The term “capital expenditure” is defined in section 40(1), for the purposes of Part VI of the Ordinance, to include interest and commitment fees incurred in respect of a loan made for the purpose of financing the provision of machinery or plant. On

the other hand, the definition excludes expenditure which is reimbursed by way of or is attributable to any grant, subsidy or similar financial assistance. It also excludes, in relation to the person incurring the expenditure, any expenditure which is allowed to be deducted in ascertaining for the purpose of Part IV of the Ordinance the profits of a trade, profession or business carried on by that person. It follows that depreciation allowances cannot be claimed in relation to expenditure which qualifies for deduction under, for example, section 16B (in respect of research and development), 16F (on building refurbishment), 16G (on the provision of a prescribed fixed asset) or 16I (in relation to environmental protection facilities, which include environmental protection machinery).

5. It should be noted that section 16G, which came into effect on 1 April 1998, provides for the situation where a qualifying item of machinery or plant was acquired in an earlier year of assessment and has accordingly been the subject of depreciation allowances. In such a case, if an appropriate election is made, a deduction is allowed under the section in respect of the 1998/99 year of assessment for the capital expenditure incurred on the provision of the item, reduced by the aggregate of initial and annual allowances made to the person concerned in prior years of assessment. The relevant amount ceases to qualify for depreciation allowances and must accordingly be excluded in relation to their computation for the 1998/99 and subsequent years of assessment. In respect of environmental protection machinery, similar transitional provisions are contained in section 16K to deal with machinery or plant acquired before the commencement of section 16I (i.e. 27 June 2008).

6. Sections 37 and 39B refer to “capital expenditure on the provision of machinery or plant”, and subsection (2) of section 37 refers to “the cost of the asset”. Both phrases are construed as meaning the net cost of acquisition of the asset to the owner for the time being who is claiming the allowances. In this regard, the net cost of acquisition represents the supplier’s price for the item, plus any charges relating to freight, insurance, delivery, import duties, etc., and less any discounts, rebates, subsidies, etc. accorded to the purchaser. The decision in *C.I.R. v. Hong Kong Bottlers Ltd. (H.K.T.C. 497)* was to the effect that cost is to be taken as meaning the same as capital expenditure incurred by the person claiming the allowance (but see paragraph 31 below as to machinery and plant which is acquired other than by purchase).

7. Hire purchase interest charges do not form part of the qualifying expenditure (see paragraphs 37 and 38 below).

Meaning of “machinery or plant”

8. The Ordinance does not provide an exhaustive definition of “machinery or plant”. However, section 40 of the Ordinance and Rule 2 of the Inland Revenue Rules provide assistance in determining what constitutes “machinery or plant” for the purposes of making depreciation allowances. The following points are pertinent in this regard.

- Section 40(1) provides, *inter alia*, that “ “capital expenditure on the provision of machinery or plant” includes capital expenditure on alterations to an existing building incidental to the installation of that machinery or plant for the purposes of the trade, profession or business”.
- Rule 2 provides that items specified in the second column of the First Part of the Table annexed to the rule are deemed to be included in the expression “machinery or plant” (see Appendix A(i)). On the other hand, the rule also provides that items specified in the second column of the Second part of that Table (Appendix A(ii)) are deemed *not* to be included in that expression (accordingly depreciation allowances cannot be made), but instead are deemed for the purposes of the Ordinance to be included in the expression “any implement, utensil and article”. The latter grouping includes such items as loose tools, crockery and linen which are normally dealt with under the “replacement” basis specified in section 16(1)(f). Finally, Rule 2 provides that wharves shall not be or be deemed to be “plant or machinery”.

9. Nevertheless, as has been stated above, the term “machinery or plant” is not exhaustively defined, and for the purposes of depreciation allowances, the Table annexed to Rule 2 per Appendix A(i) lists as the last of the items “machinery or plant, not specified in items 1 to 34”. Accordingly, where depreciation allowances are claimed in respect of expenditure on an item

not specifically listed, it is necessary to consider whether the item falls within the general description of “machinery or plant”.

10. The meaning of the phrase “machinery or plant” has been considered in a number of cases by the courts in Hong Kong and other common law jurisdictions. On the basis of the principles established, the Department has taken positions in relation to a number of items which are not specifically listed in Appendix A(i) or (ii). In this regard, Appendix B enumerates items which are recognised as machinery or plant, and Appendix C enumerates items which are not so recognised.

Capital expenditure incurred prior to commencement of business

11. Where a person carries on a trade and incurs capital expenditure on the provision of assets for a *new* trade about to be commenced, the Ordinance does not provide for deductions or allowances to be granted in respect of the expenditure against the profits of the *existing* trade. However, section 40(2) provides, for the purposes of Part VI, that in such a situation the expenditure is treated as if it were incurred on the day that the new trade commences. Accordingly, if the expenditure is incurred on the provision of machinery or plant, allowances can be granted against the profits of the new trade, once it has commenced.

12. Where a person ceases to carry on a particular trade and transfers machinery or plant previously used in it to another trade which he carries on, it is not considered that the person is entitled to claim more than one annual allowance in respect of that machinery or plant for any one year of assessment. This is because the allowance is granted to the “person” and not to the “trade”.

Basis period

13. The basis period for the purpose of calculating depreciation allowances is generally the same as that used by the taxpayer concerned for the purpose of computing assessable profits. The term “basis period” is defined in section 40(1) so that for the purposes of Part VI, apart from the situation where either of two specified exceptions is applicable, it has the same meaning as that assigned to it by section 2 of the Ordinance (i.e. “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”). The two exceptions, so far as is relevant, are:

- (a) where two basis periods overlap, the period common to both is deemed to fall into the first period only; and
- (b) where there is an interval between the end of the basis period for one year of assessment and the beginning of the basis period for the next succeeding year of assessment, the interval is deemed to fall into the second basis period.

14. The meaning assigned to the term “basis period” in Part VI ensures that on a change of accounting date by a taxpayer, initial allowance is only granted once in respect of expenditure incurred in a period which is common to two basis periods, and also that the allowance is not lost where expenditure is incurred during an interval between two basis periods.

Part II – THE “POOLING SYSTEM” – 1980/81 Onwards

Background

15. As was mentioned earlier, the “pooling system” for making depreciation allowances was introduced by the Inland Revenue (Amendment) (No. 4) Ordinance 1980 and has been in effect since the year of assessment 1980/81. The pooling system was not introduced with the intention of fundamentally changing the depreciation allowances or charges made under the old scheme. Rather, the intention was merely to save time and expense by modifying the old scheme to reduce the need to maintain detailed depreciation records in respect of individual items of machinery and plant. The pooling system seeks to achieve this objective by, in essence, creating a single “pool” of expenditure in respect of all items of machinery or plant which qualify for a particular rate of annual allowance.

The allowances

Initial allowance

16. Section 39B(1) provides for an initial allowance to be made 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 Profits Tax. As with the corresponding provision under the old scheme (section 37(1)), section 39B(1) provides that the initial allowance is made to the person for the year of assessment in the basis period for which the expenditure is incurred. There is no requirement that the asset must be in use in the basis period, but the allowance is subject to the asset eventually being acquired and used in the trade carried on.

17. As initial allowance is made in respect of capital expenditure “incurred”, it is not limited to sums actually paid. Where a contractual obligation exists, the due date for payment of deposits, instalments, etc. will be regarded as the date when the expenditure is incurred, even if actual payment occurs at a later date. It should be noted, however, that no allowance can be made in respect of what is merely a contingent liability. It follows that a deposit or advance payment is not recognised as expenditure incurred on the provision of machinery or plant unless it has been paid on a non-refundable basis in respect of a binding purchase contract. In the absence of a written contract, the date of delivery of the asset is normally taken to be the date on which the expenditure is incurred.

18. The rate of initial allowance for any year of assessment commencing on or after 1 April 1989 is 60% (section 39B(1A)(c) and, where the old scheme is applicable, section 36A(3)(c)).

Annual allowance

19. Section 39B(2) provides for an annual allowance to be given for each year of assessment. This is calculated at the appropriate rate on the reducing value of each class or *pool* of machinery or plant. A class of machinery or plant is made up of all such items eligible for the same rate of annual allowance (see paragraph 21). Unlike the position in respect of annual allowances under the old system (see section 37(2)), there is no requirement

under the pooling system to the effect that the asset must be owned and in use at the end of the basis period.

20. Section 39B(2) provides, in effect, for annual allowance to be made to a person where he has at some time (not necessarily during the basis period for the current year of assessment) owned and had “in use” any machinery or plant for the purpose of producing profits chargeable to Profits Tax. It is the Department’s view that the words “in use” should not be strictly construed. Thus where a machine is temporarily idled during the last few days of a basis period, e.g. awaiting commencement of a new production run, the machine is considered to be “in use” for the purposes of the allowance. In regard to spare parts, e.g. reserve engines for taxis, the Department’s position is that where these are “on the bench” ready for installation and use, they qualify for the allowance. However, where spares are held in store for issue or are held crated as received from the supplier, they are not considered to be “in use” for the purposes of the allowance.

Annual allowance rates

21. Section 39B(3) provides that the annual allowance shall be calculated at the rates of depreciation prescribed by the Board of Inland Revenue and shall be computed on the reducing value of each class of machinery or plant. The rates prescribed by the Board are set out in the third column of the First part of the Table annexed to Rule 2 of the Inland Revenue Rules. The Table (see Appendix A(i)) specifies the rates of depreciation for certain classifications of machinery and plant and, for those not specifically itemised, lays down a general rate of 20%. [The same rates apply in respect of annual allowances made under the old scheme (section 37(2)).]

Calculation of the allowances

22. Apart from its role in relation to the rates of depreciation, section 39B(3) also provides that the annual allowance “shall be computed on the reducing value of each class of machinery or plant”. Section 39B(4), (5), (6) and (7) detail what is meant by the reducing value of a class of machinery or plant. In essence, the “reducing value” of a class of machinery or plant (i.e. the figure which is multiplied by the prescribed rate of depreciation to calculate the

annual allowance to be made in respect of the class concerned for the year of assessment under consideration) is arrived at by *aggregating* (as applicable):

- (a) the reducing value of the class (i.e. the “pool”) brought forward from the end of the previous year of assessment;
- (b) the amount of qualifying capital expenditure incurred on the provision of machinery and plant of the same class during the basis period for the current year, less any initial allowance given in respect of that expenditure. [Expenditure does not qualify if incurred in respect of machinery or plant which is either under hire-purchase (section 39C(1)(a)) or only partly used for the purpose of producing chargeable profits (section 39C(1)(b)). These categories are further discussed in Part III below];
- (c) the reducing value (i.e. capital expenditure incurred less any initial or annual allowances made), as at the end of the previous year of assessment, of each item of machinery or plant acquired under hire-purchase which passed into the ownership of the person during the previous year of assessment (see section 39C(2) and paragraphs 37 and 38 below);
- (d) in respect of each item of machinery or plant owned and used by the person for any period immediately before using it to produce chargeable profits in the particular year of assessment, the actual cost of the item less the notional annual allowances which would have been made under section 37 if the owner had used the item since acquisition for the purpose of producing chargeable profits (see section 39B(6) and paragraphs 25 to 27 below);
- (e) the reducing value taken over (as a result of succession during the year of assessment to a trade, profession or business) of machinery or plant acquired without being purchased (see section 39B(7) and paragraph 31 below);

and *deducting* (as applicable):

- (f) the aggregate of any sale, insurance, salvage or compensation money received in respect of any item of machinery or plant belonging to that class disposed of during the basis period (see section 39B(4)(e) and paragraphs 28, 49 and 50 below); and
- (g) the reducing value (determined by the Commissioner) of any machinery or plant previously used wholly and exclusively in the production of profits which ceased to be so used during the basis period (see section 39C(3) and paragraph 30 below).

23. The following examples illustrate the operation of the pooling system. [In considering the examples in this Practice Note, it should be assumed, unless information to the contrary is provided, that the taxpayer concerned is carrying on a trade, profession or business in Hong Kong and that the machinery or plant is used therein by the taxpayer for the purpose of producing profits chargeable to Profits Tax.]

Example 1

24. A taxpayer commenced business on 2 February 1994. The accounts of the business are made up to 31 December each year. During the first year of trading, the following items of machinery and plant were purchased:

1 motor car	\$150,000	(30% annual allowance rate)
3 electric cookers	\$50,000	(30% annual allowance rate)
1 set of office furniture	\$20,000	(20% annual allowance rate)
2 room air-conditioning units	\$28,000	(20% annual allowance rate)

Machinery and plant depreciable at the same annual allowance rate is “pooled” together for the purpose of calculating the depreciation allowances. For the year of assessment 1994/95, the company is entitled to depreciation allowances totalling \$176,640, computed as follows:

	30% Pool	20% Pool	Allowance
	\$	\$	\$
Cost	200,000	48,000	
Less : I. A. (60%)	<u>120,000</u>	<u>28,800</u>	148,800
	80,000	19,200	
Less : A. A.	<u>24,000</u>	<u>3,840</u>	27,840
Reducing value c/f	<u>56,000</u>	<u>15,360</u>	
		Total	<u>176,640</u>

During the year ended 31 December 1995, the motor car was damaged beyond repair in an accident. The insurance company paid \$30,000 and the taxpayer also obtained \$1,000 from a scrap dealer for the wreck. During the same year, a new van was purchased for \$180,000, an electric cooker was disposed of for \$3,000, and a room air-conditioning unit was sold for \$2,000, replaced with a new one purchased for \$8,000.

For the year of assessment 1995/96, the taxpayer would be entitled to depreciation allowances totalling \$144,312, computed as follows:

	30% Pool	20% Pool	Allowance
	\$	\$	\$
Reducing value b/f	56,000	15,360	
Add : New assets	<u>180,000</u>	<u>8,000</u>	
	236,000	23,360	
Less : I.A.	<u>108,000</u>	<u>4,800</u>	112,800
	128,000	18,560	
Less : Sale proceeds	<u>34,000 *</u>	<u>2,000</u>	
	94,000	16,560	
Less : A.A.	<u>28,200</u>	<u>3,312</u>	31,512
Reducing value c/f	<u>65,800</u>	<u>13,248</u>	
		Total	<u>144,312</u>

* Sale proceeds: \$34,000 = \$30,000 + \$1,000 + \$3,000

Assets brought into the business after non-business use

25. Under both the old scheme and the pooling system (see sections 37(2A) and 39B(6)), notional allowances have to be computed if an item of

machinery or plant is owned and used by a person before he uses it for the purpose of producing profits chargeable to tax. In such a case, for the purpose of calculating the annual allowance in respect of the item (i.e. the amount to be included in the pool where the pooling system is applicable), the capital expenditure incurred on the provision of the item is computed by deducting from its actual cost the notional amount of the annual allowance that would have been made under section 37 to the owner if since acquiring the machinery or plant he had used it for the purpose of producing profits chargeable to tax. There is no provision for deducting a notional initial allowance from the actual cost.

26. No entitlement to initial allowance arises in such circumstances. This is because entitlement only arises under the respective Profits Tax and Salaries Tax provisions where it can be said of the relevant capital expenditure that it was incurred on the provision of *machinery or plant for the purpose of producing profits chargeable to tax under Part IV*, or in the case of employment, *machinery or plant the use of which is essential to the production of the assessable income*. It follows that where the expenditure is incurred for some other purpose, irrespective of how the machinery or plant is subsequently used, the requirement for entitlement is not satisfied.

Example 2

27. A taxpayer, who had been trading for some years, purchased a car for private use on 10 May 1994 at a cost of \$160,000. The car was transferred to business use on 12 August 1996. The taxpayer's accounts are made up to 31 March each year.

	30% Pool
	\$
Actual Cost	160,000
Less : 1994/95 Notional annual allowance	
\$160,000 x 30%	48,000
	112,000
Less : 1995/96 Notional annual allowance	
\$112,000 x 30%	33,600
Notional cost of asset	78,400

Note: For the purposes of the 30% pool in the 1996/97 and subsequent years of assessment, the car would be treated as if it had been purchased on 12 August 1996 for \$78,400.

Proceeds of machinery or plant disposed of

28. The Ordinance makes it clear that any sale, insurance, salvage or compensation moneys received in respect of machinery or plant which has been included in a pool is to be deducted in ascertaining the reducing value of the pool (section 39B(4)(e)) and, where cessation is involved, in calculating any balancing charge required to be made under section 39D(2)(b) (see paragraph 32 below). Thus, if machinery or plant is destroyed, the sum to be taken into account is generally the total of any insurance, salvage or compensation received. However, section 39D(6) provides that the total amount taken into account is *not to exceed* the capital expenditure incurred on the provision of the particular item. Where the asset was introduced into the business after non-business use, the relevant figure is the capital expenditure computed in accordance with section 39B(6) (i.e. the actual cost of the asset less notional annual allowances for the years of non-business use).

Example 3

29. The reducing value of a taxpayer's 30% pool after 1995/96 allowances was \$36,000. During the year ended 30 June 1996, a van which had cost \$138,000 was sold for \$140,000. A car, which had been purchased in July 1993 for \$320,000, was introduced into the business on 1 September 1995. The accounts of the taxpayer are made up to 30 June each year.

Year of Assessment 1996/97

	30% Pool
	\$
Reducing value b/f	36,000
Add: Notional cost of car introduced *	156,800
	<hr/> 192,800
Less : Disposal value (restricted to actual cost)	138,000
	<hr/> 54,800

Less : A.A.	<u>16,440</u>
Reducing value c/f	<u><u>38,360</u></u>

* Computation of the notional cost of the car for the purpose of its introduction into the business (see paragraphs 25 and 26 above):

	\$
Actual cost of the car	320,000
Less: Notional annual allowances for years of non-business use (two complete years):	
• 1994/95 notional annual allowance	
\$320,000 x 30%	96,000
• 1995/96 notional annual allowance	
\$224,000 x 30%	67,200
	163,200
Notional cost for business under section 39B(6)	<u><u>156,800</u></u>

Note: (i) No initial allowance is due on the car introduced as no capital expenditure was incurred during the basis period.
(ii) Any new expenditure has to be added to the pool before disposal proceeds are deducted. Even though the van was sold for \$2,000 more than its purchase price, the disposal value is not to exceed the capital expenditure incurred on the provision of the particular item.

Assets removed from pool for non-business use

30. Where an item of machinery or plant which has been used wholly and exclusively in the production of chargeable profits ceases to be so used (e.g. when it becomes used wholly or partly for private purposes), its reducing value must be deducted from that of the pool for the year of assessment during the basis period for which the change occurred. The reducing value of the machinery or plant is deemed, under section 39C(3), to be the amount which the Commissioner considers the item in question would have realised if sold in the open market at the time it ceased to be wholly and exclusively used in the production of chargeable profits. Depreciation allowances are separately

calculated for the year of change, and for subsequent years for so long as the item continues to be used (partly or wholly) in the production of chargeable profits (see paragraphs 43 and 44 below).

Succession to a trade, etc.

31. The provisions of section 39B(7) cater for the situation where a person succeeds to a trade, profession or business and are broadly similar to those of section 37(4), relating to the old scheme. Thus, if on succession to a trade, ownership of machinery or plant passes to the successor without it being sold to him, the reducing value of each pool of expenditure unallowed to the old proprietor is taken over by the new proprietor. The successor is entitled to annual allowance under section 39B(2) once the machinery or plant is used to produce chargeable profits in his trade. The successor is not, however, entitled to any initial allowance in respect of such machinery or plant (section 39B(8)). For the purpose of calculating any subsequent reduction from the pool or balancing charge on disposal, the cost of the asset acquired by the successor in this way will be deemed to be equal to the reducing value of the pool taken over.

Balancing allowances and balancing charges

32. Section 39D(2) provides that where a person *ceases* to trade and the sale, etc., moneys received for the machinery or plant are less than the reducing value in the pool, a balancing allowance equal to the difference is to be made. This is the *only situation* in which a balancing allowance can be given — any sum received on the disposal of an asset at any other time is simply deducted from the value of the pool. A balancing charge can, however, arise whenever disposal proceeds exceed the reducing value of the pool (i.e. not only on the disposal of a class of machinery or plant on the cessation of trading). However, it should be noted that by virtue of section 39D(3), no balancing charge or balancing allowance can arise where on cessation machinery or plant passes to a successor to whom the reducing value of the machinery or plant is transferred under section 39B(7).

Example 4

33. A taxpayer owned three motor vehicles as at 30 June 1994. During the year ended 30 June 1995 he sold one for \$130,000 without replacing it, and during the following year another for \$60,000, again without replacing it. In each case the vehicle was sold for less than its original cost. The accounts of the business are made up to 30 June each year.

The reducing value carried forward after the 1994/95 allowances was \$125,000 for the 30% pool. As a result of the disposals, balancing charges, computed as follows, would be made:

Year of Assessment 1995/96

	30% Pool
	\$
Reducing value b/f	125,000
Less: Disposal value	<u>130,000</u>
Balancing charge [s.39D(1)(a)]	<u>5,000</u>
Reducing value c/f [s.39D(1)(b)]	<u>nil</u>

Year of Assessment 1996/97

	30% Pool
	\$
Reducing value b/f	nil
Less: Disposal value	<u>60,000</u>
Balancing charge [s. 39D(1)(a)]	<u>60,000</u>

Example 5

34. A taxpayer commenced trading in 1976. His accounts were made up to 30 September each year. On 15 May 1996 he ceased trading. During the final year he purchased machinery costing \$20,000, which qualified for the 20% annual allowance rate. The reducing values of the 20% and 30% pools after the 1995/96 allowances were \$13,000 and \$21,000 respectively. On

cessation, the machinery and plant were sold for \$15,000 and \$28,000, for the 20% and 30% pools respectively. The resulting balancing allowance and balancing charge for the cessation year would be computed as follows:

Year of Assessment 1996/97

	30% Pool	20% Pool
	\$	\$
Reducing value b/f	21,000	13,000
Add: New asset		<u>20,000</u>
		33,000
Less: I.A.		<u>12,000</u>
		21,000
Less: Sale proceeds	<u>28,000</u>	<u>15,000</u>
Balancing allowance [s. 39D(2)]		<u>6,000</u>
Balancing charge [s. 39D(2)]	<u><u>7,000</u></u>	

Note: As a matter of practice, no annual allowance is computed for the year of cessation, but initial allowance is due on capital expenditure incurred during the final basis period.

Assets put out of use upon cessation of a trade, etc.

35. Section 38(4) and section 39D(4) and (5) contain similar rules to the effect that where machinery or plant is put out of use by reason of a person ceasing to carry on a trade, the person is deemed to have received immediately prior to the cessation sale proceeds for the machinery or plant of such amount as the Commissioner may consider it would have realised if sold in the open market. However, if within twelve months of the date of cessation the taxpayer sells the asset, he may claim the adjustment of any balancing allowance or balancing charge which may have been made to or on him as if the actual sale had taken place immediately prior to the date of cessation. The sections provide for such an adjustment to be made, notwithstanding that the assessment may otherwise have become final and conclusive under the provisions of section 70. These sections are not considered to apply where following the

cessation of a trade any machinery or plant previously used therein is transferred to another trade carried on by the same person, whether or not there is an intervening period between the cessation and the transfer.

Example 6

36. On 15 February 1995 a taxpayer ceased to carry on a business. The accounts of the business had been made up to 31 March each year. The items of machinery and plant included in the 30% pool, which originally cost \$75,000 and had a reducing value of \$21,000 after the 1993/94 allowances, were sold shortly after cessation of the business for \$80,000.

Items (consisting of office furniture) in the 20% pool, which originally cost \$20,000 and had a reducing value of \$6,400 after the 1993/94 allowances, had not been sold when the accounts for the final period of trading were submitted to the Inland Revenue Department. In accordance with section 39D(4), the Commissioner placed an open market value of \$7,200 on the furniture.

On 7 June 1995, a Notice of Assessment was issued to the taxpayer advising the assessable profits under section 18D for the final year of assessment of the business, i.e. 1994/95. No objection was lodged in respect of the assessment. However, on 11 November 1995, the taxpayer advised the Department that the office furniture had been sold for \$5,000, and claimed adjustment to the assessment in accordance with section 39D(5). Balancing charges, computed as follows, would have been included in the original assessment:

	30% Pool	20% Pool	
	\$	\$	
Reducing value b/f	21,000	6,400	
Less: Sale price	<u>80,000</u>	<u>7,200</u>	[s. 39D(4)]
Balancing charge*	<u>59,000</u>	<u>800</u>	

* The balancing charge for the 30% pool would be restricted, in effect, under section 39D(6) to \$54,000, being the total of the allowances previously granted to the taxpayer, i.e. \$75,000 — \$21,000.

The total balancing charge would be \$54,800
i.e. \$54,000 + \$800.

Upon receipt of the claim under section 39D(5), a revised assessment would be issued to reflect the following adjustment to the balancing charge previously made in respect of the 20% pool:

	20% Pool
	\$
Reducing value b/f	6,400
Less: Actual sale proceeds	<u>5,000</u>
Balancing allowance	1,400
Add: Previous balancing charge now withdrawn	<u>800</u>
Reduction in assessment	<u><u>2,200</u></u>

Part III – SITUATIONS WHERE THE POOLING SYSTEM DOES NOT APPLY

Assets acquired under hire purchase agreements

37. Section 39C(1)(a) provides that the pooling system does not apply in respect of machinery or plant being acquired under hire purchase (i.e. machinery or plant in respect of which section 37A applies). The initial and annual allowances due in respect of expenditure incurred on the provision of such machinery or plant must be calculated separately, as per Example 7 below. In effect, the legislation provides that for each year of assessment in the basis period for which the taxpayer has made an instalment payment, an initial allowance is made in respect of the capital element of the instalment payments made during the basis period. However, when the instalment payments are completed and no further initial allowance is due, the reducing value of the asset is added to the appropriate pool, i.e. in the year of assessment following the year of assessment during the basis period for which the machinery or plant passes into the ownership of the taxpayer (section 39C(2)).

Example 7

38. A taxpayer acquired a suite of office furniture at a hire purchase price of \$220,000 in January 1995. The cash price was \$160,000. A deposit of \$10,000 was paid in January 1995. The first of 24 monthly instalments was

paid in February 1995. The taxpayer closes his accounts on 31 March annually. Depreciation allowances would be made to the taxpayer as follows:

	20% HP	Allowance	Y/A
	\$	\$	
Cost	160,000		
Less: I.A. ($\$10,000 + 150,000 \times 2/24$) x 60%	<u>13,500</u>	13,500	
	146,500		
Less: A.A.	<u>29,300</u>	<u>29,300</u>	
	117,200		
		<u>42,800</u>	1994/95
Less: I.A. ($\$150,000 \times 12/24 \times 60\%$)	<u>45,000</u>	45,000	
	72,200		
Less: A.A.	<u>14,440</u>	<u>14,440</u>	
	57,760		
		<u>59,440</u>	1995/96
Less: I.A. ($\$150,000 \times 10/24 \times 60\%$)	<u>37,500</u>	37,500	
	20,260		
Less: A.A.	<u>4,052</u>	<u>4,052</u>	
Reducing value c/f *	16,208		
		<u>41,552</u>	1996/97

* The reducing value figure of \$16,208 would be transferred to the 20% pool in the year of assessment 1997/98.

Total depreciation allowances not to exceed total capital expenditure

39. It should be appreciated that initial and annual allowances are provided under the Ordinance as a process of allocation of capital expenditure. It therefore follows that where an item of machinery or plant is acquired under a hire purchase agreement, the total amount of depreciation allowances made to a taxpayer should not exceed the amount of capital expenditure incurred on the item. The following example provides an illustration of a situation where the limitation would be applied.

Example 8

40. A taxpayer entered into a hire purchase agreement in July 1993 to acquire a tractor, at a hire purchase price of \$250,000. A deposit of \$30,000 was paid. The hire purchase price included interest of \$40,000. The first of 36 monthly instalments was paid in August 1993. The taxpayer makes up accounts to 31 December each year. The following depreciation allowances would be made to the taxpayer.

		30% HP		Allowance	Y/A
		\$	\$	\$	
Cost		210,000			
Less: I.A.	* ¹	33,000	33,000		
		177,000			
Less: A.A.		53,100	53,100	86,100	1993/94
		123,900			
Less: I.A.	* ²	36,000	36,000		
		87,900			
Less: A.A.		26,370	26,370	62,370	1994/95
		61,530			
Less: I.A.	* ²	36,000	36,000		
		25,530			
Less: A.A.		7,659	7,659	43,659	1995/96
		17,871			
Less: I.A.	* ³	17,871	17,871	17,871	1996/97
Accumulated depreciation allowances				210,000	

*¹ $(\$30,000 + \$180,000 \times 5/36) \times 60\%$

*² $\$180,000 \times 12/36 \times 60\%$

*³ The amount of depreciation allowance made to the taxpayer in the year of assessment 1996/97 would be \$17,871, notwithstanding the payment of capital expenditure of \$35,000 (i.e. $\$180,000 \times 7/36$).

Balancing allowance concession

41. It is recognised that in some cases where machinery or plant under a hire purchase agreement is repossessed by, or voluntarily returned to, the vendor, the taxpayer's total capital expenditure may exceed the sum of the depreciation allowances made prior to the disposal and whatever amount, if any, is received from the vendor upon the latter's disposal of the repossessed or returned asset. In such a situation (i.e. where the machinery or plant is under hire purchase), the Ordinance does not provide for any balancing allowance to be made to the taxpayer in respect of the excess. The Department does, however, by way of an extra-statutory concession, grant such an allowance.

Example 9

42. In June 1995 a taxpayer entered into a hire purchase agreement to acquire office furniture. The hire purchase price of the furniture was \$120,000, including an interest element of \$20,000. A deposit \$10,000 was paid in June 1995, and the first of the 24 monthly instalments covering the balance was paid in July 1995. The taxpayer ceased paying instalments in April 1996 (i.e. after 9 instalments had been paid), shortly after which the furniture was repossessed (the taxpayer did not receive any payment from the vendor after the repossession). The taxpayer continued to carry on the business. The accounts of the business are made up to 31 December each year.

Whereas the total amount of capital expenditure paid by the taxpayer was \$43,750 (i.e. \$10,000 + \$90,000 x 9/24), the total of the depreciation allowances which could be made to the taxpayer under section 37A would be, as can be seen below, \$42,350 (i.e. \$19,500 + \$16,100 + \$6,750). In the circumstances, a concessional allowance in respect of the difference of \$1,400 (i.e. \$43,750 — \$42,350) would be made to the taxpayer.

	20% HP		Allowance	Y/A
	\$	\$	\$	
Cost	100,000			
Less: I.A.	<u>19,500</u>	19,500	* ¹	
	80,500			
Less: A.A.	<u>16,100</u>	<u>16,100</u>	35,600	1995/96
	64,400			

Less: I.A.	<u>6,750</u>	6,750	* ²	
Reducing value	57,650		* ³	
Concessional allowance* ⁴		<u>1,400</u>	* ⁴	<u>8,150</u> 1996/97
Total allowances				<u><u>43,750</u></u>

*¹ $(\$10,000 + \$90,000 \times 6/24) \times 60\%$

*² $(\$90,000 \times 3/24) \times 60\%$

*³ Reducing value of \$57,650 will be eliminated for the purpose of calculating depreciation allowances for future assessments.

*⁴ Excess of capital expenditure incurred over initial and annual allowances \$1,400 (i.e. \$43,750 – \$42,350)

Machinery or plant used partly for the purposes of the trade, etc.

43. Section 39C(1)(b) provides, in effect, that the pooling system does not apply to assets which are used only partially for producing chargeable profits. The allowances due in respect of any such asset need to be separately calculated in accordance with the old scheme so that the appropriate apportionment for non-business usage can be made (under section 12(2), 18F(1) or 19E(1)). Any such reduction does not affect the calculation of subsequent allowances which are computed in the first place as if the full amount had been granted, and then apportioned as appropriate in relation to the extent to which the asset is or has been used (a) in the production of the chargeable profits and (b) for other purposes (section 39A).

44. Even if partial non-business use ceases, and the asset is then used wholly for business purposes, separate calculations must continue. This is because any balancing charge on subsequent disposal of the asset has to be apportioned to take into account the earlier non-business usage.

45. The following example illustrates the method of calculating the allowances and balancing charge where the proportion of non-business use has not been constant.

Example 10

46. A taxpayer commenced to carry on a business on 1 June 1991, on which date he purchased a motor vehicle for \$280,000. This vehicle was used wholly for business purposes until 31 March 1992. As from 1 April 1992 (after the taxpayer had sold his private car), the vehicle was used partly for private purposes, with the estimated private use being 50% of the total annual mileage. Twelve months later, the private use portion had declined to 25%. In June 1994 the vehicle was sold for \$60,000. The taxpayer's accounts are made up to 31 March each year.

	30%	Allowances made against business profits	Adjustment in respect of private use	Y/A
	\$	\$	\$	
Cost * ¹	280,000			
Less: I.A.	<u>168,000</u>	168,000	(100%)	
	112,000			
Less: A.A.	<u>33,600</u>	<u>33,600</u>	(100%)	
		201,600		1991/92
Reducing value	78,400			
Less: A.A.	<u>23,520</u>	11,760	(50%)	1992/93
			11,760	
Reducing value	54,880			
Less: A.A.	<u>16,464</u>	<u>12,348</u>	(75%)	1993/94
		<u>225,708</u>	<u>4,116</u>	
			<u>15,876</u>	
Reducing value	38,416			
Sale proceeds	<u>60,000</u>			
Excess over				
Reducing value	<u>21,584</u>			
Balancing Charge	20,165 *		1,419	1994/95

*¹ For the 1991/92 year of assessment, the cost would have been included as part of the 30% pool. The reducing value of the car at the end of that year (i.e. \$78,400) would have been excluded from the pool for the separate calculation of depreciation allowances in 1992/93 (i.e. the year in which the car ceased to be used wholly for business purposes).

*² For the 1994/95 year of assessment, a balancing charge, calculated as follows, would be made:

$$\$21,584 \times \$225,708 / (\$225,708 + \$15,876) = \$20,165$$

Part IV – MISCELLANEOUS PROVISIONS

Commissioner's discretion – rate of annual allowance

47. Both proviso (b) to section 37(2) and section 39(B)(11) empower the Commissioner in his discretion to allow a higher rate for annual allowance than that prescribed by the Board of Inland Revenue. An application for an increased rate of allowance should include the following details:

- (a) the estimated working life of the asset;
- (b) the anticipated disposal/scrap value of the asset at the end of its working life; and
- (c) where excessive wear and tear is claimed in respect of the use of an asset on a specific project, the possibility of it being restored/repaired for further use in the business on completion of the project.

48. At the present time, the rates of initial and annual allowances are such that the Commissioner considers it unlikely that any claim for a higher annual allowance could be justified.

Assets sold together

49. Particularly where cessation occurs, it is not uncommon to find that assets are sold together for one price, without the consideration in respect of each asset being separately specified. Where this occurs the Commissioner is empowered, by virtue of the provisions of section 38A, to allocate a price to each individual asset.

Transactions between related parties

50. Section 38B provides for the situation where the Commissioner is of the opinion that the sale price of an asset, which qualifies for initial or annual allowances, does not represent its true market value, and any of the following circumstances are applicable:

- (a) the buyer is a person over whom the seller has control; or
- (b) the seller is a person over whom the buyer has control; or
- (c) both the seller and the buyer are persons over both of whom some other person has control; or
- (d) the sale is between a husband and wife, not being a wife living apart from her husband.

In such a case, the section provides that the Commissioner may determine the true market value at the time of the sale, and that value is deemed to be the sale price of the asset for the purpose of calculating the allowances and charges under part VI of the Ordinance.

Commissioner's power to direct that the old scheme should apply

51. Section 36A(2) gives the Commissioner power to direct the extent and the duration for which the provisions of the old scheme shall continue to apply for any year of assessment from 1980/81 onwards, whenever he is satisfied that the application of any of the provisions of the pooling system to any machinery or plant would be impracticable or inequitable.

**RATES OF DEPRECIATION, AS
PRESCRIBED BY THE BOARD OF INLAND REVENUE
[From Rule 2 of the Inland Revenue Rules]**

TABLE

FIRST PART

<i>Item</i>	<i>Rate of Depreciation</i>
1. Air-conditioning plant excluding room air-conditioning units	10%
2. Bank safe deposit boxes, doors and grills	10%
3. Broadcasting transmitters	10%
4. Cables (electric)	10%
5. Lamp standards (street)-gas or electric	10%
6. Lifts and escalators (electric)	10%
7. Mains (gas or water)	10%
8. Oil tanks	10%
9. Shipping-	
Ships, junks and sampans	10%
Lighters	10%
Tugs	10%
10. Sprinklers	10%
11. Domestic appliances	20%
12. Furniture (excluding soft furnishings)	20%
13. Room air-conditioning units	20%
14. Shipping-	
Launches and ferry vessels	20%
Hydrofoils	20%
15. Taxi meters	20%
16. Type and blocks (if not dealt with on renewals basis)	20%
17. Aircraft (including engines)	30%

18. Bar syphon apparatus	30%
19. Bicycles	30%
20. Bleaching and finishing machinery and plant	30%
21. Concrete pipe moulds	30%
22. Electric cookers and kettles	30%
23. Electronic data processing equipment	30%
24. Electronics manufacturing machinery and plant	30%
25. Motor vehicles	30%
26. Plastic manufacturing machinery and plant including moulds	30%
27. Shipping-	
Outboard motors	30%
28. Silk manufacturing machinery and plant	30%
29. Sulphuric and nitric acid plant	30%
30. Tank lorries	30%
31. Textile and clothing manufacturing machinery and plant	30%
32. Tractors — bull dozers and graders	30%
33. Weaving, spinning, knitting and sewing machinery....	30%
34. Machinery or plant, not specified in items 1 to 33, and used for the purposes of a transport, tunnel, dock, water, gas or electricity undertaking or a public telephone or public telegraphic service	10%
35. Any other machinery or plant, not specified in items 1 to 34	20%

APPENDIX A(ii)

**“IMPLEMENTS, UTENSILS AND ARTICLES”, AS
PRESCRIBED
BY THE BOARD OF INLAND REVENUE
[From Rule 2 of the Inland Revenue Rules]**

TABLE

SECOND PART

Item

1. Belting.
2. Crockery and cutlery.
3. Kitchen utensils.
4. Linen.
5. Loose tools.
6. Soft furnishings (including curtains and carpets).
7. Surgical and dental instruments.
8. Tubes for X-ray and infra-red machines.

APPENDIX B

ITEMS WHICH QUALIFY AS MACHINERY OR PLANT

In addition to the items specified in the First Part of the Table annexed to Rule 2 of the Inland Revenue Rules, the following items are recognised as “machinery or plant” for the purposes of the depreciation allowances:

Item

- (i) Design and process plans (for the construction of a machine to be used in the production of the saleable product of the taxpayer).
- (ii) Display platforms.
- (iii) First Registration Tax (paid on acquisition of a new motor vehicle).
- (iv) Iron gates (where not an integral part of a building or structure).
- (v) Office partitioning (where not an integral part of a building or structure).
- (vi) Poster-boards (advertisement hoardings).
- (vii) Signboards.
- (viii) Dry docks.
- (ix) Lighting and décor items installed to provide atmosphere or ambience in, but not forming an integral part of, licensed premises such as hotels and restaurants whose trade includes the provision of “atmosphere” or “ambience”.
- (x) Barrister’s books.

APPENDIX C

ITEMS WHICH DO NOT QUALIFY AS MACHINERY OR PLANT

Item

- (i) Acoustic tile ceilings (installed as an integral part of a building).
- (ii) Ceiling lighting points.
- (iii) Cocklofts.
- (iv) Fish ponds and fish storage barge.
- (v) Shop fronts, fixed wall and floor coverings, suspended ceilings, raised floors, balustrades and stairs.
- (vi) Telephone cable and wiring (installed as an integral part of a building).
- (vii) Wiring and electrical fixtures and fittings (installed as an integral part of a building).
- (viii) Car parks and piers.
- (ix) Canopies over petrol-filling stations.
- (x) Car-wash halls (i.e. buildings housing washing and control equipment).