

Taxation of Environmental Protection Installations (Relevant to AAT Examination Paper 5: Principles of Taxation)

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Introduction

Following on from the previous article “Taxation of Environmental Protection Machinery”, here we describe the taxation for environmental protection installations (EPIs) and give related examples. All references to statutory provisions in this article, unless otherwise specified, refer to sections in the Inland Revenue Ordinance (IRO).

What are environmental protection installations?

The term “environmental protection installations” (EPIs) is defined in Part 2 of Schedule 17 of the IRO as:

1. Any of the following installations -
 - (a) solar water heating installations;
 - (b) solar photovoltaic installations;
 - (c) wind turbine installations;
 - (d) offshore wind farm installations;
 - (e) landfill gas installations;
 - (f) anaerobic digestion installations;
 - (g) thermal waste treatment installations;
 - (h) wave power installations;
 - (i) hydroelectric installations;
 - (j) bio-fuel installations;
 - (k) biomass combined-heat-and-power installations; and
 - (l) geothermal installations.

2. Energy efficient building installations registered under the Hong Kong Energy Efficiency Registration Scheme for Buildings administered by the Electrical and Mechanical Services Department.

The Secretary for Financial Services and the Treasury is empowered to amend the list of specified EPIs under Schedule 17 by notice published in the Gazette after consulting the Director of Environmental Protection (section 16H(3)).

Tax treatment for specified capital expenditure (SCE) on EPIs on/after 27 June 2008

Any capital expenditure incurred on the provision of any EPI, excluding expenditure:

- that can be deducted under another section of the IRO or
- incurred under a hire-purchase agreement,

by a person on or after 27 June 2008, can be deducted in five equal yearly instalments, subject to apportionment if not 100 percent used in the production of chargeable profits (section 16I).

Example 1

In July 2008, A Ltd incurred \$500,000 on the provision of solar water heating installations (EPI A) for its industrial building. A Ltd prepares its accounts to 30 November each year.

As the expenditure was incurred on the provision of EPIs on or after 27 June 2008 during the basis period from 1 December 2007 to 30 November 2008, A Ltd can claim a deduction of \$100,000 (i.e. \$500,000 / 5) in respect of EPI A for each of the five years of assessment 2008/09, 2009/10, 2010/11, 2011/12 and 2012/13 if it continues to use EPI A up to the end of the basis period for the year of assessment 2012/13.

Year of assessment 2008/09	<u>EPI A</u>	<u>Deduction</u>
	\$	\$
Cost	500,000	
Deduction	<u>(100,000)</u>	<u>100,000</u>
Unallowed amount c/f	<u>400,000</u>	

Tax treatment on disposal of EPIs

If any EPI in respect of which a deduction has been allowed under section 16I in ascertaining the profits from a trade, profession or business, is subsequently sold -

- (a) if the unallowed amount exceeds the relevant proceeds of sale, the excess shall be deducted for the year of assessment in the basis period for which the sale occurs;
- (b) if there is an unallowed amount but the relevant proceeds of sale exceed that amount,

the excess shall, to the extent that it is not otherwise chargeable to tax and does not exceed the amount of the deduction, be treated as a trading receipt of the trade, profession or business, arising in or derived from Hong Kong and accruing –

- (i) at the time of the sale; or
 - (ii) if the sale occurs on or after the date on which the trade, profession or business is permanently discontinued, immediately before the date of discontinuance; or
- (c) if there is no unallowed amount, the relevant proceeds of sale shall, to the extent that they are not chargeable to tax and do not exceed the amount of the deduction, be treated as a trading receipt of the trade, profession or business, arising in or derived from Hong Kong and accruing –
 - (i) at the time of the sale; or
 - (ii) if the sale occurs on or after the date on which the trade, profession or business is permanently discontinued, immediately before the date of discontinuance (section 16J(3)).

Example 2

In October 2009, A Ltd in Example 1 sold EPI A to an unrelated company for \$320,000.

Year of assessment 2009/10	<u>EPI A</u>	<u>Deduction</u>
	\$	\$
Unallowed amount b/f	400,000	
Less: Sale proceeds	<u>(320,000)</u>	
Allowable deduction	<u>80,000</u>	<u>80,000</u>

As the unallowed amount exceeds the sale process, the excess amount of \$80,000 is deductible for the year of assessment 2009/10.

Example 3

If A Ltd in Example 1 sold EPI A to an unrelated company for \$320,000 in December 2009 instead, the sale proceeds would exceed the unallowed amount.

Year of assessment 2009/10	<u>EPI A</u>
	\$
Unallowed amount b/f	400,000
Deduction for the year	<u>(100,000)</u>
Unallowed amount	300,000
Year of assessment 2010/11	
Less: Sale proceeds	<u>(320,000)</u>
Deemed trading receipt	<u>(20,000)</u>

The excess of the sale proceeds over the unallowed amount, i.e. \$20,000, is deemed to be a trading receipt and is chargeable to profits tax for the year of assessment 2010/11.

If the sale proceeds were \$520,000 instead of \$320,000, the excess would be \$220,000 instead of \$20,000. As only \$200,000 in total has been allowed to be deducted previously, the deemed trading receipt is restricted to \$200,000.

Example 4

If A Ltd in Example 1 will sell EPI A to an unrelated company for \$50,000 in December 2013, there will be no unallowed amount (see calculation below) brought forward to the year of assessment 2013/14, and the whole sale proceeds of \$50,000 will be chargeable to profits tax in the year of assessment 2013/14.

Year of assessment 2009/10	<u>EPI A</u>
	\$
Unallowed amount b/f	400,000
Deduction for the year	<u>(100,000)</u>
Unallowed amount	300,000
Year of assessment 2010/11	
Deduction for the year	<u>(100,000)</u>
Unallowed amount	200,000
Year of assessment 2011/12	
Deduction for the year	<u>(100,000)</u>
Unallowed amount	100,000

Year of assessment 2012/13	
Deduction for the year	<u>(100,000)</u>
Unallowed amount	<u>0</u>

Sale of EPIs between connected persons

If, in relation to a sale of EPIs,

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

the Commissioner of Inland Revenue (CIR) shall, if he is of the opinion that the sale price of the facility does not represent its true market value at the time of the sale, determine such true market value, and the amount so determined shall be treated as the proceeds of that sale (section 16J(4)).

Example 5

If A Ltd in Example 2 sold EPI A to a connected person for \$200,000 while the market value was \$320,000, the CIR can treat \$320,000 as the sale proceeds of EPI A.

Destruction of EPIs

If any EPI in respect of which a deduction has been allowed to a person is subsequently destroyed –

- (a) the EPI shall be treated as if it had been sold immediately before the destruction; and
- (b) any insurance money or other compensation of any description received by the person in respect of the destruction and any money received by him in respect of the remains of the EPI shall be treated as the proceeds of that sale (section 16J(5)).

Time of sale of EPIs

The time of the sale, in relation to any EPIs, shall be taken as:

- ♦ the time of completion of the sale of the EPIs, or
- ♦ the time when possession of the EPIs is given,

whichever is the earlier (section 16J(6)).

Tax treatment of for SCE on EPIs acquired before 27 June 2008

Subject to an election under section 16K(7), if –

- (a) immediately before 27 June 2008, a person is entitled to an interest in any building or structure that is an EPI; and
- (b) that interest is the relevant interest in relation to the capital expenditure incurred on the construction of that building or structure,

that person shall, for the purposes of section 16I, be deemed to have incurred SCE, on 27 June 2008, in relation to that building or structure (section 16K(4)).

Example 6

In October 2005, B Ltd bought a commercial building and used it as its office. The cost of construction of the building, excluding land cost, was \$100,000,000. In the year ended 30 June 2007, B Ltd incurred \$20,000,000 on the provision of energy efficient building installations registered under the Hong Kong Energy Efficiency Registration Scheme for Buildings administered by the Electrical and Mechanical Services Department (EPI B).

The commercial building allowances claimed by B Ltd in respect of the commercial building and EPI B before the year of assessment 2008/09 were as follows:

Year of assessment 2006/07	<u>Commercial building</u> \$	<u>EPI B</u> \$	<u>Deduction</u> \$
Qualifying expenditure	100,000,000		
Annual allowance 4%	<u>(4,000,000)</u>		<u>4,000,000</u>
Residue of expenditure	96,000,000		
Year of assessment 2007/08			
Qualifying expenditure		20,000,000	
Annual allowance 4%	<u>(4,000,000)</u>	<u>(800,000)</u>	<u>4,800,000</u>
Residue of expenditure	<u>92,000,000</u>	<u>19,200,000</u>	

If B Ltd made an election under section 16K(7), it will be deemed to have incurred SCE of \$19,200,000 on EPI B on 27 June 2008.

Subject to an election under section 16K(7), if –

- (a) immediately before the commencement date, a person is entitled to an interest in any building or structure that would otherwise have qualified as an EPI but for the fact that that building or structure does not comply with the registration requirement under Part 2 of Schedule 17; and
 - (b) that interest is the relevant interest in relation to the capital expenditure incurred on the construction of that building or structure,
- that person shall, for the purposes of section 16I, be deemed to have incurred SCE in relation to that building or structure on the date on which the registration requirement is complied with (section 16K(5)).

The SCE deemed to have been incurred in relation to any building or structure under section 16K (4) or (5) shall be:

- the residue of expenditure in relation to that building or structure immediately before 27 June 2008, or
 - the residue of expenditure in relation to that building or structure immediately before the date on which the registration requirement under Part 2 of Schedule 17 is complied with,
- whichever is applicable (section 16K(6)).

Example 7

If the energy efficient building installations of B Ltd in Example 6 were not registered under the Hong Kong Energy Efficiency Registration Scheme for Buildings administered by the Electrical and Mechanical Services Department until 10 July 2008 (which was later than 27 June 2008 and fell within the basis period for the year of assessment 2009/10) and B Ltd made a section 17K(7) election in respect of EPI B for the year of assessment 2009/10, the SCE deemed to have been incurred in relation to EPI B is \$18,400,000 being calculated as follows:

Year of assessment 2008/09	<u>Commercial</u> <u>building</u> \$	<u>EPI B</u> \$	<u>Deduction</u> \$
Residue of expenditure b/f	92,000,000	19,200,000	
Annual allowance 4%	<u>(4,000,000)</u>	<u>(800,000)</u>	<u>4,800,000</u>
Residue of expenditure	<u>88,000,000</u>	<u>18,400,000</u>	

Election under section 16K(7) for accelerated deduction in respect of EPIs

Where a person is deemed to have incurred SCE on EPIs under section 16K(4) or (5) (the relevant provision) in the basis period for any year of assessment, the relevant provision applies to him only if he, at any time within one month after the date on which a notice of the assessment made in respect of that year of assessment under section 59 is given under section 62, elects in writing that the relevant provision shall so apply to him (section 16K(7)). An election under section 16K(7), once made, is irrevocable (section 16K(8)).

Example 8

If B Ltd in Example 6 wants to obtain accelerated deduction in respect EPI B for the year of assessment 2008/09, it can make a section 17(K) election in writing in its profits tax return for the year of assessment 2008/09 or lodge the election to the Inland Revenue Department within one month after the notice of profits tax assessment 2008/09. On making a valid election, B Ltd can claim an accelerated deduction of \$3,840,000 in respect to EPI B for the year of assessment 2008/09, being calculated as follows:

Year of assessment 2008/09	<u>Commercial</u> <u>building</u> \$	<u>EPI B</u> \$	<u>Deduction</u> \$
Residue of expenditure b/f	92,000,000	19,200,000	
Annual allowance 4%	<u>(4,000,000)</u>		4,000,000
Residue of expenditure c/f	<u>88,000,000</u>		
Deduction 20%		<u>(3,840,000)</u>	<u>3,840,000</u>
Unallowed amount c/f'		<u>15,360,000</u>	<u>7,840,000</u>

Once B Ltd has made a valid election under section 17K(7), it cannot subsequently withdraw its election.

If B Ltd has not made a valid election, it can continue to claim an annual allowance of 4 percent in respect of EPI B as a commercial building or structure for the year of assessment 2008/09.

Conclusion

The statutory provisions in relation to EPIs became operative from 27 June 2008. This article explains the deduction for capital expenditure incurred on EPIs on/before/after 27 June 2008 as well as the tax treatment for the sale proceeds of EPIs. Students preparing for Paper 5 in 2010 and thereafter should have sufficient knowledge of the application of the above provisions as well as other examinable provisions.