

**立法會**  
**Legislative Council**

LC Paper No. CB(1)2934/10-11  
(These minutes have been seen  
by the Administration)

Ref : CB1/BC/4/10/2

**Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2011**

**Fourth meeting on**  
**Tuesday, 14 June 2011, at 10:45 am**  
**in Conference Room B of the Legislative Council Building**

- Members present** : Hon Paul CHAN Mo-po, MH, JP (Chairman)  
Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP  
Hon James TO Kun-sun  
Hon CHAN Kam-lam, SBS, JP  
Hon Abraham SHEK Lai-him, SBS, JP  
Hon WONG Ting-kwong, BBS, JP
- Members absent** : Hon Miriam LAU Kin-ye, GBS, JP  
Hon Audrey EU Yuet-mee, SC, JP  
Hon Mrs Regina IP LAU Suk-ye, GBS, JP
- Public officers** : Miss Cathy CHU  
**Attending** Deputy Secretary for Financial Services and the  
Treasury (Treasury)
- Ms Shirley KWAN  
Principal Assistant Secretary for Financial Services and  
the Treasury (Treasury) (Revenue)
- Miss Fiona CHAU  
Assistant Secretary for Financial Services and the  
Treasury (Treasury) (Revenue)

Mr WONG Kuen-fai  
Deputy Commissioner of Inland Revenue (Technical)

Ms Judy YIP  
Senior Assessor  
Inland Revenue Department

Miss Betty CHEUNG  
Senior Assistant Law Draftsman  
Department of Justice

Mr Manuel NG  
Government Counsel  
Department of Justice

**Clerk in attendance** : Ms Anita SIT  
Chief Council Secretary (1)5

**Staff in attendance** : Ms Wendy KAN  
Assistant Legal Adviser 6

Mr Hugo CHIU  
Council Secretary (1)5

## **I Meeting with the Administration**

### Follow-up to issues raised at previous meeting

(LC Paper No. CB(1)2437/10-11(01) — Paper provided by the Administration on the tax treatment for various scenarios cited by members at the meeting on 21 April 2011

LC Paper No. CB(1)2447/10-11(01) — Administration's letter dated 10 June 2011 on matters arising from the meetings on 21 April 2011 and 28 May 2011)

*Other relevant papers*

(LC Paper No. CB(1)2356/10-11(01) — Administration's response to issues raised at the meeting on 21 April 2011

LC Paper No. CB(3)517/10-11 — The Bill

LC Paper No. CB(1)1988/10-11(01) — Marked-up copy of the Bill prepared by the Legal Service Division

File Ref: TsyB R 183/535-1/8/0 — The Legislative Council Brief (10-11) (C) issued by the Financial Services and the Treasury Bureau

LC Paper No. LS37/10-11 — The Legal Service Division Report on Inland Revenue (Amendment) (No. 2) Bill 2011

LC Paper No. LS42/10-11 — The Legal Service Division further Report on Inland Revenue (Amendment) (No. 2) Bill 2011

Discussion

The Committee deliberated (Index of proceedings attached at **Appendix**).

2. The Administration was requested to specify the tax assessment practices in the Departmental Interpretation and Practice Notes (DIPNs) of the Inland Revenue Department in respect of the various scenarios involving the licensing of specified intellectual property rights (IPRs), including those discussed at the meetings of the Bills Committee and those set out in item 8 of Annex A to LC Paper No. CB(1)2447/10-11(01).

*(Post-meeting note: The Administration agreed to set out the arrangements in the Departmental Interpretation and Practice Notes to be issued by the Inland Revenue Department in due course.)*

## **II Any other business**

### Date of next meeting

3. The Chairman reminded members that the next meeting would be held on 7 July 2011, at 8:30 am.
4. There being no other business, the meeting ended at 12:08 pm.

Council Business Division 1  
Legislative Council Secretariat  
25 August 2011

**Proceedings of the  
Bills Committee on Inland Revenue (Amendment) (No. 2) Bill 2011  
Fourth meeting on Tuesday, 14 June 2011, at 10:45 am  
in Conference Room B of the Legislative Council Building**

Time Marker	Speaker	Subject(s)	Action Required
000547 – 000610	Chairman	Introductory remarks	
000611 – 001312	Administration	<p>Briefing by the Administration on paragraphs 1-4 of the paper on "Tax Deduction for Capital Expenditure Incurred on the Purchase of Intellectual Property Rights" (LC Paper No. CB(1)2437/10-11(01)) ("1<sup>st</sup> Paper").</p> <p>Regarding the Chairman's query made at the meeting on 2 June 2011 about the possibility of amending sections 15(1)(b) and 15(1)(ba) of the Inland Revenue Ordinance (Cap. 112) ("IRO") to tax the upfront payment received by a licensor for licensing a specified intellectual property right (IPR) so that tax symmetry could be achieved if the Administration, as suggested by some members, treated the originally corresponding non-deductible upfront payment paid by the licensee as deductible capital expenditure, the Administration declined such proposal. The Administration reiterated its stance as set out in paragraph 10 of LC Paper No. CB(1)2356/10-11(01) and advised that the proposed amendments to sections 15(1)(b) and 15(1)(ba), which were deeming provisions applicable to income arising from licensing of IPRs by a non-resident to a Hong Kong enterprise, would be in violation of the fundamental and long-cherished principle of Hong Kong's taxation system of not taxing capital receipts.</p> <p>In addition, the Administration stressed that the policy intent of the Bill was to provide tax deduction for capital expenditure on "purchase" but not licensing of the specified IPRs. Such policy intent had been clearly reflected in the long title of the Bill and in the proposed sections 16E(9) and 16EA(13) which explicitly stipulated that any expenditure incurred on the acquisition of a licence of an IPR was not deductible.</p>	

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001313 – 001813	Chairman Administration	<p>The Chairman enquired whether any existing Departmental Interpretation and Practice Notes ("DIPNs") of the Inland Revenue Department ("IRD") specified the taxation arrangements for the licensing of IPRs. The Administration replied that the question of source in relation to royalty income was covered in a DIPN. Regarding the deduction of licence payments in connection with the licensing of IPRs, there was no need to make specific explanatory notes in the DIPN as the general deduction rule under section 16 of the IRO was applicable.</p> <p>The Chairman enquired whether a lump sum being the pre-payment of five years' licence fees in respect of an IPR would be considered as revenue or capital in nature. The Administration responded that whether the expenditure was capital or revenue in nature would depend on the terms and conditions of the transaction concerned.</p> <p>The Chairman further enquired if the pre-paid lump sum was calculated based on the usage of the IPRs in each of the five years (e.g. a company acquired a licence for the use of a registered design in manufacturing the T-shirts it sold and the pre-paid sum was deducted based on the number of T-shirts manufactured), whether the pre-paid amount was considered as capital or revenue in nature. The Administration replied that the pre-paid licence fee calculated on usage of the IPR would probably be considered as revenue in nature. The Administration reiterated that the terms and conditions of the arrangement would have to be considered to see whether the pre-paid amount was revenue or capital in nature.</p> <p>The Chairman remarked that even if the Bills Committee eventually did not amend the Bill to cover the licensing of specified IPRs, the Administration should set out clearly the taxation practices in respect of licensing of IPRs in DIPNs so that taxpayers were well informed of the arrangements.</p>	The Administration to take action as per paragraph 2 of the minutes.
001814 – 003304	Mr James TO Administration Chairman	Referring to the 1 <sup>st</sup> sentence in paragraph 5 of LC Paper No. CB(1)2447/10-11(01), Mr TO said that for specified IPRs purchased wholly or	

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		<p>partly from an associate, the Administration should allow tax deduction based on a fair and reasonable value rather than adopting an "all-or-nothing" approach as proposed in the Bill (i.e. under the anti-avoidance provisions in the Bill, no tax deduction would be allowed for the capital expenditure incurred on the purchase of a specified IPR wholly or partly from an associate).</p> <p>Mr TO also pointed out that the exclusion of the expenditure incurred on the acquisition of a specified IPR from the proposed tax deduction would lead to unintended adverse consequences. Owners of high quality IPRs were often reluctant to sell their IPRs and were only willing to license them by charging an upfront licence fee. As taxpayers would not be able to enjoy tax deduction for the upfront licence fee, they might turn to IPRs of lower quality where the owners were willing to sell the IPRs. As such, the efficacy of the proposed tax measures in promoting the use of IPRs would be undermined.</p> <p>The Administration explained that the granting of the proposed tax deduction for specified IPRs purchased wholly or partly from an associate was susceptible to abuse. Indeed, the anti-avoidance provision to exclude associates from enjoying tax deduction on the relevant IPRs was introduced in 1992 to curb the abuse prevailing at the time.</p> <p>The Administration quoted the following example of tax avoidance: Company A developed a trade mark and the related expenditure had been allowed for deduction under the existing IRO. Company A then set up a subsidiary, Company B, and sold the trade mark to Company B. In the absence of the "associate" provision, Company B could enjoy the proposed tax deduction for the purchase price of the trade mark. However, the selling price of the trade mark received by Company A was capital in nature and thus would be exempt from tax. When viewing Company A and Company B together, their overall tax liability would be reduced through the sale of the trade mark by Company A to Company B, thus</p>	

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		<p>causing revenue loss to the Government.</p> <p>Mr TO opined that whether a transaction was made between two associates should not be the sole determining factor. So long as the transaction price was fair and reasonable, the expenditure incurred on the purchase of a specified IPR should be able to enjoy the proposed tax deduction. The Administration should therefore focus on ensuring that the proposed legislation would be sufficient to enable the tax authority to determine whether a transaction between two associates was made at arm's length and hence the consideration involved did not exceed a fair market value.</p> <p>The Chairman said that for taxation law, the principle that an entity should not be allowed to create an expenditure item for itself for the purpose of tax deduction should be observed. Mr TO remarked that it might be appropriate to apply such principle to the transactions between a company and its subsidiary. He was however concerned that the anti-avoidance provisions in the Bill covered a much wider scope of transactions between associates.</p> <p>The Administration reiterated the possibility of tax avoidance for transactions between associates, and remarked that unlike other assets which would be subject to wear and tear over time, IPRs such as trade marks could on the contrary appreciate in value. The revenue loss arising from abuse or exploitation by associated party transactions could be very substantial..</p>	
003305 – 003637	Chairman Administration ALA6	<p>The Chairman referred to the submission from PricewaterhouseCoopers (PwC), and enquired about the feasibility of formulating an escape clause under the anti-avoidance provisions on transactions between associates to cater for the purchase of IPRs under normal acquisition and merger transactions.</p> <p>The Administration responded that it had made reference to the relevant pieces of legislation of comparable overseas jurisdictions, and found that the legislation did not contain any escape clause to cater for normal merger and acquisition transactions. In fact, it would be</p>	

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		<p>very difficult to specify precisely in legislation what constituted "normal merger and acquisitions transactions". Indeed, the potential acquirer would usually retain a team of professionals, e.g. lawyers, tax advisors and accountants to perform due diligence and to ensure that the intended transactions would be tax-efficient. As such, the absence of the suggested escape clause would not pose significant impact on the parties concerned.</p> <p>At the invitation of the Chairman, ALA6 remarked that the issue/difficulty was to define the meaning of "normal merger and acquisition", precisely.</p>	
003638 – 004509	Administration	Briefing by Administration on paragraphs 5-14 of the 1 <sup>st</sup> Paper.	
004510 – 004620	Chairman	The Chairman remarked that the issue of tax deduction arrangements for IPRs involved in cross-border activities (i.e. under scenario 5 of the 1 <sup>st</sup> Paper) should be discussed at the next meeting, because some members of the Bills Committee who were concerned about the issue were absent.	
004621 – 004922	Administration Chairman	<p>Briefing by Administration on Item 1 of the Administration's responses to submissions from deputations (Annex A to LC Paper No. CB(1)2447/10-11(01) (2<sup>nd</sup> Paper)</p> <p>The Chairman asked whether a taxpayer who disagreed with the true market value determined by the Commissioner of Inland Revenue ("the Commissioner") could appeal against the Commissioner's determination. The Administration advised that, according to the existing statutory appeal mechanism, the taxpayer could raise objection with the Commissioner; and if the taxpayer was still dissatisfied with the Commissioner's determination, he could lodge an appeal to the Board of Review and further to the Courts.</p>	
004923 – 005154	Administration Chairman	Briefing by Administration on Item 2 of Annex A of the 2 <sup>nd</sup> Paper. The Administration remarked that relevant arrangements would be provided in a DIPN.	

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		<p>The Chairman held the view that there were various valuation methods in determining the true market value of IPRs and it would not be appropriate or in fact infeasible to specify the specific valuation method(s) for IPRs in the legislation.</p>	
005155 – 005824	Administration Chairman	<p>Briefing by the Administration on Item 3 of Annex A of the 2<sup>nd</sup> Paper.</p> <p>The Chairman enquired why the Administration considered the existing section 61A of the IRO or the proposed section 16EA(9) was insufficient to address potential tax avoidance. The Administration explained that section 61A was only a general anti-avoidance provision and was not aimed at tackling a specific transaction or arrangement. The proposed section 16EC(1), on the other hand, focused on a specific tax avoidance arrangement and therefore would be more effective in combating such arrangement and could help avoid unnecessary disputes.</p>	
005825 – 010151	Mr WONG Ting-kwong Administration	<p>Mr WONG remarked that the trades were concerned with the proposal to empower the Commissioner to determine the true market value of the specified IPRs, and enquired (i) how the true market value would be determined; and (ii) whether there was an appeal mechanism.</p> <p>In response, the Administration replied that IRD would examine the terms and conditions of the contract concerned and, as IRD did not have relevant in-house expertise, would engage independent professional valuating organizations to determine the true market value. The Administration also confirmed that an appeal mechanism was in place.</p> <p>Mr WONG further enquired the taxation arrangement for a 'rent-and-buy' (先租後買) transaction on a specified IPR. The Administration replied that a 'rent-and-buy' transaction conducted <u>after</u> the commencement of the Bill was not covered by the proposed section 16EC(1). The Administration remarked that as provided under the proposed section 16EC(1), a 'rent-and-buy' transaction conducted before the commencement of the Bill</p>	

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		would not be eligible for the proposed tax deduction only if the transaction price concerned was not a reasonable consideration in the circumstance of the case.	
010152 – 010209	Administration	Briefing by the Administration on Item 4 of Annex A of the 2 <sup>nd</sup> Paper.	
010210 – 010435	Administration Chairman	Briefing by the Administration on Item 5 of Annex A of the 2 <sup>nd</sup> Paper.	
010436 – 010718	Administration	Briefing by the Administration on Item 6 of Annex A of the 2 <sup>nd</sup> Paper. The Chairman remarked that the issue concerned would be discussed at the next meeting.	
010719 – 010748	Administration	Briefing by the Administration on Item 7 of Annex A of the 2 <sup>nd</sup> Paper.	
010749 – 011301	Administration Chairman	<p>Briefing by the Administration on Item 8 of Annex A of the 2<sup>nd</sup> Paper.</p> <p>The Chairman sought clarification on whether the tax assessment practices set out in the Administration's response under Item 8 reflected the existing assessing practices of the IRD. The Administration replied in the affirmative.</p> <p>Regarding the first category of cases cited in the Administration's response, the Chairman enquired whether there were relevant court cases. The Administration replied that while there were no relevant court cases in Hong Kong, there was a relevant case in South Africa. The Chairman enquired whether there had been many objections to IRD's assessments for this category of cases. The Administration replied that there had been few objections in respect of these cases.</p> <p>In reply to the Chairman's enquiry, the Administration advised that the existing DIPN only covered the cases under category (c). The Chairman suggested that the DIPN should cover the various scenarios involving royalties derived from licensing arrangements cited in the paper. The Administration undertook to incorporate these categories of cases into the relevant DIPN.</p>	<p>The Administration to take action as per paragraph 2 of the minutes.</p>

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011302 – 011322	Chairman	The Chairman remarked that the issue of import processing and contract processing would be further discussed at the next meeting.	
011323 – 011457	Administration Chairman	Briefing by the Administration on paragraph 7 of the 2 <sup>nd</sup> paper.	
011458 – 011631	Clerk Administration Chairman	The Administration was requested to address Mr James TO's enquiry raised at the meeting on 2 June 2011 as to whether the purchase of a specified IPR was considered outright purchase if the relevant contract provided an option for the person who sold the IPR to buy back the IPR. The Administration responded that whether the buyer was truly the new owner of the IPR would depend on the terms and conditions agreed between the parties concerned. The buyer must show that there is a genuine purchase of the IPRs. The buyback option per se would not be the sole conclusive factor for the tax deduction arrangement.	
011632 – 011926	Clerk Administration	<p>The Administration was requested to reply to Mrs Regina IP's enquiry raised at the meeting on 28 May 2011 on whether Hong Kong's patent registration system would be expanded to cover patents registered in the United States. The Administration conveyed the response provided by the Commerce and Economic Development Bureau as follows:</p> <p>(a) the existing standard patent registration system in Hong Kong only recognized patents registered in the European Union, the United Kingdom and the Mainland; and</p> <p>(b) the Administration recognized the concerns of the trades about Hong Kong's patent registration system and had briefed the Legislative Council Panel on Commerce and Industry on 17 May 2011 on the scope and workplan of a comprehensive review of Hong Kong's patent registration system.</p>	
011927 – 012011	Chairman	The Chairman remarked that the next meeting would continue the discussion on the tax deduction arrangements for IPRs involved in cross-border activities, and proceed to the clause-by-clause examination of the Bill.	

<b>Time Marker</b>	<b>Speaker</b>	<b>Subject(s)</b>	<b>Action Required</b>
012012 – 012050	Chairman	The Chairman remarked that the scheduled meeting on 16 June 2011 would not be held and the next two meetings would be held on 7 July 2011 and 12 July 2011 respectively.	

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25 August 2011