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

Background Brief

Purpose

This paper provides background information on the Inland Revenue (Amendment) (No. 2) Bill 2011 (the Bill), and summarizes members' concerns raised during the relevant discussion at the Panel on Financial Affairs (the Panel).

Background

2. At present, under section 16(1)(g) of the Inland Revenue Ordinance (Cap. 112)(IRO), enterprises may claim tax deduction on expenditure related to the registration of trademarks, designs or patents that are used for producing taxable profits. Besides, section 16E provides that expenditure on the purchase of patent rights or rights to any know-how is tax deductible. To promote wider application of intellectual property rights by enterprises and the development of creative industries, the Financial Secretary proposed in the 2010–2011 Budget that the profits tax deduction should be extended to cover expenditure for purchase, and subsequent use, of three types of intellectual property rights (IPRs), namely, registered trademarks, copyrights and registered designs.

Proposals under the Bill

3. The Bill was gazetted on 25 February 2011 and introduced into the Legislative Council on 9 March 2011. The objects of the Bill are to amend the IRO to provide for the deduction in ascertaining profits chargeable to tax under the Ordinance of capital expenditure incurred on the purchase of a copyright, registered design or registered trade mark, to modify the provisions of the

Ordinance governing such deduction of capital expenditure incurred on the purchase of patent rights and rights to any know-how, and to provide for incidental matters.

Copyrights, registered designs and registered trade marks

4. Clause 6 of the Bill proposes to add new sections to the IRO to provide profits tax deduction for capital expenditure incurred on the purchase of copyrights, registered designs and registered trade marks (the specified IPRs). The major proposals include the following -

(a) to impose a registration requirement for those IPRs for which registration systems are available, namely trade marks and designs but not copyrights;

(b) to impose other conditions for the tax deduction, including (i) taxpayers must have acquired the "proprietary interest" of the specified IPRs; (ii) the specified IPRs must be in use for the production of chargeable profits; and (iii) where a specified IPR is used partly in the production of chargeable profits, deduction is only allowed for the portion of expenditure that is relevant to the production of such profits; and

(c) to provide that tax deduction for the specified IPRs is to be spread over five succeeding years on a straight-line basis commencing from the year of purchase; where a specified IPR, being a copyright or registered design, reaches the end of its maximum period of protection within the five-year deduction period, the deduction is to be spread in equal amounts over the number of years during which the protection of the specified IPR subsists.

Patent Rights and Rights to any Know-how

5. Given that the nature of patent rights and rights to any know-how is similar to the specified IPRs, the Administration takes the opportunity to review the relevant provisions of the current tax deduction. The Bill includes the following major proposals -

(a) to remove the "use in Hong Kong" condition currently applicable to the tax deduction for patent rights and rights to any know-how as no such requirement is imposed on other deductible capital assets under the IRO *(clause 5(1));*

(b) in line with the Government's policy of not taxing capital gains, to cap the sales proceeds for patent rights and rights to any know-how to be brought to tax at deductions previously allowed *(clause 5(5))*; and

(c) to spell out the arrangement that legal expenses and valuation fees incurred in connection with the purchase of patent rights and rights to any know-how are deductible provided that such expenditure is not deductible under any other provisions of the IRO *(clause 5(2))*.

6. The above proposed arrangements will also be applicable to the specified IPRs, as provided under clause 6 of the Bill.

Anti-avoidance Provisions

7. The Bill proposes to add the following new provisions to guard against possible tax avoidance -

(a) proposed new section 16EC(2) states that deductions will not be allowed for patent rights, rights to any know-how or the specified IPRs purchased wholly or partly from an associate; the definition of "associate" is contained in proposed new section 16EC(8);

(b) proposed new section 16EC(4) to (7) provides that deduction will not be allowed for the purchase of these rights under "sale and licence back" and "leveraged licensing" arrangements with an escape provision so that normal business activities would not be affected;

(c) proposed new sections 16E(8) and 16EA(9) empower the Commissioner of Inland Revenue (CIR) to determine, where the circumstances so warrant, the true market value for any purchase or sale of these rights in respect of which a tax deduction is claimed. The deduction allowable should be restricted to the true market price so determined. Where these rights are purchased or sold together or with any other assets for a single consideration, proposed new sections 16E(7) and 16EA(8) confer power to the CIR to allocate a consideration for each individual asset as purchased or sold having regard to all the circumstances of the transaction; and

(d) proposed new section 16EC(1) provides that a deduction will not be allowed if a specified IPR has been in use by a taxpayer under a licence before the proposed scheme commences operation, and the taxpayer terminates the licence before its expiry and purchases the specified IPRs at unreasonable consideration.

8. The Bill, upon enactment, will come into operation upon its gazettal.

Discussion at the Panel of Financial Affairs

9. On 1 November 2010, the Administration briefed the Panel on the legislative proposals. Panel members did not raise objection to the proposal. The major concerns expressed by members and the Administration's responses are summarized in the ensuing paragraphs.

10. On a member's concern about the practical benefits the proposed tax deduction measure would bring to enterprises, the Administration advised that research and development expenditure incurred for the creation of IPRs was currently tax-deductible under the IRO. On the other hand, businesses which acquired IPRs instead of developing these intangible assets on their own would not enjoy tax deduction because the related purchase cost was a capital expenditure which was not generally tax-deductible. Nevertheless, exception had been provided for, among others, capital expenditure on one-off acquisition of patent rights and rights to know-how. The legislative proposal would extend the existing scope of tax deduction to include capital expenditure incurred on the acquisition of the three specified IPRs.

11. A member expressed concern about possible abuse of the tax deduction provision. He considered that it might be difficult for the Inland Revenue Department (IRD) to judge whether the acquisition of an IPR was for business or for tax avoidance purpose. The member was also concerned that while IPRs purchased from an associated party would not be tax-deductible, enforcement could be difficult, especially when the associated party was an overseas company where its identity could not be easily verified.

12. The Administration advised that a number of measures would be in place. Firstly, transactions between associated parties would be excluded and taxpayers were required to declare in their tax returns any transactions that had involved associated parties. Besides, the tax deduction would be spread over five succeeding years, which would ensure that the relevant IPR was in fact used for the generation of chargeable profits over a period of time during which

the possible tax abuse could be monitored. Furthermore, relevant supporting documents might be required to be submitted to prove that the IPR was used for profit generation purposes. In addition, IRD would arrange random check and conduct field audits to investigate any further suspected anomalies.

13. Some members raised queries on the tax deduction period and related arrangements. The members were particularly concerned that taxpayers might not receive the full benefit if the tax deduction was to be spread over five years on a straight-line basis, as proposed.

14. The Administration explained that when considering a deduction claim, IRD would assess the nature of the taxpayer's business and how such expenditure incurred on acquiring the IPRs were connected with taxpayer's profit making activities. While the tax deduction would be spread out evenly over five succeeding years, IRD might allow the tax deduction be spread over a shorter period for IPs with a lifespan less than five years. Under the existing law, any expenses incurred from a commercial activity might be tax-deductible if it could be proved to be connected with the generation of taxable income, irrespective of whether or not actual profit was generated. The same principle would apply to capital expenditure on IPR procurement in the current proposal.

15. A member suggested that since the value of IPRs was difficult to assess, it might be advisable to adopt a more conservative approach in the initial stage by allowing tax deduction for only half or a certain proportion of the expenditure on the acquisition of the specified IPRs. The Administration advised that references had been drawn from overseas tax jurisdictions, many of which allowed full deduction of capital expenditure on IPRs to be spread over a few years.

Relevant papers

16. The relevant papers are available at the following links:

The Bill
http://www.legco.gov.hk/yr10-11/english/bills/b201102251.pdf

The Legislative Council Brief issued by the Financial Services and the Treasury Bureau on Inland Revenue (Amendment) (No. 2) Bill 2011
http://www.legco.gov.hk/yr10-11/english/bills/brief/b24_brf.pdf

The Legal Service Division Report on Inland Revenue (Amendment) (No. 2) Bill 2011
http://www.legco.gov.hk/yr10-11/english/hc/papers/hc0311ls-37-e.pdf

The Legal Service Division further Report on Inland Revenue (Amendment) (No. 2) Bill 2011
http://www.legco.gov.hk/yr10-11/english/hc/papers/hc0318ls-42-e.pdf

Minutes of meeting of Panel on Financial Affairs on 1 November 2010 (paragraph 48 to 57)
http://www.legco.gov.hk/yr10-11/english/panels/fa/minutes/fa20101101.pdf

Background brief on proposed profits tax deduction for capital expenditure on intellectual property rights prepared by the Legislative Council Secretariat
http://www.legco.gov.hk/yr10-11/english/panels/fa/papers/fa1101cb1-216-e.pdf

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