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10 June 2011

Ms Anita SIT
Clerk to Bills Committee
Legislative Council Secretariat
Legislative Council Building
8 Jackson Road, Central
Hong Kong
(Fax: 2121 0420)

Dear Ms SIT,

Inland Revenue (Amendment) (No. 2) Bill 2011

As foreshadowed in our letters dated 31 May 2011 and 1 June 2011, we are pleased to provide below the information requested by Members at the meetings held on 21 April 2011 and 28 May 2011 and the second batch of the Administration's responses to deputations' submissions.

The Administration's responses to deputations' submissions

2. As foreshadowed in our letter of 1 June 2011, we now provide the second batch of the Administration's responses to deputations' submissions at **Annex A**, which covers mainly views/comments on the proposed anti-avoidance provisions in the Bill.

To provide a comparison of the taxation arrangements proposed in the Bill with those of comparable jurisdictions, including relevant arrangements in the Mainland where appropriate

3. Our letter of 31 May 2011 has provided, among others, a table (in English only) comparing the taxation arrangements proposed in the Inland Revenue (Amendment) (No. 2) Bill 2011 ("the Bill") with those of comparable jurisdictions, namely Australia, Canada, Singapore and the United Kingdom ("UK"). The relevant arrangements in the Mainland China have also been set out in the said table at the request of Members. Further to that, we have now compiled another table (in English only) at **Annex B** which compares the anti-avoidance provisions proposed in the Bill with those of the above-named jurisdictions.

4. Similar to other tax deduction items, tax deduction for capital expenditure on the purchase of intellectual property rights ("IPRs") is prone to abuse. Hence, we propose to put in place some commonly-used measures to guard against possible tax avoidance. As a measure to combat price manipulation, we propose to empower the Commissioner of Inland Revenue to determine the true market price for any sale or purchase transactions of the IPRs. The proposed tax deduction allowable should be restricted to the true market price so adjusted. Indeed, it is noted that the tax authorities of comparable jurisdictions are all empowered to determine the true market value of the IPRs for tax deduction purpose.

5. Another essential anti-avoidance measure is that the proposed tax deduction would not be allowed for the specified IPRs purchased wholly or partly from an associated party. This is in line with a similar provision for the tax deduction arrangement for patent rights and rights to any know-how in the existing section 16E of the Inland Revenue Ordinance ("IRO"). According to past experience, associated companies could easily manipulate the transaction price of the IPRs and arrange transfer of deductible IPRs among group members for tax avoidance purpose. While some comparable jurisdictions allow tax deduction for IPRs transferred among associates, it should be noted that there is little incentive for the associated companies to make abusive use of the tax deduction in those jurisdictions as such jurisdictions levy capital gains tax and the full proceeds arising from the sale of the IPRs would be brought to tax.

6. Regarding the requirement on where the IPRs are used for production of chargeable profits, our proposal of allowing taxpayers to use the IPRs outside Hong Kong by the taxpayers themselves for

production of profits chargeable to tax in Hong Kong is more relaxed than Singapore which requires that the IPRs must be used in Singapore. Our proposal is also in line with the spirit of relevant arrangements in comparable jurisdictions like Canada and UK in the sense that the IPRs could be used overseas as long as they are used for producing chargeable profits in the resident jurisdictions.

To consider the need to standardise the definitions of "associate" among different pieces of legislation administered by the Inland Revenue Department ("IRD")

7. Among the seven pieces of legislation administered by IRD, there are eight provisions in the IRO and one provision in the Betting Duty Ordinance ("BDO") which carry definitions of "associate". By and large, the eight definitions of "associate" in the existing sections 9A, 14A, 16, 16E, 20AA, 20AE, 21A and 39E of the IRO are similar. They are embodied into different specific anti-avoidance provisions of the IRO. As each specific anti-avoidance provision targets at different tax avoidance arrangements in different context, if circumstances so warrant, the definition of "associate" may need to be adjusted suitably in order to be more focused and effective in preventing the targeted tax avoidance arrangement. The definition of "associate" in the BDO is used specifically for the betting duty regime and is therefore not comparable to the definitions of "associate" in the IRO.

Yours sincerely,

(Miss Fiona CHAU)
for Secretary for Financial Services and the Treasury

c.c. Commissioner of Inland Revenue (Attn: Mr Wong Kuen-fai)
Department of Justice (Attn: Miss Betty Cheung)

Annex A

Inland Revenue (Amendment) (No. 2) Bill 2011 ("the Bill")
The Administration's Responses to Submissions from Deputations
(Part II)

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
Anti-avoidance Provisions			
1.	The proposed sections 16E(8) and 16EA(9) which empower the Commissioner of Inland Revenue ("the Commissioner") to determine the true market value of intellectual property right ("IPR") transactions should be deleted. There is no need to provide the Commissioner with such power as the general anti-avoidance provision in section 61A of the Inland Revenue Ordinance ("IRO") can be invoked to deal with cases where IPR transactions between unassociated entities are motivated by tax avoidance.	HKICPA	To combat price manipulation, the Commissioner should be empowered to determine the true market price for any sale or purchase transactions of the IPRs. The tax deduction allowable should be restricted to the true market price so adjusted. Indeed, it is noted that the tax authorities of comparable jurisdictions are all empowered to determine for tax deduction purpose the true market value of the IPRs.
2.	For the purpose of determining the true market value of the IPRs, the Administration should establish an acceptable valuation mechanism in order to enhance transparency and avoid disputes.	HKSMEA	In claiming the proposed tax deduction, taxpayers will not be required to file the valuation reports on the IPRs concerned together with their tax returns. However, when making tax assessments, the Inland Revenue Department ("IRD") may, as it deems necessary, request taxpayers to provide documentary proofs such as valuation reports to substantiate the purchase prices of the IPRs concerned. For warranted cases, IRD may also seek advice from independent

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
			professional valuating organisations on the true market value of the IPRs concerned.
3.	The proposed section 16EC(1) (i.e. an anti-avoidance measure to disallow tax deduction for a taxpayer who has been using a specified IPR under a licence before the commencement date of the Bill and purchased the same IPR on or after the commencement date of the Bill but before the expiry of the licensing agreement with an unreasonable consideration) should be removed. The existing section 61A of the IRO or the proposed section 16EA(9) which provides for the determination of true market value could address such potential abuses.	HKICPA JLCT	The proposed section 16EC(1) is a transitional anti-avoidance provision which disallows the granting of the proposed tax deduction for specified IPRs to a taxpayer who, on or after the commencement date of the Bill, has purchased a specified IPR which he/she has been using under a licence before the commencement date of the Bill if - (a) the expiry date of the licence fell on or after the commencement date of the Bill; (b) the licence was terminated before that expiry date; and (c) the Commissioner is of the opinion that, having regard to the early termination of the licence, the consideration for the purchase is not reasonable consideration in the circumstances of the case. This transitional anti-avoidance provision aims to prevent the licensor and the licensee of a specified IPR from abusing the proposed tax deduction by turning the licensing arrangement into a sale and purchase arrangement with an unreasonably "low" purchase consideration which may be bundled with an option to buy back the specified IPR on a later day. By doing so, the licensor would enjoy the benefits of turning the taxable income (i.e. the original royalties) into non-taxable capital receipt, whereas the licensee enjoys the benefit of accelerated deduction (5-year straight-line deduction vis-a-vis annual deduction over the whole licensing period). Nevertheless, this transitional anti-avoidance measure would not be applicable to a genuine transaction where the purchase price of a specified IPR is, in the view of the Commissioner, reasonable consideration for acquiring the proprietary interest of the specified IPR. Also, this transitional anti-avoidance measure would not be applicable to

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			taxpayers who have become licensees of the specified IPRs on or after the commencement date of the Bill and purchased the same specified IPRs before the expiry dates of the relevant licences. At the time when the taxpayers enter into licensing arrangements, they already have the option to enjoy the proposed tax deduction if they choose to purchase the proprietary interest of the specified IPRs. Hence, there is little, if not none, tax motive for the taxpayers to turn the licensing arrangements into sale and purchase arrangements before the expiry dates of the relevant licences.
4.	There should not be a blanket denial of tax deduction for IPR transactions between associates (the proposed section 16EC(2) refers). Exception should be given to transfer of IPRs from overseas company to Hong Kong associated company under the same group. IPR transactions arising from merger and acquisition ("M&A") should not be caught by the "associate" provision under the proposed section 16EC(2) or any other anti-avoidance provisions.	JLCT HKCMA PWC	Under the existing section 16E of the IRO, tax deduction for capital expenditure incurred on the purchase of patent rights and rights to any know-how is not allowed if the transactions are made between "associates". The above anti-avoidance measure has been put in place since 1992 as abusive use of the tax deduction by associated companies was found. Associated companies could easily manipulate the transaction price of the IPRs for tax avoidance purpose. Moreover, as the market value of the IPRs may appreciate and we now propose to cap the sales proceeds of the IPRs to be brought to tax at deductions previously allowed, there will be incentive for one member company of a group to transfer the IPRs to another member company for tax avoidance purposes. Accordingly, we consider it necessary to adopt the above anti-avoidance measure as we provide tax deduction for copyrights, registered designs and registered trade marks which are more commonly-used IPRs. While some comparable jurisdictions allow tax deduction for IPRs transferred among associates subject to the transfer pricing and market value deeming provisions, it should be noted that in those jurisdictions, there is little incentive for associates to make abusive use of the tax deduction as capital gains tax is levied and full proceeds arising from the sale of the IPRs will be brought to tax. Based on the neutrality principle of our tax regime, we do not see any solid grounds to make arbitrary differentiation between local group companies and

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
			multi-national group companies. As such, we would not provide exceptional tax deduction treatment for transfer of IPRs from overseas companies to Hong Kong associated companies under the same group. We also do not see any valid justifications to exclude IPR transactions under M&As from the anti-avoidance provision on "associates". For M&As where huge sums of money are at stake, the parties concerned will normally seek professional advice from lawyers and accountants in order to ensure that such transactions are tax-efficient, that is, to arrange separate agreement to purchase the IPRs before the parties become associates after M&As.
5.	A partner should not be regarded as being associated with a partnership.	HKICPA JLCT	Partners are included in the definition of "associate" in order to curb possible abuses given their association with common interest in their partnerships.
6.	The proposed section 16EC(4)(b) and/or the definition of "licence" under the proposed section 16EC(8) should be revised to the effect that IPRs owned by a taxpayer but used by other persons (e.g. the taxpayer's overseas sub-contractor) outside Hong Kong in processing trade would still be eligible for the proposed tax deduction. Indeed, it is doubtful if the proposed section 16EC(4)(b) is necessary given one of the tax deduction conditions that the IPR must be used for production of chargeable profits in Hong Kong (the proposed section 16EA(2) refers). Moreover, IRD can tackle tax avoidance by way of the general anti-avoidance measures provided	ACCA HKCMA HKICPA JLCT PWC	The purpose of the proposed section 16EC(4)(b) is to deny tax deduction for the IPRs which are used outside Hong Kong by a party other than the taxpayer for production of profits not chargeable to tax in Hong Kong. The policy intent of granting tax deduction for IPRs only when the IPRs are used for producing chargeable profits in Hong Kong has been made very clear by way of the existing section 16E(1) and the proposed section 16EA(2). In line with our policy intent, the proposed section 16EC(4)(b) serves to state beyond doubt that the IPRs used outside Hong Kong by another party would not be eligible for tax deduction in Hong Kong as such IPRs are not used for production of profits chargeable to tax in Hong Kong. Deleting the proposed section 16EC(4)(b) will create uncertainty which may lead to disputes over the locality of profits in cross-border manufacturing activities. Moreover, if we were to provide tax deduction for IPRs used outside Hong Kong by the taxpayers' associates on a rent-free basis for production of finished products which would be sold to the taxpayers at a price below normal price, we may be perceived by other tax jurisdictions as encouraging transfer pricing as the above arrangements could be regarded as

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
	under the existing sections 61 and 61A of the IRO.		"offsetting transactions".
7.	The Administration should clarify whether 50% tax deduction for the purchase cost of an IPR would be provided if the taxpayer is engaged in "contract processing" in the Mainland and uses the IPR in the Mainland manufacturing activities.	PWC	A Hong Kong enterprise engaging in "contract processing" in the Mainland is responsible for supplying all necessary raw materials and production equipment, including IPRs with protection (and registration as appropriate) in the Mainland, used in the production of the finished goods concerned. The "contract processing factory" of the Mainland is basically responsible for processing the raw materials according to the instructions and requirements of the Hong Kong enterprise. The finished products so produced belong to the Hong Kong enterprise. The Mainland authorities strictly require that the finished products under "contract processing" should all be exported and the finished products would be sold by the Hong Kong enterprise. Based on the "territorial source" and "tax symmetry" principles, we allow the Hong Kong enterprise engaging in "contract processing" to apportion its profits derived from the Mainland production activities on a 50:50 basis for assessment of Hong Kong profits tax. Accordingly, we allow 50% deduction of expenses incurred by the Hong Kong enterprise for production of the above assessable profits, including the capital expenditure incurred on the purchase of the above Mainland-protected IPRs.
Others			
8.	The Administration should clarify whether royalties (i.e. licence fees) derived from licensing IPRs for use outside Hong Kong are chargeable to tax in Hong Kong.	ACCA HKICPA PWC	Whether royalties derived from licensing arrangements are chargeable to tax in Hong Kong depend on the facts of each case. No single test is decisive. For illustration purpose, we have broadly classified the relevant cases into the following three categories - (a) If an IPR is created or developed by a taxpayer and is licensed by the taxpayer to another party for use outside Hong Kong, the royalties so derived will generally be regarded as Hong Kong sourced income and

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
			hence will be subject to Hong Kong tax. This is because the royalty income is primarily generated by the taxpayer using his wits and labour to create or develop the IPR in Hong Kong. The expenses incurred in creating or developing the IPR will be deductible under the existing section 16B of the IRO if such expenses are related to research and development. (b) If a taxpayer has purchased the proprietary interest of an IPR and licenses that IPR to another party for use outside Hong Kong, the royalties so derived will generally be regarded as non-Hong Kong sourced income and hence will not be subject to Hong Kong tax. Accordingly, no deduction will be allowed for the capital expenditure incurred on the purchase of the IPR. (c) If a taxpayer has only obtained a licence to use an IPR from its owner (i.e. the taxpayer has not obtained the proprietary interest of the IPR) and then sub-license the IPR to another party for use outside Hong Kong, IRD may, in ascertaining whether the royalties so derived are Hong Kong sourced income, take the place of acquisition and granting of licence for use of the IPR as the source of income. As such, if the taxpayer has acquired and granted in Hong Kong the licence for use of the IPR, the royalties derived from licensing the IPR for use outside Hong Kong will be regarded as derived from Hong Kong and subject to Hong Kong tax. As the taxpayer has not acquired the proprietary interest of the IPR, he/she is not eligible to obtain the tax deduction as proposed in the Bill. The licence fee incurred by the taxpayer will be deductible if it satisfies the conditions provided in the IRO. The above are some general examples for reference. In determining the source of income, IRD will take into account all the relevant facts of each case.

Abbreviations for Organisations

ACCA	Association of Chartered Certified Accountants
HKCMA	The Chinese Manufacturers' Association of Hong Kong
HKICPA	The Hong Kong Institute of Certified Public Accountants
HKSMEA	Hong Kong Small and Medium Enterprises Association
JLCT	The Joint Liaison Committee on Taxation
PWC	PricewaterhouseCoopers Ltd

Financial Services and the Treasury Bureau
June 2011

Tax Deduction for Capital Expenditure Incurred on the Purchase of Intellectual Property Rights (IPRs)
(Part II – Anti-avoidance Provisions)

		Hong Kong's proposal	Australia	Canada	Mainland China	Singapore	United Kingdom
(a)	**Whether the relevant tax authority is empowered to determine the true market value of the IPRs**	Yes.	Yes.	Yes.	Could not ascertain the relevant details.	Yes.	Yes.
(b)	**Whether tax deduction would be allowed if the IPRs are purchased from associates**	No.	IPR transactions between associates are accepted for tax deduction purpose but subject to the transfer pricing and market value deeming provisions. It should be noted that Australia levies capital gains tax and full proceeds arising from the sale of IPRs will be brought to tax.	In general, tax deduction is allowed for IPR transactions between associates provided that the IPRs are purchased at market value. It should be noted that Canada levies capital gains tax and full proceeds arising from the sale of IPRs will be brought to tax.	Could not ascertain the relevant details.	Writing-down allowance (WDA) is not allowed if the related party from whom the IPRs are acquired had claimed a deduction on expenditure incurred on the creation of the IPRs and the proceeds from the sale of those IPRs are not chargeable to tax. It should be noted that WDA is provided for	Could not ascertain the relevant details.

		Hong Kong's proposal	Australia	Canada	Mainland China	Singapore	United Kingdom
						capital expenditure incurred in acquiring the IPRs from 1 November 2003 to 31 October 2013.	
(c)	**Requirement on where the IPRs are used for production of chargeable profits**	The IPRs can be used in or outside Hong Kong. If used outside Hong Kong, the IPRs must be used by the taxpayer himself/herself.	Tax deduction is not allowed for an IPR if an end-user is a lessee of the IPR and the IPR is to be used wholly or principally outside Australia by a non-resident.	The IPRs must produce income which is not exempt from tax in Canada.	Could not ascertain the relevant details.	The IPRs must be used in Singapore.	The IPRs must be used by a company which is within the charge of corporate tax of the United Kingdom.
(d)	**Whether tax deduction would be granted for IPRs involved in sale and licensing back or leverage licensing arrangements**	No, unless certain conditions [1] are fulfilled.	Whether tax deduction would be allowed depends on how the arrangement is structured and the intention and purpose of structuring the sale and licence back	Dealt with by general anti-avoidance provision.	Could not ascertain the relevant details.	No tax deduction is allowed unless the taxpayer is engaged in IPR licensing business.	No tax deduction is allowed if the IPRs are involved in sale and licensing back arrangement.

[1] Tax deduction for capital expenditure incurred on the purchase of IPRs would be granted to sale and licensing back transaction if –
(a) the end-user of the IPR purchased the IPR from the supplier on or after the commencement date of the Bill;
(b) at any time before the purchase of the IPR by the taxpayer, the end-user has not been granted with tax deduction for the capital expenditure incurred by the end-user on the purchase of the IPR; and
(c) the amount paid by the taxpayer in purchasing the IPR from the end-user is no more than the amount paid by the end-user to the supplier.

		Hong Kong's proposal	Australia	Canada	Mainland China	Singapore	United Kingdom
			arrangement. No tax deduction is allowed for IPRs involved in leverage licensing arrangement.				

Important Note

The above information is for reference only. While every effort is made to ensure the accuracy of the above information, the Government of the Hong Kong Special Administrative Region cannot guarantee this to be so and will not be held liable for any reliance placed on the same.

Financial Services and the Treasury Bureau
June 2011