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JOINT LIAISON COMMITTEE ON TAXATION

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THE HONG KONG GENERAL CHAMBER OF COMMERCE
HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
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5 July 2011

Mr. Honorable Paul Chan
Chairman
Inland Revenue (Amendment) (No.2) Bill 2011
Legislative Council Building
8 Jackson Road
Central Hong Kong

Dear Honorable Paul Chan,

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

In response your request we would like to provide you our views on the administration's replies and explanations to the deputations made by various professional bodies on the Bill.

The most controversial issue is the supposedly anti-avoidance provision contained in section 16EC (4) (b) of the Bill.

Rejecting the administration's "territorial source" and "tax symmetry" arguments

The JLCT's view is that a Hong Kong IP owner allowing its contract manufacturer to use the relevant IPs outside Hong Kong for the manufacturing of goods ordered by the owner is generally for the purpose of the owner generating its own profits derived from the trading of goods supplied by the contract manufacturer. The JLCT does not agree with the administration's view that under such a contract manufacturing arrangement, the relevant IPs are not so used, but are instead only used to generate the offshore manufacturing profits of the contract manufacturer. In fact, according to the reasoning given by the administration justifying the denial under these two arguments, the owner would still be denied the tax deduction even if it engages a contractor manufacturer located in Hong Kong. This, we believe, cannot be right. Therefore, the JLCT is of the view that so long as the trading profits of the owner are chargeable to tax in Hong Kong, there is no policy consideration justifying the denial of the tax deduction for the purchase costs incurred by the owner on the relevant IPs.

If the Bills Committee agrees with this view, it should say so to the administration (i.e., rejecting its "territorial source" and "tax symmetry" justifications for the enactment of section 16EC (4)(b)), and ask the administration to reconsider the issue from a tax policy perspective.

Enacting section 16EC (4)(b) would substantially dilute the effect of removing the "use in Hong Kong" requirement

The JLCT considers that enacting section 16EC (4)(b) would substantially dilute the effect of removing the "use in Hong Kong" requirement for granting the tax deduction (i.e., the tax deduction is now proposed to be granted so long as the relevant IPs are used in the production of profits which are chargeable to tax in Hong Kong, irrespective of the place of use of the relevant IPs). This is the case as under a typical supply-chain model, most goods of Hong Kong taxpayers are manufactured outside Hong Kong under a contract manufacturing arrangement. Situations where Hong Kong taxpayers themselves manufacture goods outside Hong Kong are rare, and the trend also indicates that typical contract processing arrangements of Hong Kong taxpayers in mainland China are declining.

No reasons from a tax policy perspective to deny the tax deduction – no "arm's length pricing issue" and "harmful tax competition" concern

The JLCT is of the view that there are no reasons from a tax policy perspective to deny the tax deduction to an owner who uses the relevant IPs outside Hong Kong under a contract manufacturing arrangement. Specifically, we do not consider there is the "arm's-length transfer pricing issue" or "harmful tax competition" concern, by way of Hong Kong granting the tax deduction to an owner of the relevant IPs under a contract manufacturing arrangement.

The JLCT considers that the administration's use of the "arm's-length transfer pricing issue" or "offsetting transactions" argument, as a justification for denying the tax deduction and enacting section 16EC (4)(b) misguided.

What we are concerned here is the enactment of a domestic tax law in Hong Kong, and what we do with our domestic tax law cannot generally affect the taxing rights of the overseas tax justifications under the transfer pricing principles. The overseas tax jurisdictions can do what they consider appropriate under the said principles, regardless of what do with our domestic tax law and practice in Hong Kong.

Therefore, whether a contract manufacturing arrangement could be viewed by an overseas tax jurisdiction as constituting "offsetting transactions" should not be of any significant concern to the IRD in its administration of the domestic tax law. As a corollary, the overseas tax jurisdictions would not be concerned about whether we treat the arrangement under our domestic tax law as constituting "offsetting transactions" or not. Different jurisdictions can take different views on the arrangement under their respective domestic tax laws. The important thing is that whatever views one takes on the arrangement would not affect the taxing rights of the other.

Bearing the above in mind, the JLCT has reviewed the basis of the administration's "arm's-length transfer pricing issue" or "offsetting transactions" justification for denying the tax deduction and enacting section 16EC (4)(b). The justification is apparently premised on the notion that based on the transfer pricing principles advocated by the Organization for Economic Cooperation and Development (OECD), the Hong Kong owner could be deemed by an overseas tax jurisdiction to have charged the contract manufacturer royalties for the use of the relevant IPs in the latter's manufacturing of goods ordered by the former. And such royalties are then offset against the price of goods paid by the owner to the contract

manufacturer. In this regard, the JLCT is of the view that a "royalty-free" contract manufacturing arrangement should not constitute such "offsetting transactions". This view is based on the fact that there are no two independent transactional income or expenditure flows that are offset against each other, a "royalty-free" contract manufacturing arrangement being the terms of a single normal commercial transaction. In fact, it can also be said that the beneficial user of the relevant IPs outside Hong Kong is the Hong Kong owner rather than the contract manufacturer, as the latter is only using the relevant IPs solely for the production of goods ordered by the former, instead of the contract manufacturer being granted a general right to freely exploit the relevant IPs for its own benefit. As such, there is in fact no basis or reason for the owner to charge royalties to the contract manufacturer. It also appears to us that it does not also make much sense to notionally gross-up the transaction as constituting the owner charging the contract manufacturer royalties - only for the same to be exactly offset against the price of goods paid by the owner to the contract manufacturer. Such a notional offset is, in our view, quite fictional. Our view in this regard appears to be borne out by the fact that from their many years of experience either as taxpayers of multi-national corporate groups or practitioners of international taxation, representatives of our constituent member organizations have not encountered any instances of overseas tax jurisdictions taking such a stance.

In any case, the JLCT takes the view that even if an overseas tax jurisdiction could regard a " royalty-free" contract manufacturing arrangement as constituting "offsetting transactions", this should not affect how we enact the domestic law contained in the bill. In this regard, one has to bear in mind that the domestic tax law of Hong Kong does not prescribe us to follow the OECD transfer pricing principles (let alone the controversy as to the applicability of the said principles to a contract manufacturing arrangement as constituting "offsetting transactions"). Rather, there are in fact doubts as to whether the domestic tax law of Hong Kong can allow the IRD to treat a contract manufacturing arrangement as constituting "offsetting transactions" by imputing notional royalty income on the owner. In light of the aforesaid, the JLCT takes the view that how we treat a contract manufacturing arrangement for Hong Kong tax purposes should entirely be the prerogative of Hong Kong - so long as it does not undermine the taxing rights of the overseas tax jurisdictions to make transfer pricing adjustments, or render Hong Kong liable to be accused of engaging in harmful tax competition.

As we pointed out above, how we treat the arrangement for Hong Kong tax purposes would not affect the power of an overseas tax jurisdiction to make any transfer pricing adjustments that it may consider appropriate. Specifically, if an overseas tax jurisdiction regards a contract manufacturing arrangement as constituting "offsetting transactions", it can deem the Hong Kong owner to have charged royalties and tax the Hong Kong owner accordingly - regardless of the Hong Kong tax treatment for the arrangement.

Furthermore, contrary to the administration's view, and as we pointed out by way of an illustrative example in our submission to the Bills Committee dated 25 May 2011, whether a Hong Kong owner charges royalties to its overseas contract manufacturer or not, would not generally affect the profit level of the contract manufacturer in that overseas tax jurisdiction. Therefore, the Hong Kong tax treatment for the arrangement would not render Hong Kong being accused of engaging in harmful tax competition - in the sense of eroding the tax base of an overseas jurisdiction.

Hong Kong can and should treat a "royalty-free" contract manufacturing arrangement as not constituting "offsetting transactions" for Hong Kong tax purposes

Therefore, for Hong Kong tax purposes, Hong Kong can and should respect the stated terms of the arrangement, i.e., a royalty-free one and then accept that the owner is using the relevant IPs to generate its profits derived from the trading of goods supplied by the contract manufacturer. As such, to the extent the trading profits of the owner are chargeable to tax in Hong Kong, tax deductions for the purchase costs of the relevant IPs incurred by the owner should be granted accordingly.

In the unlikely case that an overseas tax jurisdiction with which Hong Kong has a Comprehensive Double Taxation Agreement (CDTA) treats the arrangement as constituting "offsetting transactions" and deems the Hong Kong owner to have charged royalties, which are offset by the price of goods paid by the owner to the contract manufacturer, the IRD can then do the following. It can either agree or disagree with the transfer pricing adjustment made by the other overseas tax jurisdiction and then, where necessary, make a corresponding adjustment to avoid double taxation as appropriate under the terms of the relevant CDTA. However, given the fact that no representatives of our constituent member organizations have ever experienced any overseas tax jurisdiction taking such a stance in practice, the issue seems to be academic only.

In any case, given the highly controversial nature of the matter and the fact that to our knowledge no OECD guidelines issued so far have explicitly stated that a "royalty-free" contract manufacturing arrangement constitutes "offsetting transactions", the IRD should probably disagree with any such transfer pricing adjustment made by the overseas tax jurisdiction. As such, the IRD can refuse to make a corresponding adjustment in Hong Kong - as it does not agree that there is deemed royalty income which has suffered both overseas and Hong Kong taxes. In any case, the Hong Kong owner would very unlikely make such a claim for a corresponding adjustment in Hong Kong, This is because in the event the IRD agrees with the transfer pricing adjustment made by the overseas tax jurisdiction, the corresponding adjustment to be made in Hong Kong would probably involve the owner being denied the tax deductions for the purchase costs of the relevant IPs previously claimed, the relevant IPs now being regarded as generating offshore royalty income in Hong Kong. As such, the owner would lose out even though its deductible purchase price of goods paid to the contract manufacturer may then be upwardly adjusted by the amount of the deemed royalties now regarded as non-taxable offshore income in Hong Kong.

In the case the aforesaid transfer pricing adjustment is made by an overseas tax jurisdiction with which Hong Kong does not have a CDTA, the IRD is not obliged to entertain any request for a corresponding adjustment in Hong Kong.

Other issues of the proposed legislation as a result of the administration's enactment of section 16EC (4)(b) and taking the "territorial source" and "tax symmetry" arguments

Please see the clarification we sought from the IRD now enclosed as Appendix I (IRD's reply pending).

Tax deduction for design and trademarks, the registration of which is pending
Please see the clarification we sought from the IRD now enclosed as Appendix 1 (IRD's reply pending).

What the Bills Committee can do if the administration maintains its current stance on the enactment of section 16EC (4)(b)?

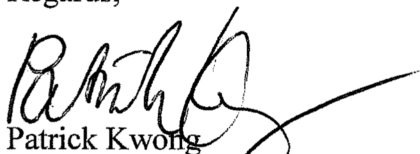
If the above approach to the resolution of the issue is not acceptable to the administration, the JLCT would suggest the Bills Committee request the administration to delete section 16EC (4)(b) in the proposed legislation. This is on the basis that according to the administration's reasoning for denying the tax deduction, section 16EC (4)(b) is not necessary – as the denial can already be made under sections16E(2) and 16EA (7) on the general principle that the expenditure was not then incurred in the production of profits chargeable to tax in Hong Kong.

The JLCT does not agree with the administration's justification for enacting section 16EC (4)(b) as serving to put the tax denial beyond doubt. We believe that the general principle of legislation is that it is only when a specific mischief is identified, a specific provision of the legislation should then be enacted to effectively deal with the mischief so identified. In this case, section 16EC (4)(b) is modeled from section 39E(1)(b)(i), the latter only being enacted in 1986 and subsequently amended in 1992 to specifically target against certain leveraged leasing arrangements for plant or machinery. In this case, the administration has not identified leveraged licensing of the relevant IPs as the mischief, and the tax denial for the reasons given by the administration can already be effectively achieved by way of the provisions contained in sections 16E(2) and 16EA(7) of the bill. Therefore, the JLCT considers that there is no reason to give the IRD any extra statutory tools to make the tax denial.

If there is any doubt that the tax denial can be made under the general principle under sections 16E (2) and 16EA (7), it is probably more because of the administration's doubts about its own reasoning for the denial than anything else.

Furthermore, like the section 39E issue, doubts would still persist even with the enactment of section 16EC (4)(b). For example, doubts in this regard would include whether a contract manufacturer using the relevant IPs solely for the purposes of manufacturing of goods ordered by the owner constitutes a license term or not within the meaning of section16EC (4)(b), or whether the principal user of the relevant IPs outside Hong Kong is in fact the Hong Kong IP owner rather than the contract manufacturer, given the nature of the arrangement.

Regards,



Patrick Kwong
Chairman - JLCT's Sub-committee on Inland Revenue (Amendment) (No. 2) Bill 2011

Appendix I

Dear Mr.Wong
Deputy Commissioner of Inland Revenue,

The Hon Paul Chan, Chairman of the Bills Committee on the Inland Revenue (Amendment) (No.2) Bill 2011 has asked the JLCT to give him its views on the replies or explanations given by the administration in response to the deputations made by the various professional bodies.

For the purposes of the JLCT giving its views to the Hon Paul Chan, we would like to seek your clarifications on the following issues.

(1) **Tax deductions for designs and trademarks, the registration of which is pending**

The JLCT has made a submission on this point that specific provisions need to be added to the proposed legislation so as to retrospectively grant the tax deductions once the registration of the relevant IPs is obtained.

In response, the administration apparently considers that no specific provisions are needed and the matter can be dealt with by way of the Inland Revenue Department (IRD) adopting a liberal approach in considering tax deductions for the relevant IPs which are undergoing a registration process. Under this liberal approach, the administration has indicated that "tax deduction would be provided to taxpayers for their capital expenditure incurred on the purchase of those IPRs as long as (a) the IPRs purchased have already been registered by the previous owners of the IPRs; and (b) the taxpayers have already submitted application for registering the IPRs under their names."

It appears to us that what the administration has in mind only relates to the scenario where a design or trademark has already been successfully registered by the vendor and the purchaser, upon acquiring the relevant design or trademark, is in the process of registering the design or trademark so acquired in his own name.

The JLCT would however like to clarify a taxpayer's eligibility to claim the tax deductions in the following two scenarios. The first scenario is that of a vendor who is in the process of applying registration of a design or trademark but the registration has not yet been successfully obtained. The vendor, while the application for registration is being processed, transfers the design or trademark to a purchaser, who then applies to register the same in his own name. In this situation, would the purchaser be granted the tax deductions retrospectively upon him successfully obtaining the registration of the design or trademark?

The second scenario is that of a vendor who transfers an unregistered design or trademark to a purchaser. Immediately upon acquiring the unregistered design or trademark, the purchaser then applies for the registration of the design or trademark. In this situation, would the purchaser be granted the tax deductions retrospectively upon him successfully obtaining the registration of the design or trademark?

(2) **Would an owner be entitled to claim the tax deductions where the relevant IPs are used under a contract manufacturing arrangement at no cost in Hong Kong?**

It is the administration's position that "where a Hong Kong enterprise allows its overseas sub-contractor to use outside Hong Kong an IPR owned by the Hong Kong enterprise at no cost, since the overseas production activities by the sub-contractor are generally not attributed to the Hong Kong enterprise, according to the "territorial source" principle, the Inland Revenue Department of Hong Kong would not charge profits tax on the sub-contractor or the Hong Kong enterprise for the overseas production activities. Accordingly, based on the "tax symmetry" principle, the Hong Kong enterprises would not be granted tax deduction for IPRs solely used in overseas production activities not carried out by the Hong Kong enterprises."

Our question is: whether, in the case the contract manufacturer is located in Hong Kong, the relevant IP owner would still be denied the tax deductions on the basis that the relevant IPs are only used to generate the manufacturing profits of the contract manufacturer which are not attributable to the owner?

(3) **Use of a foreign registered trademark by a taxpayer both for his contract manufacturer arrangement and for his own sales outside Hong Kong**

It appears to be the administration's view that a foreign registered trademark used by a Hong Kong taxpayer so as to enable his contract manufacturer (a separate legal entity) to manufacture goods ordered by him outside Hong Kong would potentially fall foul of section 16EC(4)(b). This is because the trademark would potentially be considered to be used wholly or principally outside Hong Kong under a license term by a person other than the taxpayer.

Our question is: what would be the situation if the taxpayer, apart from using the trademark under a contract manufacturing arrangement, also makes significant sales of the marked goods to the overseas jurisdiction where his contract manufacturer is located? In this situation, the trademark can then be said to be both used by the contract manufacturer as well as the taxpayer himself (by virtue of him directly making sales in that overseas jurisdiction). If this is the case, will there be any guidelines to be set by the IRD to determine whether the trademark in this sort of situation is to be principally used by the contract manufacturer for the purposes of section 16EC (4)(b).

Furthermore, even if it is determined that the trademark is not wholly or principally used by the contract manufacturer outside Hong Kong and therefore not falling foul of section 16EC(4)(b), the tax deductions would still not be granted to the taxpayer in full. This appears to be the case as the administration considers that where a trademark is used outside Hong Kong under a contract manufacturing arrangement, the relevant IPs are not used to generate the trading profits of the owner (assuming such trading profits are fully chargeable to tax in Hong Kong), but only the manufacturing profits of the contract manufacturer outside Hong Kong. As such, it could be said that the trademark is used partly to produce non-chargeable profits in Hong Kong (attributable to the trademark being used in the contract manufacturing arrangement) and partly used to produce chargeable profits in Hong Kong (attributable to the overseas sales activities of the taxpayer himself)? Therefore, the tax deductions have to be scaled down under sections 16E(2) or 16EA (7).

The JLCT would like the IRD to comment on the above observation and indicate, if applicable, the basis of making the scale down of the tax deductions in the scenario above.

Regards

Patrick Kwong
Chariman - JLCT's sub-committee on the Inland Revenue (Amendment) (No.2) Bill 2011
----- Forwarded by Patrick Kwong/Tax/FEA/ErnstYoung/HK on 06/29/2011 11:34 AM -----

Patrick Kwong/Tax/FEA/ErnstYoung/HK To kf_wong@ird.gov.hk

06/09/2011 02:28 PM

Dear Mr. Wong,

I would like to follow up on the question raised by Hon Regina Ip during the Bills Committee meeting in respect of the Inland Revenue (Amendment) (No. 2) Bill held on 28 May. The question asked related to whether a foreign registered trademark would be regarded as being used in the production of profits chargeable to tax in Hong Kong.

You indicated in the meeting that the use of a registered trademark is territorial in scope and therefore, for example, a US registered trademark could only be used in the US and not anywhere else. As such, if a taxpayer (e.g., a pure trader of the marked goods and all manufacturing of the goods by its contract manufacturers being carried out in Hong Kong) does not have sales operations in the US triggering the use of the US registered trademark, the relevant purchase costs attributable to the US trademark would not be tax deductible.

Admittedly, whether a foreign registered trademark is used in the production of profits chargeable to tax in Hong Kong is a matter of fact. However, taxpayers would typically like to register their marks in as many places as possible as a matter of legal protection of the marks, even though for the time being they may not have any sales operations in some of the places concerned.

My specific question is as follows. A Hong Kong taxpayer, for the purposes of its trading operations, acquires from a non-associate a trademark registered in 10 jurisdictions. However, for the relevant years when tax deductions for the purchase costs of the trademark are claimed, the taxpayer only has sales operations in 6 of the 10 jurisdictions concerned. The taxpayer's profits derived from the use of the trademark from its sales in the 6 jurisdictions are fully chargeable to tax in Hong Kong. The question is whether the purchase costs of the trademark attributable to the 4 jurisdictions where the taxpayer for the relevant years has no sales operations would then be disallowed.

As a matter of practice, we believe there is a case to grant tax deductions for the purchase costs of the trademark registered in the 10 jurisdictions concerned in full. This would be on the basis that the registration of the trademark in the 4 jurisdictions concerned could be regarded as being used in the production of profits chargeable to tax in Hong Kong in the sense that the registration in those 4 jurisdictions protects the actual sales operations of the taxpayer in the other 6 jurisdictions concerned. This is

particularly the case so long as there is no evidence that the purpose of the taxpayer to acquire the trademark in the 4 jurisdictions concerned is to derive non-chargeable profits in Hong Kong, e.g. by way of licensing the trademark in the 4 jurisdictions to produce non-taxable offshore royalty income. We hope you can clarify the Department's position in this sort of situation.

The JLCT would also welcome the Department's views on our submission made to the Bills Committee, in particular on the necessity of the proposed sections 16EC(1) and 16EC(4)(b) legislation.

Regards

Patrick