財 經 事 務 及 庫 務 局
(庫 務 科)

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FINANCIAL SERVICES AND THE TREASURY BUREAU
(The Treasury Branch)

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本函檔號 Our Ref. :
來函檔號 Your Ref. :

4 November 2011

Ms Anita SIT
Clerk to Bills Committee
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road, Central
Hong Kong
(Fax: 3529 2837)

Dear Ms SIT,

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

In relation to the written submission of 27 October 2011 from the Federation of Hong Kong Industries ("FHKI") to the Bills Committee and the issues arising from the meeting of the Bills Committee held on 4 August 2011, the Administration's consolidated responses are set out in the ensuing paragraphs.

Written submission from FHKI to the Bills Committee

Proposed section 16EC(4)(b) of the Bill

2. According to the proposed section 16EC(4)(b) of the Bill, if the intellectual property rights ("IPRs") purchased by the taxpayers are registered or protected at a place other than Hong Kong and the taxpayers have then provided (either at cost or at no cost) such IPRs for use by another party at that place, the taxpayers would not be eligible for the proposed tax deduction for capital expenditure incurred on the purchase of such IPRs. This is because such IPRs

are not used for the production of profits chargeable to tax in Hong Kong. However, the proposed section 16EC(4)(b) would not be applicable to taxpayers who have used by themselves the IPRs in cross-border activities for production of profits chargeable to tax in Hong Kong. These taxpayers would still be eligible for the proposed tax deduction. In view that the FHKI and the Bills Committee would like to have better understanding of the implementation of the proposed section 16EC(4)(b), we set out below for illustrative purpose some examples on the tax deduction arrangements for IPRs used in different cross-border activities.

(A) *A Hong Kong company, after acquiring the proprietary interest of a Hong Kong registered trade mark*[1]*, contracts a manufacturer in the Mainland to produce goods bearing the Hong Kong registered trade mark for sale in Hong Kong to produce profits chargeable to tax in Hong Kong.*

3. As the Hong Kong company has only purchased the Hong Kong registered trade mark and has not acquired the proprietary interest of that mark for the Mainland, it has no right to grant a licence to the Mainland manufacturer to use the relevant Mainland trade mark. In the above scenario, the Hong Kong company has not licensed the right to use the relevant trade mark to any person outside Hong Kong. Hence, section 16EC(4)(b) of the Bill is not applicable. Provided that other provisions of sections 16EA and 16EC are satisfied, the Hong Kong company is eligible for tax deduction in respect of the capital expenditure incurred on the purchase of the Hong Kong registered trade mark.

(B) *A Hong Kong company acquires the proprietary interest of a Hong Kong registered trade mark. The relevant mark has not been registered or used in the Mainland by anyone else. The Hong Kong company then registers the mark in the Mainland. For the purpose of contracting a manufacturer in the Mainland to produce goods bearing the Mainland registered trade mark, the Hong Kong company has licensed the right to use the Mainland registered trade mark to the Mainland manufacturer. The goods produced by the Mainland manufacturer are sold in Hong Kong by the Hong Kong company and produce profits chargeable to tax in Hong Kong.*

4. The Hong Kong company has only purchased the Hong Kong registered trade mark but not the Mainland registered trade mark. It has become the registered owner of the Mainland registered trade mark because it has subsequently registered the trade mark in the Mainland. The cost incurred is the Mainland registration fee only. The trade mark allowed to be used by the

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[1] The territorial scope of protection of a Hong Kong registered trade mark is solely restricted to Hong Kong.

Mainland manufacturer through licensing arrangement is the one registered in the Mainland by the Hong Kong company and not the Hong Kong registered trade mark purchased by the Hong Kong company in the first place. As such, section 16EC(4)(b) of the Bill is not applicable. Provided that other provisions of sections 16EA and 16EC are satisfied, the Hong Kong company is eligible for tax deduction in respect of the capital expenditure incurred on the purchase of the Hong Kong registered trade mark.

(C) *A Hong Kong company, after acquiring the proprietary interests of a trade mark registered both in Hong Kong and in the Mainland, contracts a manufacturer in the Mainland to produce goods bearing the trade mark by granting to the manufacturer a licence covering the right to use the Mainland registered trade mark. The goods produced by the Mainland manufacturer are then sold in Hong Kong and in the Mainland by the Hong Kong company and produce profits chargeable to tax in Hong Kong.*

5. As the Hong Kong registered trade mark purchased by the Hong Kong company is used by the company itself to produce profits chargeable to tax in Hong Kong, section 16EC(4)(b) of the Bill is not applicable. Provided that other provisions of sections 16EA and 16EC are satisfied, the Hong Kong company is eligible for tax deduction in respect of the capital expenditure incurred on the purchase of the Hong Kong registered trade mark.

6. Regarding the Mainland registered trade mark purchased by the Hong Kong company, different tax treatments should be adopted according to the uses of the registered trade mark. For the part used in production activities, since the Mainland registered trade mark is granted by the Hong Kong company to the Mainland manufacturer by means of a licence (either at cost or at no cost) for use in the latter's production activities, section 16EC(4)(b) of the Bill is applicable. The part of the capital expenditure incurred on the purchase of the Mainland registered trade mark for use in the production activities will not be allowed for tax deduction. However, for the part used in sales activities in the Mainland, as the Hong Kong company sells its own goods (the goods are sold either by the Hong Kong company itself or by a Mainland agent commissioned by the Hong Kong company) and the Mainland registered trade mark is not used by a person other than the Hong Kong company, section 16EC(4)(b) of the Bill is not applicable. Provided that other provisions of section 16EA and 16EC are satisfied, the Hong Kong company is eligible for tax deduction in respect of the capital expenditure incurred on the purchase of the part of the Mainland registered trade mark used in sales activities.

7. As demonstrated in the above examples, given the unique territorial nature of the registration system and protection of the IPRs, the tax deduction

proposed by the Bill is applicable to IPRs used by Hong Kong companies in cross-border activities.

8. Our policy intent is to allow tax deduction in respect of any IPRs used for the production of profits chargeable to tax in Hong Kong. Such policy intent has been clearly reflected in the existing section 16E(1) and the proposed section 16EA(2). The proposed section 16EC(4)(b) is in line with our policy intent. We consider the proposed section 16EC(4)(b) essential given the established taxation principles of "territorial source" and "tax symmetry" and the need to avoid tax loss. For the same reasons, we could not amend the proposed section 16EC(4)(b) in response to the Hon Audrey EU's proposal to include an exemption clause (i.e. if the relevant IPR is used outside Hong Kong by a person other than the taxpayer for production of goods to be sold solely to the taxpayer, the proposed section 16EC(4)(b) will not be applicable).

9. Separately, the written submission from FHKI touches on the licensing of IPRs (either at cost or at no cost) by a Hong Kong IPR owner to a trading company in Hong Kong or a manufacturing company in the Mainland. Regarding the taxation arrangements for IPRs used under licensing arrangements, our letters to the Bills Committee on 1 June 2011 and 10 June 2011 have already provided detailed explanation. The relevant information has now been extracted at Annex 1 for Members' easy reference.

Timing of deduction

10. FHKI has indicated in item 2 of its written submission that it may take some time for the relevant registration authorities to complete processing of taxpayers' applications for registering the assignments of registered trade marks or registered designs purchased by them and for registering themselves as the registered owners. Before becoming the registered owners, the taxpayers may not be able to use the registered trade marks or registered designs for production of profits chargeable to tax in Hong Kong. The taxpayers are therefore unable to fulfil the tax deduction requirements proposed by the Bill. We would like to hereby clarify that, for the purpose of granting tax deduction as proposed by the amended section 16E and the proposed new section 16EA of the Bill, the Inland Revenue Department ("IRD") has to ascertain that the taxpayers have fulfilled the following requirements -

(a) the taxpayers have purchased the IPRs covered by the Bill, and for the IPRs where registration systems are available (i.e. patents, trade marks or designs), the registrations of these IPRs concerned must be in force; and

(b) the IPRs mentioned in (a) above have been used by the taxpayers for production of profits chargeable to tax in Hong Kong.

11. The purpose of the registration requirement set out in paragraph 10(a) above is to specify the scope of patents, trade marks or designs that may be eligible for tax deduction. In other words, the Bill requires that the patents, trade marks or designs purchased by taxpayers must have already been registered.

12. For the purpose of ascertaining that the taxpayers have fulfilled the requirement of purchasing IPRs which have been registered as stated in paragraph 10(a) above, IRD would accept documentary evidence provided by the taxpayers to support that the IPRs purchased by them are registered ones. We understand from the Intellectual Property Department that in order to protect their right in the patents, registered trade marks or registered designs purchased, taxpayers would normally submit applications to the relevant registration authorities for registering the assignments of the relevant IPRs such that they would become the registered owners. If the taxpayers could demonstrate to IRD that they are applying for registering as the registered owners of the relevant patents, registered trade marks or registered designs, this would assist in clearly establishing that they have purchased the relevant IPRs. If the taxpayers' applications for registering the assignments of the relevant IPRs are rejected eventually, this will cause IRD to have reasonable doubt on whether the taxpayers have in fact purchased the patents, registered trade marks or registered designs concerned, and IRD would conduct further investigation as a result. Nevertheless, if the taxpayers are able to provide other documentary proof to the satisfaction of IRD that they have purchased the registered patents, registered trade marks or registered designs, IRD would not claw back the tax deduction previously provided to the taxpayers.

13. As regards the requirement of "use" set out in paragraph 10(b) above, we will implement the requirement taking into account the intangible nature of the IPRs - if taxpayers can prove to the satisfaction of IRD that they have carried out concrete steps in relation to the use of the IPRs for production of chargeable profits, IRD may accept that the taxpayers have fulfilled the requirement of "use" stipulated in the Bill. IRD would, having regard to the relevant facts of individual cases, determine if the taxpayers concerned have "used" the purchased IPRs for production of chargeable profits.

Anti-avoidance provision on purchase from associate

14. In our letter to the Bills Committee on 10 June 2011 and in the diagram tabled at the meeting of the Bills Committee held on 4 August 2011, we have already explained in detail the loopholes for tax abuse and the potential tax loss arising from IPR transactions between associates. As such, the anti-avoidance measures on "associates" are essential. According to the existing section 16B of the Inland Revenue Ordinance ("IRO"), enterprises which have

developed in-house IPRs can apply for tax deduction in relation to the relevant expenses on research and development.

Issues arising from the meeting of the Bills Committee on 4 August 2011

Proposed section 16EC(4)(b) of the Bill

15. In paragraphs 2 to 9 above, we have already addressed Members' concerns and views on the proposed section 16EC(4)(b). Members may wish to refer to the relevant paragraphs.

To provide the correspondence between the Administration and the State Administration of Taxation ("SAT") on the offsetting transactions involved in cross-border activities

16. The Administration has already explained in its letter to the Bills Committee on 1 August 2011 the offsetting transactions involved in the use of IPRs in cross-border activities. In this regard, SAT has confirmed that according to Article 40 of the "Implementation Measures of Special Tax Adjustments", "where the respective transactions involving payments and receipts between related parties are being offset, tax authorities conducting comparability analysis and making tax adjustments should, in principle, restore the transactions". As we have already relayed to the Bills Committee the content of the written reply from SAT, we do not see the need to provide the relevant correspondence to the Bills Committee.

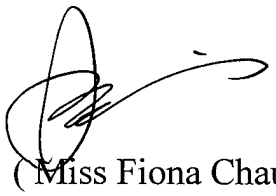
To provide the list of approved research institutes under section 16B of the IRO

17. The research institutes approved under section 16B of the IRO are as follows -

(a) Sir Sik-nin Chau Foundation for Industrial Development;
(b) The Chinese Language Press Institute Ltd;
(c) Federation of Hong Kong Industries (Testing Centre); and
(d) Hong Kong Plastics Technology Centre Co. Ltd.

18. Regarding the illustrations provided by the Administration at the meeting on 4 August 2011 for the Bills Committee's reference, the expression "patents" referred in the cases used to show the applicability of the proposed section 16EC(4)(b) should be "registered designs". The amended version (in Chinese only) is at Annex 2. Please accept our apologies for any inconvenience caused.

Yours sincerely,



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

Encl.

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

Annex 1

Extracts of the Annex to the Administration's letter to the Bills Committee on 1 June 2011

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
C. Deduction Arrangement			
4.	The Administration should re-affirm that where an IPR owner licenses his/her IPR for use by another person in Hong Kong, the IPR owner would be regarded as having fulfilled the requirement of using the IPR for production of chargeable profits under the proposed section 16EA(2).	HKICPA	The term "use" in the proposed section 16EA(2) has its ordinary meaning which encompasses licensing of IPRs to a licensee.

Extracts of Annex A to the Administration's letter to the Bills Committee on 10 June 2011

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
Anti-avoidance Provisions			
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 -

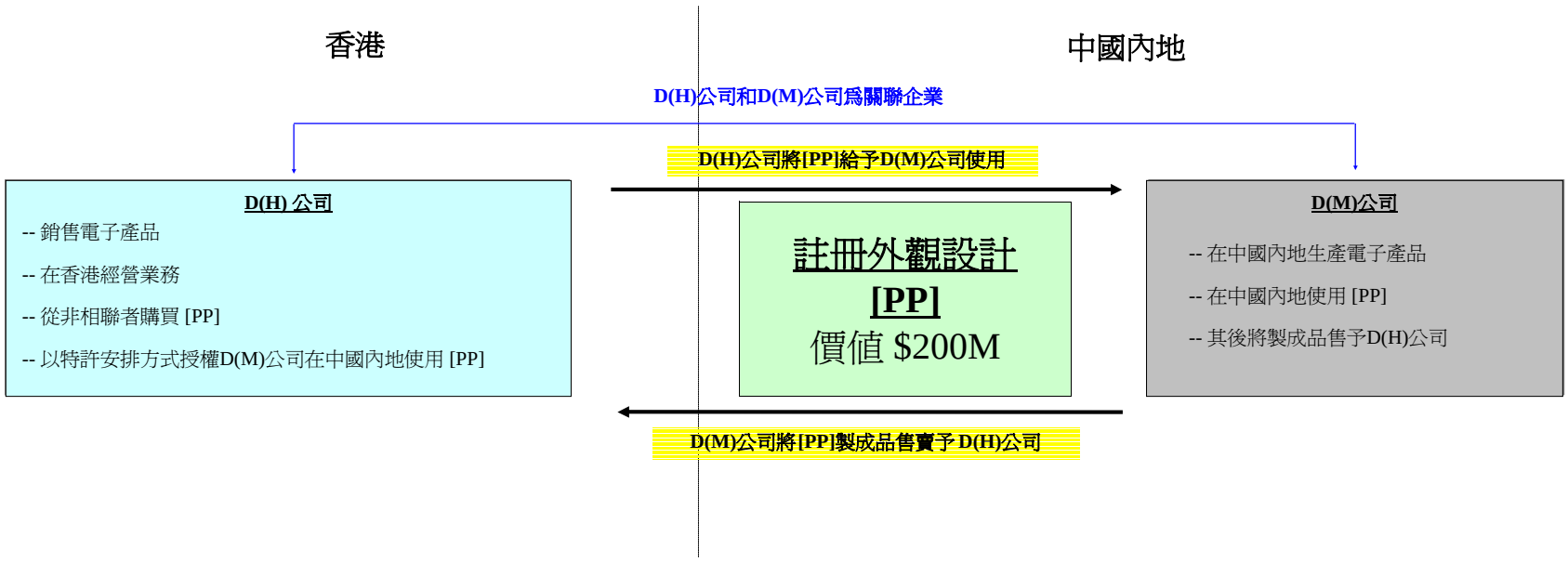
Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
			(a) If an IPR is created or developed by a taxpayer and is licensed by the taxpayer to another party for use outside Hong Kong, the royalties so derived will generally be regarded as Hong Kong sourced income and 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.

Item No.	Views/Comments from Deputations	Organisations	The Administration's Responses
			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
HKICPA	The Hong Kong Institute of Certified Public Accountants
PWC	PricewaterhouseCoopers Ltd

在特許安排下，有關知識產權是完全或主要在香港以外地方使用
〔條例草案建議的第16EC(4)(b)條〕

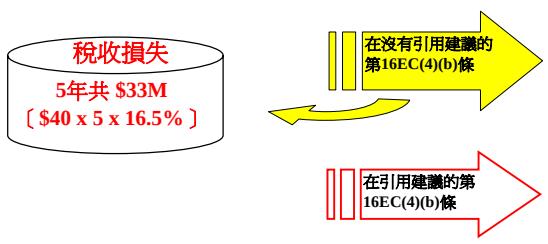


(I) 抵消交易

- D(H)公司給予D(M)公司在中國內地使用[PP]，D(H)公司沒有向D(M)公司收取特許使用費。
- D(M)公司將使用[PP]的製成品以較低價格售賣予D(H)公司。

香港	D(H)公司 $M	中國內地	D(M)公司 $M
營業額 - 銷售 [PP] 製成品購貨成本	100	營業額 - 供應 [PP] 製成品予D(H)公司	60
減：購貨成本 - 支付D(M)公司製成品售價	(60)	減：製造成本 - [PP] 製成品	(30)
	40		
減：攤銷購買 [PP]的資本開支〔$200M ÷ 5〕	(40)	應課稅利潤	30
應課稅利潤	0		
應繳稅款 @16.5%	0	應繳稅款 @25%	7.5

由於D(H)公司沒有向D(M)公司收取 [PP] 特許使用費，D(M)公司以低於正常價格的價格〔即$60M〕將使用 [PP] 製成品售予D(H)公司。若D(H)公司向D(M)公司收取特許使用費〔假設爲$10M〕，D(M)公司售賣予D(H)公司的貨價應相應提升至$70M。



D集團公司〔D(H) + D(M)〕
總稅款 = $7.5M

D集團公司〔D(H) + D(M)〕
總稅款 = $40M x 16.5% + $7.5M
= $14.1M

建議的第16EC(4)(b)條與我們的政策原意一致，旨在清晰地說明，由於由其他人士在香港以外地方使用的知識產權，並非用以產生香港的應課稅利潤，所以不能在香港獲得扣稅。因有關安排可被視爲“抵消交易”，若我們就上述的知識產權提供扣稅，可能會令其他稅務管轄區視香港爲鼓勵轉讓定價的地方。

(II) 還原抵消交易

- D(H)公司應向D(M)公司收取 [PP] 特許使用費 $10M。
- D(M)公司應就 [PP] 調整該製成品的銷售價。

香港	D(H)公司 $M	中國內地	D(M)公司 $M
營業額 - 銷售 [PP] 製成品	100	營業額 - 供應 [PP] 製成品予D(H)公司	70
減：購貨成本 - 支付D(M)公司製成品售價	(70)	減：製造成本 - [PP] 製成品	(30)
應課稅利潤	30	減： [PP] 特許使用費	(10)
		應課稅利潤	30
應繳稅款 @16.5%	4.95	應繳稅款 @25%	7.5

在還原抵消交易後，D(M)公司以正常價格$70M供應 [PP] 製成品予D(H)公司，表明D(M)公司是在有代價情況下在內地使用 [PP]，並將代價包含在貨價之內，賺取D(M)公司的利潤。

在還原抵消交易後， [PP] 製成品的正常價格應爲 $70M ，以包含D(H)公司向D(M)公司收取的 [PP] 特許使用費，即$60M + $10M = $70M。

	D(H)公司 $M
[PP] 特許使用費收入	10
應課稅利潤	10
應繳稅款 @7%	0.7

由於D(M)公司在內地使用[PP]，D(H)公司從D(M)公司收取的特許使用費須繳納內地稅。

還原抵消交易後

D集團公司〔D(H) + D(M)〕
總稅款 = $4.95M + $0.7M + 7.5M = $13.15M

注意事項：

政府當局因應立法會法案委員會的要求，就《2011年稅務(修訂)(第2號)條例草案》（“條例草案”）擬議的條文列舉例子，以協助議員了解相關條文。本文所載的例子純粹是一個假設的個案，只供解說之用。當條例草案獲得通過並生效後，稅務局在引用有關條文時，須考慮個別個案的所有相關事實。