

For discussion
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Legislative Council Panel on Financial Affairs

**Legislative Proposals to Provide Profits Tax Deduction for
Capital Expenditure on Intellectual Properties**

PURPOSE

This paper briefs Members on the legislative proposals to implement the 2010-11 Budget initiative in respect of profits tax deduction for capital expenditure on registered trade marks, copyrights and registered designs.

BACKGROUND

Existing profits tax deduction

2. Under Hong Kong's tax system, an enterprise's revenue expenditure is generally deductible under profits tax. As such, an enterprise's revenue expenditure for the use of intellectual properties ("IPs") (e.g. royalties, licence fees and other forms of regular payments), like its other revenue expenditure, is deductible from profits tax. If an enterprise develops its IPs in the ordinary course of business, the revenue expenditure so incurred, such as rent, salaries and promotion cost, is also deductible as ordinary business expenditure. Besides, to promote protection of rights to IPs, tax deductions have been specifically provided for the registration expenditure incurred in Hong Kong or overseas on three specified types of IPs, namely patent, trade mark and design.

3. If an enterprise develops its IPs other than in its ordinary course of business, the expenditure so incurred is likely to be considered as capital in nature, but may still be deductible as long as it qualifies as "research and development". While capital expenditure of an enterprise is generally not deductible as it has an enduring benefit and we do not tax capital gains, exception has been provided for, among others, capital expenditure on one-off acquisition of patent rights and rights to know-how.

PROPOSALS

Proposed profits tax deduction

4. To promote the wider application of IPs by enterprises, to encourage innovation and upgrading and to facilitate development of creative industries in Hong Kong, the 2010-11 Budget has proposed, among others, to provide profits tax deduction for the capital expenditure on three commonly-used types of IPs, namely registered trade marks, copyrights and registered designs.

Registered Trade Marks

5. Under the Trade Marks Ordinance (Cap. 559), a “trade mark” means any sign which is capable of distinguishing the goods or services of one undertaking from those of other undertakings and which is capable of being represented graphically. A trade mark may consist of words (including personal names), indications, designs, letters, characters, numerals, figurative elements, colours, sounds, smells, the shape of goods or their packaging and any combination of such signs.

6. Registration for trade marks in Hong Kong provides prima facie evidence of ownership of the marks. In line with international practices, the registration regime in Hong Kong runs on a territorial basis, meaning that trade marks registered in Hong Kong enjoy no legal protection overseas and vice versa. Trade marks are registered for use in one or more specific classes of goods and services. Unlike copyrights and registered designs, registered trade mark rights can be perpetual provided that registration is renewed every 10 years.

Copyrights

7. According to the Copyright Ordinance (Cap. 528), copyright is a property right which subsists in original literary, dramatic, musical or artistic works; sound recordings, films, broadcasts or cable programmes; and the typographical arrangement of published editions. Copyright is an automatic right which arises when a work is created and recorded in some way (on paper, electronically, etc). Unlike other IPs such as trade marks and designs, there is

no registration regime for copyright works in most of the jurisdictions including Hong Kong for the purpose of legal protection. In general, copyright protection could last until 50 years after the death of the creator of the work.

Registered Designs

8. Under the Registered Designs Ordinance (Cap. 522), “design” means features of shape, configuration, pattern or ornament applied to an article by any industrial process, being features which in the finished article appeal to and are judged by the eye. Like the registration regime for trade marks, the design registration system in Hong Kong runs on a territorial basis. Registration is valid for up to 25 years from the date of registration provided that it is renewed every 5 years.

Legislative Proposals

9. To effect the proposed profits tax deduction for capital expenditure on registered trade marks, copyrights and registered designs (hereafter referred collectively as “the relevant IPs”), we need to amend the Inland Revenue Ordinance (Cap. 112) (“IRO”).

10. In line with the policy objective of facilitating the development of a knowledge-based economy, we will confine the proposed tax deduction to the relevant IPs with genuine commercial value. Noting that it is a common practice for enterprises to register their IPs with genuine commercial value under available registration regimes for legal protection, we will impose a registration requirement for those IPs for which registration system is available, namely trade marks and designs but not copyrights, as a safeguard to help minimise tax exploitation by screening out trade marks and designs created merely for tax benefit and hence of dubious commercial value. Registration in Hong Kong or overseas would both be recognised for tax purpose.

11. Besides the registration requirement, we propose that taxpayers should fulfil the following conditions in order to be eligible for the proposed tax concession for the relevant IPs -

- (a) Taxpayers must have acquired the “proprietary interest” of the relevant IPs. With the “proprietary interest” of an IP, a taxpayer is able to exploit the IP for further improvement or development, which

is in line with the policy objective of encouraging innovation and upgrading;

- (b) The relevant IPs are for use in Hong Kong in the production of chargeable profits;
- (c) Where a relevant IP is used partly outside Hong Kong and/or partly in the production of chargeable profits, deduction is only allowed for the portion of capital expenditure that is relevant to the use of that IP in Hong Kong for production of chargeable profits; and
- (d) Where a relevant IP is owned by more than one taxpayer, tax deduction for each taxpayer is granted for the amount of capital expenditure that is proportional to his/her share or interest (i.e. proprietary interest) in the relevant IP.

We will also amend the IRO to clarify that other related or incidental capital expenditure (e.g. legal expenses) incurred on the acquisition of the relevant IPs would also be deductible provided that such deduction is not provided for under any other provisions of the IRO.

12. We propose that deduction for the relevant IPs be spread over five succeeding years on a straight-line basis starting from the year of purchase. This proposed staggered deduction could alleviate the revenue implication on the Government in a single year as valuation of the relevant IPs could be considerably high and hence the significant amount of tax deductions claimed. Moreover, as taxpayers have to submit proof that the relevant IPs are in use for the production of their chargeable profits during the prescribed spread-over period, we could monitor the situation of abuse accordingly.

13. Tax deduction for capital expenditure on IPs is prone to abuse because of the intangible nature of such items and the difficulty in valuation. Hence, we propose to put in place the following measures to guard against possible tax avoidance -

- (a) Deductions will not be allowed to taxpayers engaging in certain avoidance arrangements whereby the relevant IPs are transferred in circular route purely for tax benefit;

- (b) Deductions will not be allowed for the relevant IPs purchased wholly or partly from an associated party;
- (c) Sales proceeds of the relevant IPs will be brought to tax, but the taxable amount will be capped at deductions previously allowed; and
- (d) The Commissioner of Inland Revenue (“CIR”) will be empowered to determine, where circumstances so warrant, the true market price for any sale or purchase transactions of IPs claiming tax deduction. Deduction allowable should be restricted to the true market price so adjusted. CIR will also be empowered to allocate the purchase price for individual IPs having regard to all the circumstances of the transaction where two or more IPs are purchased or sold together for a single price.

WAY FORWARD

14. We plan to introduce the relevant legislative amendments into the Legislative Council in the latter half of the current legislative session.

Financial Services and the Treasury Bureau
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